Carve-Outs for Prudential Measures and Trade in Financial Services

The GATS and Preferential Trade Agreements

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Thesis submitted for assessment with a view to obtaining the degree of Doctor of Laws of the European University Institute

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**Thesis summary**

Paragraph 2(a) of the GATS Annex on Financial Services is generally known as the Prudential Carve-Out (PCO). Essentially, it allows WTO Members to adopt the measures they deem appropriate for prudential reasons when regulating trade in financial services. The provision has not yet been interpreted in WTO dispute settlement proceedings. However, it is extremely relevant in light of the 2008–2009 financial crisis and the worldwide regulatory developments that ensued. A number of scholars have looked into the issue and it seems to be their common view that, technically, the PCO ought to be classified as an ‘exception’ to the obligations and the commitments contained within the GATS. This classification leads to important interpretative consequences, mostly with regard to the allocation of the burden of proof in the event of a dispute.

The main argument of this thesis is that the PCO should rather be classified as a ‘provision that excludes the application of other provisions’. This alternative interpretation is more consistent with the negotiating history of the provision, the negotiators’ intention, as well as the underlying economic rationale. Characterising the PCO in this manner also has implications for the allocation of the burden of proof (which under this interpretation would fall on the complainant and not on the defendant) and for the degree of deference that WTO judges should pay to the rights and the prerogatives of the regulators in the domain of financial services.

The thesis is structured as follows: Chapter 1 introduces the research question and methodology of the thesis and provides a review of the existing literature. Chapter 2 is devoted to the negotiating history and the economic rationale for the PCO and gives an account of developments in prudential regulation after the entry into force of the GATS as well as of relevant discussions between WTO Members in the Committee on Trade in Financial Services of the GATS. Chapter 3 analyses the PCOs in all Preferential Trade Agreements notified to the WTO Secretariat as of December 2014, highlights the main features and classifies the different categories of PCOs that have emerged. Chapter 4 is dedicated to the new approach advocated by the thesis. The final chapter (Chapter 5) suggests an agenda for a reform of the PCO of the Annex on Financial Services of the GATS, taking into account the developments that have occurred in trade negotiations at the preferential level over the last twenty years.
A mia madre Margherita e a mio padre Renato,
che mi hanno insegnato ad essere prudente

A mio fratello Cristiano,
che mi ha insegnato l'importanza di correre dei rischi
Summary

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During the spring of my second year I was an intern at the Trade in Services Division of the WTO. All I can say about my supervisor there, Juan Marchetti, is that he is one of the most knowledgeable and generous people I have ever met.

In my third year I was a stagiaire in the Trade Team of the Legal Service of the EU Commission. Two people from my days at the second floor of Berlaymont deserve a special mention. Gustavo Luengo, my supervisor, taught me an important lesson of rigor and legal methodology. He has always had a positive pedagogical approach and I learnt a lot from him. Bart De Meester had the patience to share his expertise on trade in services with me and to let me always express my point of view, even when it proved to be bizarre or simply wrong.

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Since I started my PhD, my beloved Juventus FC has won four consecutive national titles. Thank you. Fino alla fine!
I also sometimes wonder whether all of this belongs to the realm of “real life”. I have thought of it many times during the last months, especially walking past Borgo Pinti, Via dei Servi or Piazza Santissima Annunziata at night going back home. I do not have a precise answer but my instinctive reaction is to shrug and smile. I would say: “it was not offside”. Or, even better, using the words of a “European” poet, Paul Valéry: “Le vent se lève!... Il faut tenter de vivre”.

Firenze, 8 September 2015
List of Acronyms and Abbreviations

AA: Articles of Agreement of the International Monetary Fund
AB: Appellate Body
ALOP: Adequate Level of Protection
ANZCERTA: Australia New Zealand Closer Economic Agreement
ASEAN: Association of South-East Asian Nations
BCBS: Basel Committee on Banking Supervision
BIS: Bank for International Settlement
BRRD: Bank Recovery and Resolution Directive
CA: Agreement on Civil Aircraft
CCP: Central Counterparty
CETA: EU-Canada Comprehensive Economic and Trade Agreement
CRD: Capital Requirements Directive
CRTA: Committee on Regional Trade Agreements
CSDs: Central Securities Depositors
CSI: Coalition of Services Industry
CTFS: Committee on Trade in Financial Services
EEA: European Economic Area
EFTA: European Free Trade Association
EMIR: European Markets and Infrastructure Regulation
FSAP: Financial Sector Assessment Program
FSB: Financial Stability Board
FSOC: Financial Stability Oversight Council
GATT 1947 and GATT 1994: General Agreement on Tariffs and Trade
GATS: General Agreement on Trade in Services
GDP: Gross Domestic Product
GNS: Group Negotiations on Services
GPA: Agreement on Government Procurement
G-SIBs: Global Systemically Important Banks
G-7: Group of Seven
G-10: Group of Ten
G-20: Group of Twenty
HFT: High Frequency Trading
HQLA: High Quality Liquidity Assets
IAIS: International Association of Insurance Supervisors
IBM: International Bovine Meat Agreement
IC: Inuit Community
IDA: International Dairy Agreement
IMF: International Monetary Fund
IOSCO: International Organization of Securities Commissions
LCR: Liquidity Coverage Ratio
LoI: Letter of Intent
LTV: Loan-to-Value
MERCOSUR: Mercado Común del Sur (in Spanish)
MFN: Most Favoured Nation
MiFID: Markets in Financial Instruments Directive
MiFIR: Markets in Financial Instruments Regulation
MoU: Memorandum of Understanding
MRA: Mutual Recognition Agreement
NAFTA: North-American Free Trade Agreement
NT: National Treatment
OECD: Organization for Economic Cooperation and Development
OTC: Over-the-counter
PCO: Prudential Carve-out
PTA: Preferential Trade Agreement
RCEP: Regional Comprehensive Economic Partnership
RGFS: Really Good Friends of Services
SEACEN: South East Asian Central Banking and Monetary Authorities
SIFIs: Sistemically Important Financial Institutions
SPS: Agreement on the Application of Sanitary and Phytosanitary Measures
TBT: Agreement on Technical Barriers to Trade
TED: Turtles Excluder Device
TiSA: Trade in Services Agreement
TNC: Trade Negotiations Committee
TPP: Trans-Pacific Partnership
TPRM: Trade Policy Review Mechanism
TTIP: Trans-Atlantic Trade and Investment Partnership
UN: United Nations
URR: Unremunerated Reserve Requirements
USTR: United States Trade Representative
VCLT: Vienna Convention on the Law of Treaties
Table of cited cases

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- Panel Report, **Brazil – Measures Affecting Imports of Retreaded Tyres (Brazil – Retreaded Tyres)**, WT/DS332/R, adopted 17 December 2007
- Panel Report, **China – Measures Affecting Electronic Payment Services (China – Electronic Payment Services)**, WT/DS413/R, adopted 31 August 2012

**GATT 1947 Panel Reports**


**NAFTA Chapter 11 Arbitration Panels**

- Fireman’s Fund Insurance Company v Mexico, ICSID Case No. ARB(AF)/02/01, Award (17 July 2006)

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Chapter 1 – Introduction - Why a thesis on the GATS Prudential Carve-Out?

1.1 The research question

The main question this work aims to provide an answer to is: what is the legal function assigned to Paragraph 2 (a) of the Annex on Financial Services of the GATS, commonly known as the Prudential Carve-Out (PCO)?

Some authoritative documents, including the 2009 Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, have pointed to trade agreements – both at the multilateral as well as the bilateral level - as being among the drivers for the deregulation that has taken place in many jurisdictions since the mid-nineties. In particular, the claim is that trade liberalisation has limited the possibility for domestic governments to support the stability of their financial systems.

Most trade agreements dealing with financial services include a provision that aims to preserve some regulatory freedom for Members wishing to step in and modify the existing domestic rules on financial services for “prudential reasons”. The paradigmatic example in this regard is the PCO of the GATS. It allows WTO Members to adopt measures they deem appropriate for prudential reasons when regulating trade in financial services. The provision has not yet been interpreted in WTO dispute settlement proceedings. However, it is extremely important to clarify its scope of application and legal function in light of the 2007/2008 financial crisis and the worldwide regulatory developments that ensued.

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1 See para. 208: “The framework for financial market liberalization under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors” The document is available at the following website: http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf (last accessed on 8 September 2015).
The issue of the classification and the legal function performed by a provision of an international agreement is not a mere academic quandary. Grando\(^2\) has conducted a comprehensive analysis of the way in which WTO case law distinguishes between the various rules that allow Members to be exempted from compliance with more generic rules. The author subdivided the various provisions she analysed into two categories: “exceptions” and “provisions that exclude the application of other provisions”.

Such a distinction has implications with regard to the allocation of the burden of proof in the event of a dispute. Depending on the classification the burden of proof should fall on the complainant (for “provisions that exclude the application of other provisions”) or on the respondent or regulating Member (for “exceptions”). Moreover it also has an impact with regard to the degree of deference that WTO judges must pay to the regulating Members. In the case of “provisions that exclude the application of other provisions” judges are typically more deferential towards the policy preferences expressed by Members whose regulations are challenged.

The main argument of this thesis is that the PCO should be classified among those provisions which “exclude the application of other provisions”, to borrow from the terminology adopted by Grando. This implies that, in the event of a dispute, the burden of proof should be allocated to the Member alleging a violation of one or more WTO obligations and not on the regulating Member. Moreover, WTO judges should be extremely careful when scrutinising the policy choices made by domestic governments in pursuit of prudential objectives as the text and the rationale of the PCO allow them substantial freedom.

1.2 The PCO in the literature

Most likely as a result of the lack of litigation on this issue, the PCO has not been among the most popular topics of research in the field of WTO law. However, a select number of works have tried

to shed light on the provision and to understand its legal function and scope of application. The aim of this subsection is to provide an overview of the current understanding of the provision.

One of the most frequently cited pieces on the topic is an article by Eric Leroux. The author classifies the provision as a “rather broad” exception and argues that the PCO covers a priori all measures taken by Members for prudential reasons. With regard to the final clause of the provision, the author describes it as an anti-avoidance clause, which amounts to an obligation of good faith and likens it to the chapeau of Article XX of the GATT 1994. The same approach is shared by subsequent scholarly works (as well as at least one previous contribution).

Other authors agree with the classification of the provision as an “exception” and explain the consequences of such an approach in the event of a dispute. Essentially, this classification implies that the burden of proof ought to be allocated to the respondent, following the general principle of law according to which it is up to the defendant to prove that the conditions required to benefit from an exception have been met (quicunque exceptio invokat, ejusdem probari debet).

Other works dealing with the PCO insist on highlighting the wide scope of the provision and avoid classifying it according to the legal function it performs or point to the differences

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4 Ibid. (p. 431).
between the provision under analysis and other relevant exception-type provisions in the GATS and other WTO Agreements.  

Surprisingly, only a small number of authors have ever paid attention to the heading of the PCO (Domestic Regulation), and pinpointed the correspondence between the provisions of the GATS and those of the Annex on Financial Services, thus interpreting Paragraph 2(a) of the latter as an addendum to Article VI of the GATS.

Among the scholarly papers that have attempted to study and clarify the scope and function of the PCO, only the paper by McAllister Shepro seeks to develop a legal standard against which domestic measures should be evaluated in order to assess their compliance with the requirements and the scope of application of the provision under analysis. It is important to clarify the arguments of the author as it is the only comprehensive attempt to develop a legal standard for the PCO in the literature to date.

First of all, the author makes clear at the outset that she understands the PCO to be “an exception provision, similar to, but distinct from, the GATT XX and the GATS XIV exceptions”. The peculiarity of the PCO, according to the author, is that although it can only be applied when a violation of a GATS obligation or commitment has occurred, the defence must be raised at the very beginning of the panel proceedings, or else it will not be successful.

Secondly, after the PCO has been invoked and both parties to the dispute have submitted their views and arguments, the panel should embark on the interpretation of the provision, according

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12 Ibid. (p. 26)
13 The author argues that this is the case following the reasoning developed by the Appellate Body in US – Gambling (paras. 269 and ff.). However, she also notices that the same report acknowledged the following: "Whether a defense has been made at a sufficiently early stage of the panel proceedings to provide adequate notice to the opposing party will depend on the particular circumstances of a given dispute (Para. 272)". See ibid., fn. 117.
to the rules set forth in the Vienna Convention on the Law of Treaties (VCLT) and clarified in WTO case law in the Appellate Body Report in *US – Shrimp*.\(^{14}\) First, the Panel or Appellate Body should evaluate the text of the provision under scrutiny. If the text is “equivocal or inconclusive” it should seek for “confirmation of the correctness of the reading” from the “object and purpose of the treaty as a whole”. Then, WTO documents can provide context and, as a last resort, the negotiating history of the provision can serve as a supplementary means of interpretation.

Thirdly, the author clarifies the way she sees the standard of review in disputes concerning prudential measures in the realm of financial services. According to the said author the Panel or Appellate Body should provide answers to three questions in order: “[f]irst, did the member state adopt a measure non-conforming with their GATS commitments? Second, was the measure used to avoid said commitments? Lastly, was the measure taken for prudential reasons?”.\(^{15}\)

\(i\) The first stage of the standard of review is intuitive, as absent succesful claims of GATS obligations or commitments it is immaterial whether a domestic measure was adopted in pursuance of prudential goals, in accordance with the rights and the limits set out in the Agreements and its qualified defences. There is no need, therefore, to develop the explanation of this stage of the standard any further.

\(ii\) The second stage of the standard of review is arguably a more delicate one. This step, in the view of the author, is about whether a measure was used to avoid the Member’s obligations or commitments. The author recalls a background note from the WTO Secretariat on financial services\(^{16}\) according to which Members should act in good faith in the implementation of prudential measures in the field of financial services. Good faith is a general principle of international law that does not belong exclusively to the realm fo the WTO but is codified in Article 26 VCLT (the *pacta sunt servanda* rule). The author, on one hand, points to the fact that the provision does not make explicit reference to “good faith”. On the other hand, however, she recalls that WTO case law has already established that “good faith is a core principle [underlying]  


\(^{15}\) Ibid. (pp. 37 and ff.).

the WTO Agreement”. In the view of the author, good faith is the only possible guiding principle for a balance in the standard of review of prudential measures overriding a Member’s obligations or commitments. She states that through this guiding principle it is possible to avoid two opposite and “extreme” interpretations that were clearly not contemplated in negotiations and that are totally absent from the wording of the provision. However, good faith is not a self interpretative concept and depends on the time, context and situations in which it is invoked. As such, this approach leaves considerable discretion for judges to make evaluations on a case-by-case basis.

At one end of the spectrum, McAllister Shepro puts what she calls “the self-executing standard of review” which would in effect lead to a situation whereby no standard of review whatsoever is applied. As it will be clarified in the following Chapter, during the overview of the negotiating history, the idea to exclude prudential measures from the jurisdictions of WTO Panels and Appellate Body was present during the discussions on how to draft the provisions under analysis. As emerges from the structure of the GATS Annex on Financial Services, which contains a provision specifically addressing the issue of the composition of the Panels in the event of disputes on prudential measures, this possibility was discarded by the Uruguay Round delegates.

At the other end of the spectrum, there would be a “necessity test” such as that provided for by some of the categories of measures listed in Article XX of the GATT 1994 and Article XIV of the GATS. Furthermore, with regard to this other option the author casts doubts on the feasibility of its application to the provision at issue. Again, the words “necessity” or “necessary” are absent from the text of the provision. Were they present they would require for a rather stringent link between the measure enacted and the prudential goal pursued, if not for the introduction of the least trade distortive means. The author is aware that the aforementioned chapeau amount, at most, to obligations to perform treaties in good faith, although more stringent ones.

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18 Paragraph 4 of the Annex on Financial Services of the GATS.
McAllister Shepro, therefore, argues that this second stage of the standard of review should work as follows. *In primis*, the good faith of WTO Members should be presumed, as she claims was clarified by the Appellate Body in *EC – Sardines*:

Peru expresses doubts about the usefulness and efficacy of this obligation in the TBT Agreement. Peru argues that a Member may not respond fully or adequately to a request for information under Article 2.5, and that, therefore, it is inappropriate to rely on this obligation to support assigning the burden of proof under Article 2.4 to the complainant. We are not persuaded by this argument. We must assume that Members of the WTO will abide by their treaty obligations in good faith, as required by the principle of *pacta sunt servanda* articulated in Article 26 of the Vienna Convention. And, always in dispute settlement, every Member of the WTO must assume the good faith of every other Member.\textsuperscript{19}

Therefore, the respondent in a dispute needs only make a *prima facie* case that it had adopted measures in pursuance of prudential goals. After this *prima facie* case is established, then the burden is rebutted and, again according to the author, it is up to the complainant to provide evidence to the contrary. In order to rebut the presumption of good faith, the author correctly points out that it is necessary to make a case that the regulating Member had acted by abusing of its rights (*abus de droit*).\textsuperscript{20}

iii) The last stage of the standard of review designed by McAllister Shepro is devoted to the analysis of whether the challenged measure was adopted for prudential reasons. The author confines this assessment to the last phase of the analysis. In her view, as long as the regulating Member is able to provide an explanation according to which the challenged measure is based on a plausible prudential reason the conditions for it to benefit from the shelter provided by the PCO are satisfied. In her words:

\textsuperscript{20} McAllister Shepro, 'Preserving National Regulatory Autonomy in Financial Services: The GATS’ Prudential Carve-Out' (p. 47).
The purpose of the measure need only meet a subjective, threshold intent requirement of avoiding financial sector danger or risk. This requirement should be considered satisfied unless the contested measure has no plausible objective or reasonable relation to the prudential reason advocated.\textsuperscript{21}

McAllister Shepro concludes that the only possible way to successfully overcome the PCO defence would be for the complainant to prove that the former had enacted its regulation acting in bad faith. Intuitively, this does not seem to be an easy task, especially given the disproportionate allocation of information between the parties in a dispute.

In sum, we can say that it is a common view among commentators that the PCO should be classified as an “exception”, with a small number of scholars taking a more nuanced stance.

To date, however, no comprehensive work has analysed the PCO of the GATS. This work aims to fill a gap in the literature by advancing an alternative approach which is more loyal to the intention of the drafters and the economic rationale performed by the provision in light of the architecture of the discipline on trade in financial services of the GATS.

\section*{1.3 Methodology and plan of the work}

The PCO is drafted in an open-ended fashion. It does not define what the word “prudential” means, it provides a non-exhaustive list of broad policy reasons that can be considered as being prudential and it is not clear whether regulating Members have to fulfil any prerequisites before deploying prudential policy tools when enacting or modifying disciplines affecting trade in services.

\textsuperscript{21} Ibid. (p. 52).
Therefore, it is necessary to look at the negotiating history of the provision and the subsequent activities of WTO Members by examining what they have put in their schedules of specific commitments and the debates in which they have taken part in the context of the Committee on Trade Financial Services (CTFS) of the GATS. Furthermore, the economic rationale for financial regulation and, more specifically, for prudential regulation is examined in order to understand whether it made sense to introduce a provision like the PCO in the Annex on Financial Services of the GATS.

Next, an examination is conducted to establish whether PCOs are included in preferential trade agreements (PTAs) and to identify common patterns as well as the different typologies of provisions that have emerged over the last twenty years. It is noted that the model set up in the GATS is still the most commonly adopted in trade negotiations. It is also shown that Members, when they really want to ‘lock in’ their trade commitments and ensure the PCO is narrowly interpreted or only available upon satisfaction of one or more requirements (be it a necessity test or a non-discriminatory application of prudential measures), have the necessary tools to do so. It is emphasised that this happens only in a minority of cases, given that the overwhelming majority of preferential PCOs give parties substantial leeway when they regulate financial markets according to prudential concerns. Finally, recent developments in current negotiations were also examined. Given that the PCO in the GATS is rather obscure in terms of its language, and not really efficient, an overview of the developments in preferential negotiations is instrumental in understanding whether some already existing features in other trade agreements can be imported at the multilateral stage.

Finally, this work seeks to illustrate that there are a number of problematic implications of the mainstream interpretation of the PCO. By importing the case law on exceptions into the domain of the PCO, we show how the former cannot easily be reconciled with the wording of the PCO, the intention of the drafters as well or the economic rationale behind prudential regulation.

The economic analysis, combined with the negotiating history of the PCO, shows that the main will of the negotiators was to avoid Type I errors (false positives), i.e. situations in which the court finds against a defendant even though the behaviour of the latter was not unlawful. This outcome
cannot be reconciled with the mainstream interpretation advanced by the few scholars that have attempted to analyse the PCO. The classification of the PCO as an exception would imply a different rationale for the provision, namely that of avoiding Type II errors (false negatives), which are those cases in which the judges find in favour of the defendant even though its behaviour was unlawful. In other words, in the realm of “exceptions”, a legal system considers erring in favour of the complainant a less harmful option than erring in favour of the Member invoking the exception in the event of a dispute. This research shows that this cannot be the case and that the PCO should be classified as a “provision that excludes the application of other provisions”.

This work is structured as follows. Chapter 2 gives an account of what we currently know about the PCO of the GATS. It first analyses the provision and its negotiating history, then gives an account of the economic rationale for prudential regulation. Finally, it seeks to explain the main developments in prudential legislation after the entry into force of the discipline on financial services of the GATS and the main discussions that have taken place within the CTFS of the WTO with regard to possible reforms of the PCO. Chapter 3 provides an in-depth analysis of the PCOs contained in PTAs. It provides a classification of the various PCOs in different categories according to certain features and then looks at the recent developments in current negotiations. Chapter 4 puts forward the approach advanced by the present work. The first part of the chapter represent the pars destruens in the sense that it criticises the interpretation provided by the majority of the scholars who have dealt with the PCO so far. The second part of the chapter, on the other hand, advances an alternative approach more in line with the structure of the Annex on financial services of the GATS, its negotiating history and the rationale behind it. Chapter 5 concludes the work. It acknowledges that, notwithstanding the various readings that can be made of the PCO, the language of the latter is not sufficiently clear and reveals inefficiencies in its construction. Therefore, the present work suggests possible paths that can be followed should WTO Members decide to reform the provision.
Chapter 2 – The PCO of the GATS: Negotiating history, rationale, changes in regulation and the current understanding of the provision

This chapter aims to provide an overview of the current understanding of the so-called “Prudential Carve-Out” (PCO), provided by Paragraph 2 of the Annex on Financial Services of the GATS. The PCO is a unique instrument aiming to address the issue of the interplay between trade liberalisation and financial regulation. Recent developments show the shortcomings of the consolidated view of the PCO that both academics and practitioners share. Before embarking on a critique of the way the PCO is currently understood, it is important to carefully analyse all the sources of knowledge we have at our disposal.

As will be shown later in the chapter, the evolution of the prudential toolbox after the crisis and the developments in the economic science made Members of the World Trade Organization (WTO) uncertain about where to draw the line between prudential and protectionist purposes, with particular regard to some specific measures. Recent discussions in the context of the Committee on Trade in Financial Services (CTFS) at the WTO demonstrate the discomfort of some Members with regard to exact scope of application of the PCO and the legal function it performs. As the regulatory landscape changed substantially after the 2007/2008 global financial crisis, it is important to clarify how prudential measures in financial services are regulated in the context of the GATS, how the system became the way it is today and why the current system did not function to the satisfaction of the Members.

The chapter is structured as follows: Section 2.1 describes the origins of the WTO discipline on trade in financial services; Section 2.2 briefly recalls the main provisions in the Annex on Financial Services of the GATS dealing with prudential measures; Section 2.3 gives an account of the negotiating history of the PCO of the GATS; Section 2.4 is devoted to an economic analysis of prudential regulation in the domain of financial services and tries to draw out the economic rationale of the PCO against that background; Section 2.5 examines the main forums for international cooperation in financial regulation; Section 2.6 deals with the evolution of
prudential regulation after the entry into force of the GATS; Section 2.7 sets out the subsequent practice by the WTO Secretariat as well as WTO Members with regard to the PCO. Finally, Section 2.8 concludes the Chapter.

2.1 The multilateral discipline on trade in financial services: Origins and negotiations

There is a gap in the literature since there is no comprehensive negotiating history of the Annex on Financial Services of the GATS to date. Uruguay Round negotiators usually met informally during the talks on the discipline on financial services, hence the difficulty and the need to put together the pieces of the story.22 Telling the story of how the PCO was drafted is useful for different reasons. First of all, it is a necessary intellectual enterprise; because the events and the debates among the drafters that precede the crystallisation of a norm in a treaty are a unique source of knowledge for the interpreter seeking to understand the real intention of the negotiators and what they meant when contracting particular instruments. Furthermore, Article 32 of the Vienna Convention on the Law of Treaties (VCLT) explicitly refers to the ‘preparatory work of the treaty’ as a supplementary means of interpretation under determined circumstances, therefore it is potentially helpful in the attempt to advance an alternative approach which more fully reflects the intention of the negotiators and the legal function they assigned to the PCO.

Only a few records of meetings held are available. Even with this and similar caveats, the study of the minutes of these meetings nonetheless sheds light on the scope of the provision and is useful in understanding the real will of the parties. Furthermore, no Panel or Appellate Body report has ever addressed the issue so far, thus recourse to the negotiating history is one of the few reliable resources scholars have in order to understand its ambit. Finally, before moving to the analysis of the negotiations, it is fundamentally important to make one last caveat here: recourse to negotiations is no panacea: different views are often expressed and the records do not always

reflect agreement. In other words, we can say that the negotiating records shed light on the issue even though they do not fully respond to all the questions posed. With this in mind, we turn to the examination.

2.1.1 Financial Services as the driving force for the negotiation of a multilateral agreement on trade in services

While the idea of liberalizing international trade in goods at the multilateral level became popular right after the end of World War II, it took more time for negotiations on trade in services to start to take place. The first multilateral agreement on trade, the General Agreement on Tariffs and Trade (GATT), dates back to 1947 and only encompasses disciplines regarding trade in goods.\(^{23}\) There is more than one reason for the absence of services in that framework. First of all, services were traditionally considered as ancillary to trade in merchandises. Furthermore, the share of services produced and consumed within the domestic markets was significantly higher than that traded at the international level. In addition, in the immediate aftermath of World War II, the technological revolution which dominated the second half of the 20\(^{th}\) century was only about to start and services were still a small percentage of Gross Domestic Product (GDP) across markets. Finally, the evolution of the services market was unequal: for instance which it represented a small percentage of the GDP of Organization for Economic Co-operation and Development (OECD) countries, it was barely existent in developing countries.

As the world became increasingly ‘flat’ (to use Thomas Friedman’s inspired definition)\(^{24}\), mainly due to technological innovations, there were more opportunities for trade in services across borders, and the share of trade in services gradually expanded and eventually overtook that of trade in goods.\(^{25}\) Actors became increasingly aware of the barriers in place and the possibilities

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connected with the progressive liberalisation of commerce in services and of the interconnectivity of services to many production sites. The first voice in favour of a multilateral round of negotiations for the liberalisation of trade in services was the US financial services sector.

Ascher, at that time Director of Service Industry Affairs in the Office of the United States Trade Representative (USTR) stated:

In the 1970s, the growth of the services sector became more pronounced. In the United States, the sector accounted for a larger portion of gross national product and for most of the new jobs created (sixty-seven percent of GNP in 1988 and seventy-five percent of employment). Moreover, the potential for wider distribution of services internationally through new technologies gained greater recognition. At that time, major companies in the services sector (...) began seeking treatment in international trade equal to goods-producing companies. (...) Many were concerned about restrictions and discriminatory practices in foreign countries which denied them the opportunity of international sales.26

The US Congress, through the 1974 Trade Act, expanded the mandate of US trade negotiators so as to also include the goal of reducing barriers to trade in services.27 Marchetti and Mavroidis report how important the role played by the Coalition of Services Industry (CSI) was in sensitising the political debate in the US about the need for a multilateral agreement on trade in services.28 Within the CSI, the role of financial services companies was prominent. They were

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27 US Trade Act, 1974, Section 2112, Barriers to and other distortions of trade: "(...) (3) the term "international trade" includes (A) trade in both goods and services (...)."
28 Juan A. Marchetti and Petros C. Mavroidis, 'The Genesis of the GATS (General Agreement on Trade in Services)', The European Journal of International Law, 22/3 (2011b), 689 - 721. Interestingly, the authors explain why American Express, a leading company in the US financial services financial services sector, put efforts lobbying for an agreement on trade in services: "At the time, the company was specializing in travellers’ cheques, charge cards, insurance, and investment services. This business depends on the rapid transmission of large amounts of data across national borders through sophisticated computer and telecommunications networks. Trans-border data flows, essential in fact to international banking and financial services, were threatened by protection, and so was data
actively engaged in public and academic debates, were part of US delegations to various GATT meetings and managed to tighten links with counterparts all over the world, particularly in Europe.

The EU at that time was not enthusiastic about putting services on the agenda of the negotiations for three main reasons. First, the EU was unable to speak with one voice on the issue in the negotiations and second the EU itself was facing obstacles to the liberalisation of services in its internal market. Third, as Bhagwati argues, EU authorities were worried about services negotiations because they thought this would force them to make concessions in other market sectors. In particular, they feared that they would have to relax their protectionist policies in the field of agricultural products in exchange of concessions in the services market.

Most developing countries were hostile to the possibility of negotiating the opening up of their markets for trade in services: they feared that they would not be able to obtain concessions in other sectors and they also wanted to avoid a situation whereby their economies would be dominated by foreign companies and investors (and many thought that priority should be given to agricultural trade and textiles in any case). Further, developing countries were concerned that the introduction of a unitary dispute resolution mechanism could lead to “cross-sanctions”, which would affect their strategic markets as a retaliation against barriers in trade in services.

The US was keen to pursue a landmark agreement and tensions arose regarding the scepticism of the developing countries. However, the discussions reached a turning point in June 1986 when USTR Clayton Yeutter issued a statement whereby he threatened the possibility that the US

processing. Clearly, this was of outmost importance to American Express. The rationale for protection varied across countries: privacy reasons, protection of strategic sectors, infant industry and employment. A new agreement regulating trade in services should aim at disciplining the rationale for protection, opening up trade on a worldwide basis." (p. 694).

29 Throughout this work, the acronym EU is used to refer to the European Union and its predecessors (European Communities, European Economic Community and so on), invariantly.
31 Hugo Paemen and Alexandra Bensch, From the GATT to the WTO - the European Community in the Uruguay Round (Leuven: Leuven University Press, 1995) 293.
32 Marchetti and Mavroidis, 'The Genesis of the GATS (General Agreement on Trade in Services)' (p. 698).
33 Jarreau, 'Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer's Perspective' (p. 23).
would turn to bilateral and plurilateral agreements if trade in services were not included in the Uruguay Round talks that were scheduled to start a few weeks later.  

The EU, for its part, was struggling to reach a common position. In particular, the then French President of the Republic François Mitterrand was very vocal against the requests of the US. It was only subsequently that the EU slowly began to change its position, turning from a “reluctant participant” to an “active player”. According to Marchetti and Mavroidis three main factors contributed to the shift in the attitude of EU officials. Firstly the EU wanted to avoid the political costs of blocking a multilateral round of negotiations which would have meant isolation and fewer opportunities for European services suppliers. Secondly, services suppliers managed to strengthen their lobbying efforts, following the example of their peers in the US. Eventually, EU bureaucracy came to be strongly in favour of a positive conclusion of a negotiating round because international trade represented the only area where EU political institutions could play an effective role in external relations. This change of attitude in the EU also bolstered developing countries who had initially been skeptical about entering the discussions for a comprehensive agreement on trade in services within the realm of the yet-to-be-born WTO. The EU was the middle man between the assertive position of the US and the reluctance to commit shown by the G-10 group. The Café au Lait group, composed of both developed and developing countries, managed to act as a “bridge-building coalition” and was instrumental in helping all parties involved to reach an agreement.

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34 Marchetti and Mavroidis, 'The Genesis of the GATS (General Agreement on Trade in Services)'; “In June 1986, the US tabled a concrete proposal for a Ministerial Declaration which included clear terms for a negotiation on trade in services. At the same time, the USTR Clayton Yeutter publicly announced that the US would turn to bilateral and plurilateral arrangements, instead of the GATT, if the trading nations did not agree on including the necessary subjects in the agenda of the Uruguay round in particular services” (p. 702).


36 Juan A. Marchetti and Petros C Mavroidis, 'From Reluctant Participant to Key Player: EU and the Negotiation of the GATS', in Inge Govaere, Reinhard Quick, and Marco Bronckers (eds.), Trade and Competition Law in the EU and Beyond (Cheltenham: Edward Elgar, 2011a), 48 - 95.

37 Ibid.: “Granted, it was unclear whether the EU had competence on services. This would not, however, stop the EU Commission from pushing the agenda further: adding services in the trade agenda would augment its competences and its relative position towards the Council in their inter-agency game” (p. 65).

38 Argentina, Brazil, Egypt, India, Yugoslavia, Cuba, Nicaragua, Nigeria, Peru and Tanzania.

39 Marchetti and Mavroidis, 'The Genesis of the GATS (General Agreement on Trade in Services)' (p. 720).
2.1.2 The negotiations on financial services

Negotiations followed what was already happening in practice: as a result of technological developments some liberalisation was already taking place. The role played by financial services in the context of the Uruguay Round was twofold. On the one hand financial services were arguably the major driver pushing trading nations to sit around a table and discuss the possibility of an agreement on the liberalisation of cross-border trade in services. On the other hand, since financial services are at the heart of contemporary economics, as soon as Uruguay Round negotiators started discussing the issue problems emerged with regard to the potential conflict between liberalisation of trade in financial services and the loss of sovereignty in a delicate sector. Hence, they represented a major potential stumbling block for the positive conclusion of the Uruguay Round talks for a multilateral discipline governing trade in services. It is not a coincidence that, at the conclusion of the Uruguay Round, relatively few commitments on financial services were made and that it took more time for Members to come out with an agreement on the relevant sectoral discipline.

After the initial stage of trade talks during the 1990s key players changed their attitude towards the conclusion of negotiations in the field on trade in services, specifically on financial services. The EC made it clear that it would not back any agreement that did not include financial services. Moreover, the US insisted that concessions in the field of financial services should be meaningful. These two trading nations proposed the inclusion of a “non-application” clause in the GATS. In the words of Jarreau:

The purpose of the non-application clause was to force reciprocity. The clause would have permitted signatory countries to deny MFN treatment to the services and service suppliers of any other signatory if the market-opening commitments of the other signatories were deemed inadequate.

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40 Jarreau, 'Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer’s Perspective’ (p. 23).
41 Ibid.
This was meant to address an issue that arose in the context of financial services negotiations. Jarreau reports the dissatisfaction of the US at the time, in particular, with the unwillingness of South American and Asian countries to make substantial commitments. Eventually, such a clause was not included in the text of the Agreement.

Over time developing countries started nuancing their positions and began to accept a positive conclusion of negotiations for an agreement dealing with financial services trade liberalisation. On the contrary, the situation was moving in the opposite direction in the US. In addition to being afraid of the lack of substantial commitments by its trading partners, the US negotiators were under huge pressure from Washington due to concerns about how more open markets could potentially harm rather then benefit domestic business, especially in delicate sectors like banking, telecommunications or transport.

As a consequence by 1991 the US had substantially changed its position in the negotiations, moving from being an active proponent of the introduction of meaningful disciplines on financial services in the GATS to maintaining that the latter could be excluded from the scope of application of the Agreement.

In March 1992, the Group of Negotiations on Services (GNS) conducted an assessment of initial commitments on market access and national treatment, and the US judged the initial offers of sectoral commitments in financial services from Japan and Latin American countries to be unsatisfactory. It is for this reason that the US decided to play the strategic card of announcing the possibility of including financial services disciplines in the list of MFN exemptions in order to put pressure on its trading partners to make an effort to commit to more substantial market openness.

The situation was extremely complicated. On the one hand there was significant distance between the parties as to the degree of concessions they were ready to make. On the other hand,
the US administration needed to strike a deal before the expiry of the “fast-track” authority\textsuperscript{45} which was due to occur on 15 December 1993: precisely the day when the Uruguay Round came to a close in Punta del Este. During the very last hours of the negotiations Members agreed to conclude the agreements that are still in force: the GATS, the two Annexes on Financial Services and the Understanding on Commitments in Financial Services. However, since they could not agree on the issue of whether or not to extend MFN treatment on a conditional or unconditional basis, they extended the negotiating period for financial services.

The extended period was due to expire within six months after the entry into force of the WTO Agreement (June 30, 1995). By the end of that period, frictions between the US on one side and Japan and the Latin American countries on the other were still apparent. The EU definitively took the lead of the negotiations when the US withdrew their offer of unconditional MFN in financial services. European negotiators obtained a one-month extension and managed to reach an agreement on the Second Protocol to the GATS, which is commonly known as the “Interim Agreement”\textsuperscript{46}. Members agreed that the latter would be temporary and replaced by a permanent agreement on financial services which was to follow.

In 1996, WTO Members convened in Singapore for the Ministerial Conference. In the Ministerial Declaration that followed Members agreed to resume financial services negotiations in April 1997\textsuperscript{47}. Again, negotiations on the issue proved to be difficult. At that time the Asian continent was experiencing a dramatic financial crisis. However, Members still managed to sign the Fifth Protocol to the GATS (in WTO terminology the “Financial Services Agreement”) at the end of 1997. The US joined in, withdrawing the MFN exemptions in banking and securities. Moreover, as

\textsuperscript{45}Fast track is a procedure under US law under which the Congress agrees in advance that a trade agreement negotiated by the Executive will be either ratified or rejected as it is, but it will not be amended after its conclusion. Such a procedure substantially reduces the political tension at the domestic level and speeds up negotiations. The opponents of this practice lament that it amounts to a reduction of democratic guarantees, because democratic elected congressmen do not have the power to intervene and to amend trade agreements when they can be somehow detrimental for their own constituencies. For a thorough explanation, see John H. Jackson, William J. Davey and Alan O. Sykes, \textit{Legal Problems of International Economic Relations (Sixth Edition)} (St. Paul, MN: WEST, 2013) 1338 (pp. 97 – 100).

\textsuperscript{46}Second Protocol to the General Agreement on Trade in Services, 24 July 1995, available at the website: \url{http://www.wto.org/english/tratop_e/serv_e/2prote_e.htm} (last accessed on 8 September 2015).

\textsuperscript{47}WTO Doc. WT/MIN(96)/DEC, Singapore Ministerial Declaration, adopted on 13 December 1996, para. 17, available at the website: \url{http://www.wto.org/english/thewto_e/minist_e/min96_e/wtodec_e.htm} (last accessed on 8 September 2015).
Jarreau has stated, almost all Members made efforts to maintain or improve their initial commitments. Rather than the Agreement itself and the norms contained therein, it was an overall more generous approach from the international community in terms of substantial concessions made that tilted the balance towards a deal. The Protocol entered into force in March 1999.

The discipline on financial services at the multilateral level is a convoluted mix of different instruments. The interpreter, when dealing with financial services issues in WTO law, has to take into account the GATS framework agreement, the Schedules of Specific Commitments, the Annex on Article II Exemptions as well as the lists on Article II exemptions, the GATS Annex on Financial Services, the Understanding on Commitments in Financial Services, the Interim Agreement and the Financial Services Agreement.

### 2.2 The Annex on Financial Services of the GATS and prudential measures

The Annex on Financial Services is an integral part of the GATS framework agreement and sets out the relevant discipline on trade in financial services including insurance. Paragraph 2 (*Domestic regulation*) includes the PCO and reads as follows:

2. Domestic Regulation

(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial

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48 The US kept a broad exemption on insurance services, as a direct response to measures taken by Malaysia in order to make US companies to reduce their holdings in the host country. See on this Jarreau, 'Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer’s Perspective' (p. 30).

49 In this context, it is also worth noting that some countries maintained more protectionist behaviour. Jarreau (ibid., p. 31) refers mainly to India, Malaysia and South Korea.
system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

Two other provisions of the Annex are relevant for prudential measures. Paragraph 3 (Recognition) allows Members to sign Recognition Agreements (either unilaterally or sub specie of Mutual Recognition Agreements (MRAs)) relating to domestic prudential regulations. Should they decide to do so they must afford adequate opportunity to any other Member in a comparable situation to negotiate its accession to similar agreements. To date not a single MRA on financial services has been notified to the WTO Secretariat.\(^{50}\)

Finally, according to Paragraph 4 (Dispute Settlement), when Panels are established to judge on prudential issues or, more in general, on cases relating to trade in financial services, they

"(...) shall have the necessary expertise relevant to the specific financial service under dispute".

Panellists for disputes concerning prudential issues should be selected from a specific roster.

2.3 The negotiating history of the GATS PCO

It is now time to take a closer look to the negotiations of the PCO in the Annex on Financial Services of the GATS. Until late 1989 negotiators discussed which sectors to include in the multilateral agenda for negotiations. In September 1989, at the 23rd meeting of the Group of Negotiations on Services (GNS)\(^{51}\), a discussion took place concerning general issues relating to

\(^{50}\) Juan A. Marchetti and Petros C. Mavroidis, ‘I Now Recognize You (and Only You) as Equal: An Anatomy of (Mutual) Recognition Agreements in the GATS’, in Ioannis Lianos and Okeoghene Odudu (eds.), *Regulating Trade in Services in the EU and the WTO: Trust, Distrust and Economic Integration* (Cambridge, 2012), 415 - 44.

trade in financial services. This meeting can be considered the first occasion where negotiators debated trade in financial services. At that meeting negotiators made clear their views on the necessity of leaving some leeway for governments interested in adopting domestic prudential measures. There was overall consent about the necessity of respecting national sensitivities connected to prudential regulation and many delegations took the floor to insist on this point, with the US and the EU at the forefront.\(^{52}\) The former insisted on respect for national specificities and the need not to confuse effective market access and national treatment with the need to relax prudential measures.\(^{53}\) The EU, for its part, argued that progressive liberalisation of financial services markets should not lead to deregulation at the domestic level, especially in the field of prudential measures.\(^{54}\) Australia advanced the view that some sort of review mechanism of national prudential schemes was needed.\(^{55}\) The common view was that national prudential schemes should not be relaxed in the name of opening up markets to trade.

This preliminary discussion was the start of the negotiations on trade in financial services. In 1990 a “Working Group on Financial Services including Insurance” was established. The mandate of the working group was to discuss the opportunity to negotiate an Annex on Financial Services to the GATS and its possible contents. Reyna\(^{56}\) and Marchetti\(^{57}\) report that negotiators felt that the GATS as it was imagined at this stage did not sufficiently address the intricacies of Financial Services. Therefore, a detailed annex specifically dealing with Financial Services was needed. The group held only four formal meetings.

\(^{52}\) Other countries also took the same stance, namely: Sweden, Brazil, Pakistan, Canada and Singapore.
\(^{53}\) Uruguay Round Doc. MTN.GNS/25, paras. 16 and 31.
\(^{54}\) Ibid., para. 33.
\(^{55}\) Ibid., para. 34.
\(^{57}\) Marchetti, 'The GATS Prudential Carve-Out'.
2.3.1 Five options, different starting positions

The first meeting of the WG on Financial Services was held from 11-13 June 1990. The Chairman, when introducing the agenda item concerning a prudential ‘exception’, asked the members to focus on “how and where to draw the line between those measures that were consistent with the agreement and those that might go beyond it”. In order to facilitate the discussion between Members, the Chairperson himself had a non-paper circulated before the meeting containing five possible options to introduce a ‘carve-out’ on prudential measures:

The first option provided for a prudential carve-out limited to a qualified national treatment provision. The second option was broader, permitting all "reasonable" prudential and fiduciary measures. Option three was a variation of option two, enumerating examples of permissible measures. Option four provided for an unqualified right to take such measures. Option five aimed at defining as precisely as possible the prudential actions that would be permitted, so as to reduce legal uncertainties.

As such, from the very beginning of the negotiations on financial services, the idea to introduce a provision according to which parties could maintain a margin for manoeuvre when adopting domestic prudential regulations - notwithstanding any other GATS obligation or commitment - gathered momentum (most likely because every domestic regime contained similar measures). It can be said that, for some delegations at least, the introduction of a carve-out was the condition sine qua non to give negotiations the green light. Uruguay Round participants, however, had different views with regard to both the scope of application as well as the legal function to be assigned to the provision.

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58 Uruguay Round Doc. MTN.GNS/FIN/1, 'Working Group on Financial Services Including Insurance - Note on the Meeting of 11 - 13 June 1990'.
59 Ibid., para. 78.
60 Ibid.
The subsequent discussion reveals how, notwithstanding the fact that the majority of members were clearly in favour of a relatively broad carve-out, only relatively few members already had a clear idea about the kind of provision that would have represented the best solution. The majority of the delegations were in favour of option 2 (a broad carve-out, permitting all reasonable prudential and fiduciary measures). That said, upon a closer look at the record some nuances can be discerned even among those delegations with the same approach.

TABLE 2.1: Positions of the delegations with regard to the Chairperson’s proposal for a Prudential Carve-Out

<table>
<thead>
<tr>
<th>Trading Nation</th>
<th>Preferred Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Combination of Options 1 (prudential carve-out limited to a qualified national treatment provision) and 2 (all &quot;reasonable&quot; prudential and fiduciary measures)</td>
</tr>
<tr>
<td>Canada, Japan, India, US</td>
<td>Option 2 (all &quot;reasonable&quot; prudential and fiduciary measures)</td>
</tr>
<tr>
<td>Sweden (also on behalf of other nordic countries)</td>
<td>Combination of Options 3 (variation of option two, enumerating examples of permissible measures) and 4 (unqualified right to take such measures)</td>
</tr>
<tr>
<td>Switzerland and South Africa</td>
<td>Option 5 (definition as precise as possible of the prudential actions that would be permitted, so as to reduce legal uncertainties)</td>
</tr>
<tr>
<td>EU, Thailand, Brazil, Egypt, Singapore, Malaysia, Hungary and Poland</td>
<td>None of the proposed options</td>
</tr>
</tbody>
</table>

The debates reveal the existence of different positions and nuances with regard to the scope of application as well as the legal function that ought to be assigned to the PCO.
The representative from Canada stated that there was no particular need to limit the coverage of the carve-out to national treatment.\(^\text{61}\) Rather, it was preferable in the view of the Canadian delegation to keep the scope of application of the provision broader. In this regard this delegation sought a clearer definition of "what was prudential and what was not" in order to avoid misunderstandings. Canada explicitly stood in favour of the justiciability of prudential measures before the WTO judges, so that WTO Members would not fall into the temptation to abuse of the carve-out.

Japan proposed an obligation to notify domestic prudential regulatory schemes to the Secretariat, so as to enhance transparency.\(^\text{62}\) India argued for the need to put specific provisions into the agreement for developing countries.\(^\text{63}\) The Indian delegate said that option 2 was preferable, suggesting specification of the examples (an indicative list) of prudential measures that Members could lawfully adopt.

The EU was in favour of regulatory diversity at the national level.\(^\text{64}\) It did not express an opinion in favour of any of the proposals for a carve-out that had been tabled by the Chairman but stressed the importance of acknowledging different sensitivities at the national level on financial regulation. Similarly, Thailand\(^\text{65}\) did not favour any of the proposals for a carve-out that were on the table at that meeting.

Australia\(^\text{66}\) argued that options 1 and 2 were more attractive. However, speaking about option 2 - according to which all "reasonable" prudential and fiduciary measures should be permitted - it warned about the need to reach a broad consensus on the definition of "reasonable" and the type of measures that this term could include (since the term was not self-interpreting). As we will see infra, the term "reasonable" is not part of the GATS PCO. However, it was included in the corresponding provision of the Chapter on Financial Services of the North American Free Trade Agreement (NAFTA), which was being negotiated approximately during the same period.

\(^{61}\) Ibid., para. 79.
\(^{62}\) Ibid., para. 80.
\(^{63}\) Ibid., para. 81.
\(^{64}\) Ibid., para. 82.
\(^{65}\) Ibid., para. 83.
\(^{66}\) Ibid., para. 84.
Sweden, intervening also on behalf of the other Nordic countries, shared the Australian view on the “reasonableness” test. As for the preferred option of the group it represented, the Swedish delegation was in favor of a combination of options 2 and 3:

(... in the sense of an illustrative list of legitimate objectives for prudential and fiduciary regulations including monetary policy objectives, protection of fair and orderly markets, protection of depositors, investors, insurance policy holders and consumers, and prevention of inappropriate practices.

The US took a very strong position in favor of option 2: a positive conclusion of the negotiations on a prudential carve-out was “vital” for the US. In its view trading nations needed to keep as much freedom as possible when regulating in order to address prudential concerns, as long as they did not use the carve-out as a means to circumvent their multilateral obligations.

In contrast, Switzerland and South Africa argued that option 5 was the best possible solution. In particular, Switzerland warned that an unspecified “reasonableness test” would put pressure on the judges, whereas a more specific provision would have been more useful for the sake of legal certainty.

Brazil, Egypt and Singapore thought that it was difficult at that stage to negotiate an agreement on a prudential carve-out and refused to choose one of the tabled options. Malaysia argued for the need to allow trading nations the maximum possible flexibility when regulating financial services on the basis of prudential concerns. The Polish delegate stated that since his country

67 Ibid., para. 85.
68 Ibid., para. 86.
69 Ibid., paras. 87 – 88.
70 “Option five aimed at defining as precisely as possible the prudential actions that would be permitted, so as to reduce legal uncertainties”.
71 Uruguay Round Doc. MTN.GNS/FIN/1.
72 Ibid., para. 92.
was on its way to reconstruct its economy and its financial market, the issue deserved further consideration and that the time was not right to choose one of the proposed options.\textsuperscript{73}

As regards the possibility of submitting prudential measures to the scrutiny of WTO judges, Canada declared itself in favour of such an option, whereas the strongest opposition to this possibility came from Thailand, Malaysia and Hungary.\textsuperscript{74} However, the tone of the discussion suggests that most Members did not really consider the possibility of completely excluding the justiciability of prudential measures for fear of opportunistic and protectionist behaviour.

Little at this stage was said with regard to the specific legal function that would be assigned to the PCO. It can be said that, among the options proposed, only Option 1 (National Treatment does not apply to prudential measures) or Option 5 (exhaustive list of prudential measures excluded from the coverage of the agreement) suggested giving the PCO the legal function of an exception-provision. All of the other options, which were also the most popular among the Members, tended to suggest other directions.

2.3.2 The EU, the US and SEACEN countries tabled three formal papers

Following these discussions the EU, the US and a group of South East Asian countries submtitted three formal papers to the Secretariat. The West was not united at that stage and showed different sensitivities with regard to the issue. The South East Asian countries were extremely concerned with the idea of opening up their financial services markets. As stated above, Asia was recovering from the 1988 Korean financial crisis and financial regulators from that region were reluctant to give up on their powers at a time when their financial sectors were being rebuilt and were proving to be essential for the development of these fragile economies.

\textsuperscript{73} Ibid., para. 93.
\textsuperscript{74} Ibid., para. 79, para. 83, para. 94, para. 94, respectively.
TABLE 2.2: Three formal proposals on prudential measures.

<table>
<thead>
<tr>
<th>EU</th>
<th>US</th>
<th>SEACEN Countries</th>
</tr>
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<tbody>
<tr>
<td>No PCO proposed – Measures to ensure the supervision of financial institutions can override free movement of capitals</td>
<td>A provision that allows trading nations to adopt all reasonable measures to address micro- and macro-prudential concerns</td>
<td>Broad PCO. Non justiciability of prudential measures.</td>
</tr>
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</table>

The EU submitted a proposal for a draft of the Annex on financial services.\textsuperscript{75} The document did not provide for a carve-out comparable to that approved at the end of the negotiations. Rather, the proposal by the EU aimed to remove unnecessary obstacles to the free movement of capital account transactions. However, \textit{en passant}, the proposal submitted by the EU contained a reference to measures with the aim of ensuring wide powers for central banks and similar authorities to operate the prudential supervision of financial institutions.\textsuperscript{76}

Article 14 of the EU proposal, under the heading “Payments and transfers for capital account transactions”, read:

\begin{quote}
14.1. Each party shall permit payments and transfers for capital account transactions other than those referred in Article XIII.1 of the Agreement, to be made to or by a financial services provider of another party, freely and without delay into and out of the territory of the first party in a freely convertible currency at the spot exchange rate on the date of the transfer
\end{quote}

\textsuperscript{75}Uruguay Round Doc. MTN.GNS/FIN/W/1, 'Working Group on Financial Services Including Insurance - Communication from the European Communities - Proposal by the European Community Draft Financial Services Annex to the Agreement on Trade in Services', 10 July 1990.

\textsuperscript{76}Interestingly, since Article 14.2 cited above, last sentence, does not include the measures provided in its letter d) among those which can have the effect of impeding capital movements, we can infer \textit{a contrario} that -according to the EU proposal- measures for the prudential supervision of banks and other financial institutions could also have the effect to limit (or even to impede) capital movements. The issue of capital controls will be addressed in more detail in the next chapter.
with respect to spot transactions, to the extent that such payments and transfers relate to the provision of cross-border services which are not prohibited by such party.

14.2. Notwithstanding the provisions of paragraph 1, any party may adopt or maintain:
   a) restrictions on payments and transfers for capital account transactions that are applied pursuant to Article 15 of this Annex;
   b) measures required to prevent infringement of their laws and regulations, inter alia, in the field of taxation;
   c) procedures for the declaration of capital movements for purposes of administrative or statistical information or in order to verify the authenticity of the transactions;
   d) measures to ensure the prudential supervision of financial institutions.

The measures and procedures referred to in letters b) and c) above shall not have the effect of impeding capital movements (Emphasis added).

The US\textsuperscript{77}, in contrast, stressed its main concerns relating to a multilateral framework for negotiations on trade in financial services. As regards the issue of prudential measures, it noted:

\begin{quote}
(...) Any agreement covering financial services should respect the traditional duties, rights, and responsibilities of finance ministers, central bank governors, and other regulators and officials in the financial services sector. More specifically, any such agreement must contain a provision which permits a Party to take reasonable actions necessary for prudential reasons, for the protection of investors and depositors, or for the protection of persons to whom a fiduciary duty is owed by a financial service provider.
\end{quote}

In the view of the US delegation, therefore, members of the new agreement on financial services should have the possibility to adopt “reasonable” micro-prudential measures, in addition to the traditional macro-prudential instruments relating to the traditional duties of central banks and governments.

\textsuperscript{77} Uruguay Round Doc. MTN.GNS/FIN/W/2, 'Working Group on Financial Services Including Insurance - Communication from the United States - Submission by the Unites States on Financial Services', 12 July 1990.
South East Asian Central Banking and Monetary Authorities Countries (SEACEN)\textsuperscript{78} submitted a third paper. This group maintained a very strong position in favour of a broad carve-out. In the view of the Members of the group, in terms of importance prudential measures overrode all other possible provisions of the future agreement.

(iii) The process of financial liberalization must take cognizance of the over-riding importance of prudential consideration, monetary policies and national development objectives. In developing countries like SEACEN members, financial services play a pivotal role in economic development. Hence, liberalization must ensure that developments in the financial sector do not adversely affect the effectiveness of national institutions and the overall general well-being of the economy as well as allow flexibility to nations in the design and implementation of banking and credit policies which are normal functions of a central bank or monetary authority.\textsuperscript{79}

The document underlined the importance of both micro and macro-prudential concerns in the regulation of financial services. In the SEACEN countries’ view measures taken for prudential reasons should not be subjected to any dispute settlement procedure.\textsuperscript{80}

The SEACEN group (established informally in 1966 and provided with legal status as of 1982) already had some experience in the field of mutual assistance in developing central bank policies, facilitating exchanges among its members and respecting high prudential standards.\textsuperscript{81} The members of SEACEN were very active in GATS negotiations and keen on substantially liberalizing their markets and their main concern was on financial stability due to their experience in this

\textsuperscript{78} Representing Indonesia, Korea, Nepal, Malaysia, Myanmar, Philippines, Singapore, Sri Lanka and Thailand.


\textsuperscript{80} The paper submitted by SEACEN countries basically formalized the positions already expressed by Thailand in the first meeting of the negotiating group (See Uruguay Round Doc. MTN.GNS/FIN/1, para.83).

\textsuperscript{81} However, history tells us that the prudential standards they were so jealous of did not help those countries when they were hit by the Asian financial crisis of the mid 1990s.
area.\textsuperscript{82} Being part of a group helped relatively small States to have their voices heard because of their increased bargaining power.\textsuperscript{83}

\textbf{2.3.3 The Brussels Ministerial Conference (December 1990)}

A draft text of the GATS was prepared for the Brussels Ministerial Conference of December 1990 but there was substantial disagreement among the parties with regard to the exact scope of an Annex on financial services. As such there were ultimately no provisions in the draft dealing with financial services.\textsuperscript{84}

During the 1990 Brussels Ministerial Conference a proposal for a financial services Annex\textsuperscript{85} circulated (submitted originally by Canada, Japan, Sweden and Switzerland and then later backed by the EU and the US). It contained a provision specifically dealing with prudential measures and was intended to be an addendum to Article XIV (General Exceptions) of the draft agreement.\textsuperscript{86} Its language was more or less similar to that of the PCO currently in force. The Brussels meeting was supposed to mark the end of the Uruguay Round. However, due to disagreement on agricultural

\begin{footnotesize}
\textsuperscript{82} Quoting from the minutes of Uruguay Round Doc. MTN.GNS/FIN/3, 'Working Group on Financial Services Including Insurance - Note on the Meeting of 13 - 15 September 1990', para. 4: "The requests of SEACEN countries, submitted in MTN.GNS/FIN/W/3, were not aimed at protecting domestic financial markets, but the stability of the financial system. Liberalization should also take account of the particular characteristics of the relatively immature financial systems in developing countries and the central role of the system in fulfilling the socio-economic development objectives of countries. Hence, the position put forward indicated a willingness to liberalize, which had been the member countries' policy anyway, but in a graduated manner."


\textsuperscript{84} See Reyna, \textit{Services}: "The text provided for a financial services annex, since the parties agreed that the GNS needed such an annex. However, there was no agreement on the scope and content for a financial services annex, due to the uncertainty over application of MFN, so the financial service annex consisted of a blank paper" (p. 55).

\textsuperscript{85} Uruguay Round Doc. MTN.TNC/W/50, 'Trade Negotiations Committee - Communication from Canada, Japan, Sweden and Switzerland', 3 December 1990.

\textsuperscript{86} Uruguay Round Doc. MTN.TNC/W/50/Add.2, 'Trade Negotiations Committee - Communication from Canada, Japan, Sweden and Switzerland - Addendum n. 2', 15 October 1991: "In addition to Article XIV of the Framework, the following shall apply: 1. Nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Party of reasonable measures taken for prudential reasons, including for the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owned by a financial service provider, or to ensure the integrity and stability of a Party's financial system. Such measures shall not be applied in a manner which would constitute a means of arbitrary or unjustifiable (a) restriction on the provision of financial services by financial service providers of another Party or (b) discrimination between domestic and foreign financial service providers or between countries. (...)".
\end{footnotesize}
issues (more precisely, about the transformation of the European Common Agricultural Policy), the meeting failed to reach its ultimate goal. However, with regard to the coverage of the provision an agreement was reached, at least in the sense that no tangible opposition was raised against the introduction of a PCO. Negotiators agreed to a broad PCO with a non-exhaustive list of prudential reasons according to which Members could freely adopt or modify their domestic regulation without being found in violation of other obligations or commitments. No definition of the concept of “prudential” was provided for in the text of the provision. This agreement represents the basis for the PCO in force today.

The discussion then shifted to the issue of whether or not to apply dispute settlement provisions to prudential measures, an issue that, as mentioned above, had already been raised in the first meeting. Against the view of the SEACEN countries, Canada, the EU, Japan and the US were strongly in favour of the application of the dispute settlement provisions to measures taken for prudential reasons.

At the end of the talks parties agreed to take prudential measures out of the realm of exceptions (under which it could have been harder to justify the adoption of prudential regulatory schemes by the respondent in the event of a dispute). However, they also agreed that prudential measures could be nonetheless scrutinised and, potentially, outlawed by the WTO judiciary. Although it would be tempting to see in this story a compromise that could be defined as ‘domestic regulation in exchange of justiciability’, there is no evidence in this regard, given the lack of official documentation available.

The GNS Co-chairman proposed a draft text for an Annex on financial services on 14 October 1991 and then, after discussions within the Group Negotiations on Services and consequent slight modifications, parties entered the final stage of negotiations. In a meeting held on 20 December 1991, the Chairman of the Trade Negotiations Committee, Arthur Dunkel, issued a draft text for

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87 See Uruguay Round Doc. MTN.GNS/46, 'Group of Negotiations on Services - Note on the Meeting of 21 October to 1 November and 29 November 1991'.

56
all the negotiating areas (the so-called "Dunkel Draft"). The PCO provided by the "Dunkel Draft" had the same wording and structure of the provision now in force.

It is reasonable to argue that the Dunkel Draft represented the agreed compromise on the PCO by the negotiators. Prudential measures, therefore, were not the most complicated issue debated during the Uruguay Round. Records from the negotiations reveal that, despite different sensitivities and different stages of development, Uruguay Round participants were fully aware of the intrinsic fragility of financial markets and even those who were pushing more strongly in favour of more market openness for financial services were not willing to give away their regulatory autonomy on prudential disciplines. On the contrary, financial services proved to be, on the whole, extremely problematic.

Trading nations did not manage to reach a conclusive agreement on the relevant rules of the game by the end of the Uruguay Round. They had an agreement on the Annex on Financial Services and the Understanding on Commitments on Financial Services (which are optional instruments, not necessarily binding on all WTO members), but it was an interim agreement. This is due to the fact that there was substantive disagreement on issues relating to Market Access, with the US particularly unhappy with regard to the initial commitments made by Japan and other Asian countries. For this reason, negotiations continued until the approval, in December 1997, of the Fifth Protocol to the GATS, also known as the Financial Services Agreement.

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89 Jarreau, 'Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer's Perspective' (p. 28).
2.4 Why the PCO? The economics of prudence

2.4.1 “Prudence is never enough”: The economics of prudential regulation in financial services

The market for trade in financial services is peculiar in many respects. First of all, it is a highly regulated environment. While the demand for deregulation in other economic sectors is more widespread, when it comes to banking (and finance, in general) positions tend to be more nuanced. The financial sector is at the heart of today’s economies, especially in industrialised countries, and the integrity and soundness of financial institutions and the financial system considered as a whole are crucial factors for the stability of the entire economy of a country or a region. As can also be seen in relation to the current economic crisis that originated in the failure of financial “giants”, “the social costs of the failure of an institution exceed the private costs”.\(^90\)

Financial regulation is fundamentally justified by market failures, both ex ante and ex post. Left unregulated, the financial sector could produce socially inefficient market outcomes. These inefficiencies can derive from market power, information asymmetries and negative externalities. In this review we will concentrate on specific market failures, namely the existence of multiple equilibriums, pecuniary externalities and moral hazard. These examples are provided with the caveat that many more possible distortions may exist.

Multiple equilibriums are the consequence of a coordination problem, due to the fact that banks borrow money on a short-term basis and invest long-term. This maturity mismatch, which is valuable economically, can fail catastrophically if the mismatch between short term (liquid) liabilities (bank deposits) and long term (illiquid) loans gives rise to concerns among bank depositors. Diamond and Dybvig\(^91\) set out the classic theory of bank runs and multiple equilibriums. In a nutshell, they model fractional-reserve banks as intermediaries transforming


illiquid assets into liquid liabilities and depict the relationship among depositors as a coordination game with two Nash equilibria: one good and one bad.

A good equilibrium is where, according to Diamond and Dybvig, save for a fraction of depositors in real need of funds, bank customers do not withdraw their deposits before the ordinary maturation date. In such a situation, financial institutions are in the position to pay back the funds and the interests that have matured when the depositor decides to withdraw their money. This is a situation in which there is a satisfactory flow of information and depositors do not panic.

However, and recent news are full of examples, agents in financial markets are sensitive to shocks, and this may lead to a bad equilibrium. Depositors may decide to withdraw their money from banks for fear that many other customers will do the same or because they fear that their deposits may depreciate. This situation may precipitate a “bank-run” whereby banks are forced to liquidate their assets to satisfy depositors before the natural time for the maturity. In this situation, both depositors and financial institutions incur losses. The former may be late in asking for their assets from banks and end up with nothing or a small fraction of the original deposit. The bank faces a loss because it has fewer funds to use in its activities. The final outcome of this problem of coordination, in which it is rational for depositors to withdraw as early as possible, is a scenario in which banks can become bankrupt.

A variety of reasons unrelated to the bank’s condition, such as a bad earnings report, a commonly observed run at some other bank or a negative government forecast can trigger a general bank run. Deposit insurance mechanisms (analysed by Diamond and Dybvig), as well as minimum capital requirements, the act of improving the share of equity within the bank’s capital, lender-of-last-resort facilities from Central Banks and liquidity requirements are all examples of regulations aimed at solving the coordination problem at the origin of this market failure.

Another rationale for banking regulation is provided by the existence of pecuniary externalities associated with banks’ activities. Pecuniary externalities are third party effects that operate entirely through the price mechanism (for example when the increased demand for cars by some

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92 For instance, this has recently occurred in early 2015 in Greece.
drives up the price of cars for all). Under complete markets pecuniary externalities would offset each other. For example, if the price of cars goes up consumers will be worse off but producers will be better off. The loss to consumers is offset by the gain to producers, therefore the resulting equilibrium is Pareto-efficient.

However, once there are market imperfections (which are frequent), such as asymmetric information or incomplete markets, agents facing credit frictions act in a fragmentary fashion and do not internalise market price reactions leading to welfare-reducing pecuniary externalities. These are particularly relevant in credit markets. Banks may be exposed to losses and be constrained to a position in which they have to reduce the funds they are able to lend. This may impede borrowers from accessing the necessary money to make investments or to run their businesses, thus spreading the pecuniary externalities to sectors of the real economy. Depending on the dimension of such a problem, pecuniary externalities may constitute a valid reason for regulators to step in.

Pecuniary externalities can also be a problem between banks. The externalities can either take the form of direct financial contagion or indirect financial contagion. The first case is due to the fact that banks are usually exposed largely to other financial institutions in the interbank market (this situation is commonly known as “interconnectedness”). In this situation, when a bank is not able to pay its liabilities in full to another bank there arises a situation of contagion.

Contagion, however, can also take place on an indirect basis. A bank on the verge of failure may try to liquidate its assets in the fastest possible way (fire sales). This is likely to lower market prices, thus also affecting other financial institutions in the market. Moreover, there is also another side of pecuniary externalities that must be considered. As Ulltveit-Moe et al put it:

There can also be indirect contagion through interbank funding: if one bank incurs unexpected losses, it will tend to reduce its lending and hence reduce the supply of funding through the interbank market. This tightens the funding supply to other banks, and may lead to reduced lending from these banks. If banks expect such tightening to occur, precautionary liquidity hoarding may result, amplifying the tightening. (…) [T] he sum of the risks that the
individual banks take into account is less than the sum of all the risks their activity generates, i.e. systemic risk. This difference is in fact the sum of the pecuniary externalities.\textsuperscript{93}

Many banks experienced these kinds of problems during the 2007-2008 financial crisis. Such problems point to the fact that regulators should not only care about the robustness of financial institutions taken singularly. Bank regulators, on the contrary, should also address a macro-dimension, since financial markets are intrinsically vulnerable.

There is another market failure that dominates the background of financial markets: moral hazard. Banks typically act in a situation in which neither the depositors nor the shareholders are in the position to effectively control operations. Financial contracts are too complex and depositors often lack adequate expertise to judge whether an operation is too risky or safe.\textsuperscript{94} This lack of efficient control by shareholders and depositors leads bank operators to undertake risky investments. In the end, shareholders will benefit if the risky operation is successful. In the opposite situation, they enjoy limited liability, hence they may only loose part of their equity. On the contrary, creditors will be exposed to losses.

Among the regulations that aim at reducing moral hazard, Ulltveit-Moe et al identify risk-based deposit insurance premia, and regulation of the remuneration schemes of bank managers as means to induce them to behave more prudently.\textsuperscript{95} We should also bear in mind, however, that while such regulations may make investments less risky they may also make them less remunerative in case of success. This may lead to situations of underinvestment and, therefore, the regulator may find itself in a delicate situation.

The recent financial crisis has shown how deleterious these market failures – as well as the absence of adequate prudential regulation – can be in a context of integrated (financial) markets. In particular, the crisis showed how shocks may be transmitted through the financial system,

\textsuperscript{93} Karen H. Ulltveit-Moe et al., 'Competitiveness and Regulation of Norwegian Banks', \textit{Staff Memo - Norges Bank} (2013), 93 (p.47).
\textsuperscript{94} Lack of control by shareholders, instead, is due to other reasons including the structure of banks according to which usually property and governance are separated.
\textsuperscript{95} Ulltveit-Moe et al., 'Competitiveness and Regulation of Norwegian Banks' (p. 49).
how complicated crisis management and bank resolution may become if coordination among financial regulators is limited, and how incentives to monitor and support banks and their foreign affiliates can differ between home and host-country authorities.96

The presence of externalities and moral hazard are not the only economic explanations for financial regulation. Llewellyn pinpoints other rationales that provide reasonable incentives to adopt prudential regulation, namely market imperfections and failures, economies of scale in monitoring, 'lemons' and confidence, the “grid lock problem” and the intrinsic difference between financial products and contracts.97

*Market imperfections and failures:* Were unregulated financial markets perfectly competitive, the costs of regulation would be borne by the consumers. Since financial markets are frequently imperfect, as the cyclical financial crises that the world has experienced so far shows, the benefits of sound financial reforms outweigh the costs to be borne by clients of financial firms. Financial contracts have, among others, two distinctive features: they take place between parties that do not have the same ability to access all the necessary information to properly evaluate the risks connected to the investment and – and this is the second characteristic - they are normally long-term. As such, financial firms may have the incentive to gamble more or to have a more risky attitude at a later point in time than that of the conclusion of the contract with the client. When regulation of financial markets is sub-optimal, consumers may underinvest because of a reasonable fear of future losses on the capital invested. Alternatively, situations of this kind may provide an incentive to consumers to act as free-riders, assuming that all other investors have adequately collected the necessary information to evaluate the integrity of the financial institutions involved in the transaction.

*Economies of scale in monitoring:* As stated above, financial contracts are typically long-term contracts, and consequently the way in which a financial institution behaves after the conclusion of a contract influences the value of the financial services at the centre of the latter. Since consumers lack the instruments and knowledge to effectively monitor the financial firms they

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96 Stijn Claessens and Juan A. Marchetti, 'Global Banking Regroups', *Finance & Development*, 50/4 (2013), 14 - 17.
conclude a contract with, regulatory agencies are called to perform this task. Effective systems of monitoring and proper supervision can collect information with the appropriate techniques and in an impartial way and have the power to enforce regulation or to authoritatively influence governments to intervene. This could not happen were the task of monitoring left to the customers.

"Lemons" and confidence: In a seminal paper published in 1970 the Nobel prize in economics George Akerlof theorised a framework to determine the economic costs of asymmetric information. In so doing, he referred to the used automobiles market as a prototypical example. A customer who wants to buy a used car typically has more difficult access to the relevant information they may need for a proper assessment of the quality of the product than that of the seller. Hence, the buyer may not easily distinguish a good car from a “lemon” (a colloquial term for “bad cars” in American English), and may eventually end up buying a ‘lemon’ for the price of a good car. Alternatively, it can work in a different way, in the sense that the price of lemons may decrease significantly and the market could eventually collapse. In order to avoid situations of this kind, consumers may leave the market, leading to a complete breakdown of the market. Mutatis mutandis, the same problem with asymmetric information and confidence between buyers and sellers arises in the realm of financial services markets. Purchasers, in order to avoid the costs of buying a product which would reveal its poor quality after some time, may decide to avoid the risk of entering a peculiar market that shares some features with gambling. In such a scenario, regulation plays an important role. Providing the public good of minimum standards for the tradability of financial products, financial regulatory bodies reduce the costs of lack of confidence and can play a role in the attempt to take ‘lemons’ out of the market.

The “grid lock” problem: Llewelyn describes the situation of “grid lock” in financial markets as one in which firms know what would be the optimal behaviour to adopt vis-à-vis consumers, yet undertake hazardous operations in order to gain higher returns. This may lead to two main problems: adverse selection and moral hazard. A firm that decides to behave honestly towards its

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99 It is preferable to use the expression ‘can play’ instead of ‘play’ because junk financial products are far from being removed from the market.
100 Llewelyn, supra, fn. 73.
clients may do so by imposing a higher cost on itself, thus becoming non-competitive with respect to other players in the market and therefore losing ground (adverse selection). Such a situation may induce ‘good firms’ to follow the example of the bad ones in order not to be totally cut off from the market (moral hazard). Essentially, this may create ‘grid lock’ in the financial market, encouraging firms to behave inappropriately. This is yet another reason for sound regulation of financial markets so as to ensure fair conditions for competition and sound behaviour by firms when they negotiate contracts with their clients.

**Difference between financial services and other kinds of contract**: Financial products have distinctive features in the economy. As mentioned above, financial contracts are typically long-term in nature and as a result the effective value of the transaction may vary over time. Financial regulation may play a role in reducing transaction costs, with the adoption of stricter rules of transparency for financial services suppliers, thus helping customers have higher information about the products they are about to buy.

Financial markets can be highly volatile and it is often impossible to make sound forecasts about developments in this sector. In turn, negative consequences deriving from a regulatory or supervisory failure could spread to all other sectors of the economy. This is why, especially in the aftermath of the 2007/2008 financial crisis, both international and national authorities stressed the need to revise the financial regulation architecture and to provide supervisory authority with the necessary tools in order to timely intervene and limit the negative consequences of financial distress. A collapse in the financial sector is likely to trigger domino effects in (potentially) all other sectors of the economy.

Actors in markets can purchase different kinds of products. These can be classified in many ways but, for the purpose of the current work, we shall differentiate between “experience goods” (goods whose characteristics and quality can be easily ascertained after the consumption), “search goods” (goods whose quality can be evaluated before the purchase) and “credence goods” (goods whose utility and impact is difficult to be evaluated even after consumption). The more information is needed by consumers in order to assess the quality of a product the stronger

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101 See Section 2.5, infra.
the rationale for regulation is, since information is costly. Financial products, after all that has been written thus far, are “credence goods”. Information asymmetry is quintessential to financial markets and as such there is a strong rationale for regulators to step in and try to correct imperfections and market failures.

2.4.2 The Rationale for the PCO

Against this background it is not surprising that Uruguay Round participants decided to give discretion to financial regulators to adopt any regulations and policies they deem appropriate in order to prevent – or limit the effects of – financial instability.

As was shown above, at the beginning of the negotiations of a multilateral agreement on trade in services not all trading nations were enthusiastic about signing an agreement concerning liberalisation of cross border trade in financial services. Along with the intuitive concerns raised by developing countries (which were afraid of a loss in sovereignty in a strategic sector) caution was also expressed by trading nations with different backgrounds and levels of income. Even those Members which at the time of negotiations were inclined to deregulate many market sectors and were pushing for tangible liberalisation in international trade in financial services made efforts to find a balance between new market opportunities and clauses for the protection of their domestic financial markets.

The first part of the of the non-exhaustive list of reasons provided by the PCO according to which WTO Members can adopt regulations notwithstanding their obligations or commitments refers to the “protection of investors, depositors, policy holders and persons to whom a fiduciary duty is owed”. In the terminology of financial markets, regulations addressing issues of this kind are generally known as conduct regulation because the main focus of this regulatory approach is to target the way financial firms conduct business with their clients and customers. Conduct regulation addresses different issues that may vary from disclosure requirements to fair practices, from the prohibition to issue untrue statements to rules that aim to avoid situations of market manipulation. It has already been pointed out that the PCO only provides for a non-
exhaustive list of reasons according to which Members can put in place regulations and as such – for the sake of the present discussion - it is only possible to mention a select number of examples.

The rationale for conduct regulation lies in the fact that financial contracts typically take place between parties that do not have access to the same amount of information (or if they do, do not share the same expertise on the issues and therefore are not in the same position to evaluate the pros and cons of the transactions they engage in). These situations are generally termed ‘principal-agent problems’ in economics and can lead to failed contracts either because the consumers may not receive the necessary information in order to be completely aware of the conditions they agree upon, or the contracts turn out to be different from what the principal (namely the client) expected or even because the agent (the financial institution) becomes insolvent or cannot honour its obligations.\footnote{Llewellyn, 'The Economic Rationale for Financial Regulation' (p. 12).}

The second part of the non-exhaustive list covers measures adopted in order to ensure ‘the integrity and the stability of the financial system’. Essentially this refers to ‘prudential regulation’ which can be divided into the two subcategories of microprudential and macroprudential regulation. The former deals with the preservation of the safety and solvency of financial institutions taken individually whereas the latter deals with the protection of the financial system taken as a whole.

\section*{2.5 International cooperation on financial (and prudential) regulation}

The WTO is not the only forum dealing with the regulation of financial services. A plethora of other bodies issues measures dealing with financial services, which creates many problems in terms of overlap of disciplines of a different nature. On the one hand public international law agreements (like the WTO Agreement, for instance) provide a framework discipline for progressive liberalisation of trade in financial services. On the other hand, it is bodies of a hybrid
nature (whose measures are effectively implemented at the national level without having binding force) that have largely performed the “rule-making” task.\textsuperscript{103}

The international financial regulation landscape that has taken shape since the 1970s is complex and has evolved at different speeds in the various fields. Some areas of financial regulation are “governed” by detailed recommendations and standards such as capital rules in banking, for instance. In contrast, other fields of financial law have progressed unevenly.

2.5.1 The rationale for international cooperation on financial regulation

It is useful to analyse the reasons for cooperation on financial regulation and why the path towards harmonisation of financial rules at the international level has been less smooth than in other fields of law such as trade in goods, for instance.

Verdier identifies five possible objectives of international regulatory cooperation in the domain of financial services: securing cross-border coordination of enforcement and supervision; liberalising international finance by harmonising regulatory requirements; compelling States to improve their financial regulation; securing collective action to raise prudential standards and making credible commitments to overcome time inconsistency problems.\textsuperscript{104} In the view of this author, international cooperation in financial regulation has been successful over the years in the achievement of just two out of the five objectives cited above. Namely it helped national regulators and supervisors in coordinating their actions and finding reciprocal assistance and it allowed national governments to liberalise the cross-border flows of capitals and financial services between one another by lowering some regulatory barriers through harmonisation and recognition of requirements.


The history of international cooperation in the domain of financial cooperation can hardly be considered successful, especially if compared to other domains such as trade, for instance. If this is the case, then, why do governments keep following the same strategy rather than abandoning a path dominated by soft law and non-binding international recommendations? The answer can only be partial at this stage, given that the phenomenon is still on-going. However, there are some explanations and lessons from the recent past that can be reported.

In the view of some authors an explanation can be found using the prism of rational choice theories.\textsuperscript{105} The idea is that national governments calculate the costs and benefits of international cooperation and, more carefully, of transfers of pieces of sovereignty. According to this view, soft law provides for some incentives for compliance (and there is indeed evidence of high levels of compliance in some sectors), while still preserving the possibility for governments to act (or react) in a fast and flexible way, addressing the specificities of their national markets together with their peculiar problems.\textsuperscript{106}

In contrast, Verdier advances an alternative twofold explanation.\textsuperscript{107} The first side of the coin has to do with historical path dependence, that is institutional routes undertaken in the past influencing future choices. The framework of international cooperation on financial regulation emerged gradually in a context in which international flow of capitals and financial services was limited to exceptional circumstances. Financial globalisation took off when the international community was not prepared and as such the answers to problems were mainly given at the national level. This process started in the mid-1970s when regulators and supervisors became aware of the fact that the negative externalities of the insolvency of a financial institution in one domestic jurisdiction may negatively affect depositors and financial institutions based in other jurisdictions.\textsuperscript{108}

\textsuperscript{105} \textit{Ex multis}, see Brummer, \textit{Soft Law and the Global Financial System - Rule Making in the 21st Century}.  
\textsuperscript{106} Although studies reveal how some countries have adopted a strategy of “mock compliance”, that is they formally have complied with standards and recommendations issued at the international level but, in reality, they have ignored them in practice. For a thorough analysis of this phenomenon, please see Andrew Walter, \textit{Governing Finance - East Asia's Adoption of International Standards} (Ithaca, US: Cornell University Press, 2008) 256.  
\textsuperscript{107} Verdier, “The Political Economy of International Financial Regulation”, (pp. 1425 and ff.).  
\textsuperscript{108} In this regard, the history of the birth of the Basel Committee, which is provided \textit{infra}, is illustrative.
In that context, regulators started meeting informally in order to exchange their views and to explore possible solutions, albeit jealously protecting their margin for intervention in the domain of financial services. Today, informal forums dominate the international arena and it would be impossible to think of an evolution of this framework towards an international hard law setting.

The second aspect that Verdier puts forward in his analysis relates to the intrinsic political economy of international financial regulation. Essentially, financial regulation and supervision at the domestic level are traditionally heavily delegated to specialised agencies with different degrees of autonomy and independence from political institutions. This peculiarity has an impact at the international level in the sense that these specialised agencies are those entitled to the setting up of standards and recommendations in most cases. Moreover, the financial industry also has some peculiarities. Financial markets are probably those in which issues of asymmetric information arise most dramatically. Big corporations and financial institutions enjoy the possibility of moving large amounts of money and as such they can significantly influence political processes by means of financing electoral campaigns. On another level, however, they also have impressive technical expertise; they are well organised and it is relatively straightforward for them to gather and to promote their interests. Finally, there can be divergent interests between great powers and smaller States in this domain. Whilst great powers such as, for instance, the United States or the EU may well have an agenda to pursue and the incentives to work for stronger standards, some other countries may have the contrary interest to free-ride on the situation, leaving the burden to the bigger powers while attracting investors and firms with the promise of a cheaper regulatory environment.

The complexity of the interaction of the actors involved makes it hard for international cooperation in the delicate domain of financial markets to follow a smooth path. The following table, prepared by Verdier, convincingly summarises the different positions that the main actors in financial markets typically hold with regard to the various regulatory objectives that can be


pursued by means of international cooperation. It represents a useful graphic tool to understand how hard it is to reconcile the different preferences that the various actors in financial services markets may have.


<table>
<thead>
<tr>
<th></th>
<th>Regulators</th>
<th>Large Firms</th>
<th>Great Powers</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enforcement/Supervisory Cooperation</td>
<td>++</td>
<td>~</td>
<td>+</td>
<td>++</td>
</tr>
<tr>
<td>Liberalization</td>
<td>~</td>
<td>++</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Improving regulation in Specific Countries</td>
<td>~</td>
<td>~</td>
<td>+</td>
<td>~</td>
</tr>
<tr>
<td>Adopting Stricter Prudential Standards</td>
<td>~ to ++</td>
<td>(varies)</td>
<td>~ to ++</td>
<td>-</td>
</tr>
<tr>
<td>Committing to Cross-Border Resolution</td>
<td>~</td>
<td>~</td>
<td>~</td>
<td>--</td>
</tr>
</tbody>
</table>

Key: ++ = strongly positive; + = positive; ~ = neutral/indifferent; - = negative; -- = strongly negative

**2.5.2 The main international forums dealing with financial regulation**

Many international bodies address issues related to trade in financial services.\(^{111}\) This section will give account of the main international forums dealing with banking and financial services. International forums on financial regulation can be roughly divided into two categories.

The first is composed of three sectorial standard setting organisations that are of particular importance for the sake of the present work: the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO). The Joint Forum on Financial Conglomerates, established in 1996, brings the latter three organisations together in order to facilitate dialogue on issues of common interest.¹¹²

The second category is composed of those bodies through which political leaders define macro-strategic objectives that are crucial for the stability of the international system. Two are particularly relevant for the current discussion: the Group of 20 (G-20) and the Financial Stability Board.

### 2.5.2.1 The Basel Committee on Banking Supervision

Until the 1970s it was commonplace to consider financial regulation as being something confined within the boundaries of nation States. However in 1974 a major event shook the financial world. Bankhaus Herstatt, a financial institution based in Cologne, Germany was declared insolvent by the competent domestic agencies after a series of risky foreign exchange exposures. This event represented a turning point due to the fact that the foreign exchange community started to fear that some international counterparts would not be able to honour their obligations. After a series of other similar (albeit minor) events¹¹³ the governors of the central banks of the then Group of 10 industrialised countries (G-10) established the Standing Committee on Banking Regulations and Supervisory Practices, housed by the Bank for International Settlements (BIS) in Switzerland.

The BCBS, which is the natural heir of the Standing committee, broadened its membership in 2009 with a view to including all G-20 Members plus Hong Kong and Singapore. However, the BCBS kept the nature and structure of its predecessor in the sense that Members meet informally,

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¹¹² More information are available at the following website: [http://www.bis.org/bcbs/jointforum.htm](http://www.bis.org/bcbs/jointforum.htm) (last accessed on 8 September 2015).

¹¹³ For a comprehensive account of the events that preceded the establishment of the BCBS, see D. A. Singer, *Regulating Capital - Setting Standards for the International Financial System* (Ithaca and London: Cornell University Press, 2007) 163 (pp. 38 and ff.).
with limited records of their meetings and decision-making processes adhering to the rule of consensus. The standards issued by the BCBS are not binding but are mere recommendations.\textsuperscript{114}

There are two main areas of financial regulation in which the BCBS is actively involved with: banking supervision and capital adequacy of financial institutions. With regard to banking supervision, the Standing Committee issued its Concordat in 1975 and has proceeded with subsequent revisions of the document. The main idea behind the BCBS’ recommendations on banking supervision, known as ‘consolidated supervision’, was that home country supervisory agencies should be responsible for all the operations conducted by their national financial institutions, both in the domestic market as well as when they operated abroad.

In 1997, the BCBS released twenty-five Core Principles on best practices on banking supervision, moving from the original idea that mainly consisted of principles for the coordination of national supervisory authorities. In 1999, the BCBS issued a document entitled “Core Principles Methodology” with the aim of avoiding divergent interpretations.

These instruments have undergone successive revisions over the years and, more importantly, since the 2007/2008 economic crisis. In 2012, the BCBS revised the Principles and merged them and the Methodology into one document. The new version of the Principles takes into account some lessons learned from the 2007/2008 financial crisis and stresses the need for a systemic approach on the micro-supervision of financial institutions and the necessity to invest resources in the supervision of globally systemic important financial institutions. Finally, the Committee also emphasised better corporate governance, transparency and disclosure of information.

With regard to standards on capital adequacy, the BCBS has revised its recommendations several times over the years. In December 2010 the Basel Committee released the Basel III capital

\textsuperscript{114} Implementation of the BCBS standards takes place on a voluntary basis and these standards are effectively transformed into national law also in jurisdictions other than the parties to the BCBS. Moreover, pressure from international organisations matters. The IMF and the World Bank run the Financial Sector Assessment Program (FSAP), with the view of analysing the conditions of the financial markets of those countries that agree to voluntarily submit themselves to the scrutiny. Part of the program is devoted to the timely implementation of international standards. Moreover, members of the Financial Stability Board have agreed on a peer review mechanism to review the status of the implementation of standards on financial regulation. See De Meester, \textit{Liberalization of Trade in Banking Services - an International and European Perspective} (p. 86).
framework. The main features of this new framework can be briefly summarised as follows: the document changed the definition of capital and introduced a new leverage ratio; countercyclical capital buffers were introduced. The implementation process of these standards is scheduled to be completed in January 2022.

2.5.2.2 The International Organization of Securities Commissions

In 1987, a group of domestic securities regulators started to discuss the necessity of working towards the harmonisation of capital requirements in the securities industry. The rationale behind this is the same as that which led to the creation of the BCBS, namely that of avoiding a failure in one domestic market spreading its negative effects to the rest of the world and to minimise the inefficiencies and the asymmetries of information deriving from differences in domestic rules.

Today IOSCO includes around 150 Members and is based in Madrid. Given the complexity of securities regulation at the domestic level, particularly in federal States, secondary securities regulators are granted the status of non-voting members. Moreover, the IOSCO has a consultative committee (the Self-Regulatory Organizations Consultative Committee) in which self-regulatory bodies can put forward their perspective on securities’ markets.

In June 2010, IOSCO published the revised version of the Objectives and Principles of Securities Regulations, which consists of a set of 38 principles based on three main objectives of securities regulation, mainly: “protecting investors; ensuring that markets are fair, efficient and transparent; reducing systemic risk”. Another important document is the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of

115 In 2013, the BCBS also adopted a new standard on liquidity coverage ratio.
116 These innovations will be explained in greater detail in Section 2.6.3, infra.
Information (MMoU), last revised in 2012.\textsuperscript{118} The document sets out principles for mutual assistance, information sharing and cooperation among securities regulators.

\textbf{2.5.2.3 The International Association of Insurance Supervisors}

The IAIS, registered as a non-profit organisation under Swiss law, is located in the offices of the BIS in Basel. Established only in 1994, this organisation is relatively young when compared to its sibling organisations described so far. Membership of IAIS is relatively broad, comprising 180 national and local authorities as well as international organisations. Additionally, 120 (non-voting) insurance professionals participate in the life of the Association in their capacity as “observers”.

The General Meeting of the IAIS decides on guidelines and technical standards with a qualified majority of two-thirds of the voting members. Singer, however, provides anecdotal evidence according to which members of the IAIS strive for consensus and tend to avoid situations of conflict and tension in which a two-thirds majority vote is required.\textsuperscript{119}

Two are the main instruments developed in the context of the IAIS: the Multilateral Memorandum of Understanding (MMoU), adopted in February 2007, which is a framework for cooperation and exchange of information between insurance supervisors,\textsuperscript{120} and the \textit{Insurance Core Principles}, last amended in October 2013, which deals, \textit{inter alia}, with issues of capital adequacy, risk management and corporate governance.\textsuperscript{121}


\textsuperscript{119} Singer, \textit{Regulating Capital - Setting Standards for the International Financial System} (p. 97).

\textsuperscript{120} IAIS Multilateral Memorandum of Understanding on Cooperation and Information Exchange, available at the website: \url{http://iaisweb.org/index.cfm?event=getPage&nodeId=25287} (last accessed on 8 September 2015).

\textsuperscript{121} IAIS Insurance Core Principles Standards Guidance and Assessment Methodology October 2011 (revised October 2013), available at the website: \url{http://iaisweb.org/index.cfm?event=showPage&nodeId=25224} (last accessed on 8 September 2015).
2.5.2.4 The Group of 20

The G-20 is a forum for international cooperation that gathers together 19 States plus the European Union.\textsuperscript{122} The leaders of the G-20 meet annually whereas finance ministers and governors of central banks meet more often during the year. The forum does not have a permanent staff and Members rotate on a yearly basis in order to hold the chair of the G-20 and to provide facilities and a temporary staff dedicated to the meetings and the activities of the Members. It does not have a formal voting system. Rather, it was conceived originally as a discussion forum and as such the aim of parties is to reach consensus-based compromises for public declarations to be issued at the end of the summits.

The role of this forum has evolved after the 2007/2008 financial crisis. In the first three summit meetings (Washington in 2008 and London and Pittsburgh in 2009), the leaders of the G-20 discussed the multilateral response to the financial turmoil and highlighted in their official statements the necessity of an international set of rules for the governance and supervision of financial markets. In particular, in the official statement after the Pittsburgh summit at the end of 2009,\textsuperscript{123} the leaders of the G-20 agreed, among other things, to strengthen capital and liquidity requirements (put in place by the BCBS). Moreover, they emphatically decided to “[t]o reform the global architecture to meet the needs of the 21\textsuperscript{st} century” and, to this extent, established the Financial Stability Board (FSB), whose structure and activities will be dealt with in the next subsection.

Six years after the declaration at the Pittsburgh meeting some commentators have noteded how reality the optimistic tone adopted by G-20. In addition to the incomplete reforms advocated in the context of the BCBS, a global regulatory and supervisory architecture of financial markets seems as distant a prospect as it ever has.\textsuperscript{124}

\textsuperscript{122} Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States.


2.5.2.5 The Financial Stability Board

The Financial Stability Board (FSB) evolved out of the Financial Stability Forum launched by the G7 in the aftermath of the Asian financial crisis in the late 1990s. It now comprises 36 institutions including departments of finance, central banks, domestic supervisory agencies, international organisations and standard setting bodies.125

It is a more complex and structured organisation than the G-20 with a permanent secretariat and a secretary general. Members participate in a Plenary, which is assisted by three committees, one dealing with supervision and regulation, another one which discusses issues of cooperation and a third entrusted with the mandate of monitoring the implementation of the FSB agenda. In addition to these bodies, a Standing Committee provides Members with operational guidance between the various sessions of the Plenary.

The FSB has been actively involved in recent years in the development of global principles for the regulation of hedge funds as well as the activities of credit-rating agencies. Moreover, it plays a central role in the framework of international cooperation on financial regulation. In fact, it provides a “Compendium of Standards”126 in which the economic and financial standards that are accepted by the international community as being instrumental for the safety and soundness of financial systems are reported. The FSB also conducts and publishes peer reviews on the implementation of internationally agreed standards at the national level. Finally, the Board plays a major role in the identification of those financial institutions which can be considered of systemic importance.

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125 A full list of the Members is available at the following website: http://www.financialstabilityboard.org/about/fsb-members/ (last accessed on 8 September 2015).

126 Available at the website: http://www.financialstabilityboard.org/what-we-do/about-the-compendium-of-standards/ (last accessed on 8 September 2015).
The history of financial markets is one of booms and busts. The interplay between domestic prudential regulations and obligations in trade agreements is particularly relevant in the aftermath of crises. Occasionally governments need to intervene quickly in order to limit more dramatic consequences of financial turmoil and avoid speculation. Even when international organisations like the International Monetary Fund (IMF) are involved in recovery programs, providing financial aid in exchange of the implementation of reforms in domestic legislation, it is possible that governments deem it necessary to intervene with regulations more than just once, since there can always be unforeseen circumstances.

Following the entry into force of the WTO, the world was shocked by the Asian financial market crisis in 1997-1998. As mentioned above (when discussing the negotiating history of the GATS Annex on Financial Services) Members of the nascent WTO agreed during the 1996 Ministerial Meeting in Singapore that they would resume negotiations on financial services as of April 1997. It comes as no surprise that negotiations in that field, which had already proved to be difficult, became even more so due to the explosion of the financial crisis that hit East Asia in the spring of 1997. Arguably, the context in which WTO Members negotiated the disciplines on financial services helps to explain why they did not move much further in comparison to the Draft text that already circulated at the Brussels Meeting.

The remained of this chapter gives an account of the main aspects of regulatory changes intervened in Members hit by financial crises after the entry into force of the GATS. Subsection 2.6.1 will recall the changes in legislation adopted by Indonesia, Korea and Thailand in the aftermath of the East Asia financial crisis of 1997-1998. The choice of this sample lies in that those countries were arguably the most severely hit by the financial upheaval and the fact that they requested assistance from the IMF. Subsection 2.6.2 provides a brief sketch of changes in legislation in the EU and the US after the 2008 financial crisis. This can hopefully help to understand whether the concept of ‘prudential reasons’ has evolved over time and to what extent
WTO obligations and commitments have represented impediments or obstacles for trading nations dealing with the consequences of financial turmoil. Finally, subsection 2.6.3 will provide a recap of the main instruments that are considered to be part of the macroprudential toolbox of financial regulators today.

2.6.1 After the 1997 East Asian financial crisis

Although the impact of the crisis differed in many aspects in the various countries that were hit and the spread of the contagion did not occur everywhere at the same pace, it is safe to say that broad similarities can be highlighted as regards the financial crisis in Indonesia, Thailand and Korea, and the situation in these countries before and after 'the music stopped'.

The East Asian crisis generally took both national governments and commentators by surprise. Asian countries were growing at a steady pace, with growth rates of 5% or more before 1997. Nevertheless the crisis highlighted the inherent weaknesses that led those economies to economic difficulty. First of all, inadequate regulation and lax supervision was a feature of all these economies. National governments had put in place implicit safety nets, thus encouraging morally hazardous behaviours of both lenders and borrowers. The latter knew that eventually national governments would have bailed out financial institutions experiencing difficulties with regard to their balance sheets. Further, all three countries were exposed to large private short-term foreign currency debt. These countries were exposed to speculative attacks, and were eventually forced to allow their currencies, which were pegged to the US Dollar, to float.

The IMF coordinated the policy responses in those countries. To quote from a working paper by IMF officials:

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127 This is the inspired expression used by Alan Blinder in his contribution on the 2007/2008 financial crisis: Alan S. Blinder, After the Music Stopped - the Financial Crisis, the Response and the Work Ahead (New York: Penguin, 2013) 476.


129 Timothy Lane et al., 'Imf-Supported Programs in Indonesia, Korea and Thailand', IMF Occasional Paper (1999), 1 - 82.
The IMF's support was organized under the Emergency Financing Mechanism. This mechanism, with a shortened period of negotiation, review, and approval by the IMF’s Executive Board, permitted the programs to be put in place very quickly in response to immediate and overwhelming market pressures. At the same time, it forced exceptionally quick analysis by IMF staff and negotiations with country authorities. At times, decisions had to be based on more than usually incomplete information.130

In Thailand where it all began the government launched a program of privatisation of banks and introduced measures aiming to align its banking sector to internationally agreed best-practice standards.131 Temporary ceilings on deposit rates were imposed and capital controls, which were put in place when the crisis occurred in May 1997 were lifted as of August 1997.

Indonesia had high levels of overseas borrowing, experienced a rapid and reckless expansion of the financial systems, as well as problems concerning non-performing loans and could not sustain the pegging of the Rupiah to the US Dollar.132 Its policy response consisted of widening the exchange rate band with the Rupiah finally allowed floating in August 1997; fiscal policies implemented in order to preserve a budget surplus of 1% of GDP; tight monetary policy; amendments in the banking law, in order to encourage private ownership; strengthening of the legal and supervisory framework for banks and increasing the minimum capital requirements in line with the standards issued by the Basel Committee.

Korea, the third country to request assistance from the IMF, focused mainly on restructuring its financial sector.133 Among the measures adopted were the implementation of Basel standards, revision of the Bank of Korea Act and the introduction of stricter conditions for support to financial institutions in distress.

130 Ibid. (p. 1).
2.6.2 Financial regulation in US and EU after the 2008 financial crisis

The US and the EU are the key players in the world market for financial services. Being the main importers and exporters of financial services and the key players in the relevant international forums in which financial regulation is discussed, it is important to see, (although only briefly as it is not the core of the present work) how they implement the guidelines, principles and standards they contributed to establish and the main steps that they have taken in the aftermath of the recent financial crisis.

2.6.2.1 Post-crisis financial regulation in the United States

At the time of writing the world is still recovering from what was in all likelihood the most dramatic economic crisis since 1929. It is complicated to target one factor that triggered the financial meltdown of 2007/2008. The origins of the turmoil, however, can probably be traced in the shocks that occurred in the US, with the collapse of gigantic financial institutions. Two main factors contributed to the outbreak of the crisis, namely: the housing prices bubble and the diffusion of toxic financial products.\(^{134}\) These events occurred against the background of a process of deregulation that took place in the United States for years before the crisis involving both Republican and Democratic administrations.\(^{135}\)

Traditionally, US law was very strict in forbidding commercial banks from being involved in investment activities (and, vice versa, investment banks were not allowed to receive deposits).\(^{136}\) This legislation was the object of subsequent reform culminating in the Financial Services Modernization Act of 1999 (commonly known as the Gramm–Leach–Bliley Act), which repealed

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\(^{134}\) The literature on the causes of the 2007/2008 financial crisis is endless. For an extensive overview see Alan S. Blinder, *After the Music Stopped - the Financial Crisis, the Response and the Work Ahead* (New Yourk: Penguin, 2013) 476 (pp. 29 and ff.).


\(^{136}\) See Sections 16, 20, 21 and 32 of the US Banking Act of 1933, commonly known as the “Glass-Steagall Act”.
relevant parts of the Glass-Steagall Act in order to remove barriers for the activities that financial institutions could be involved in. The main legislative act introduced as a response to the financial crisis is the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), signed into law by President Barack Obama in 2010.137

The enactment of the Dodd-Frank Act had huge implications for the financial market landscape in the US. Not only have the rules on financial services activities undergone profound changes, but the number, function and names of the competent agencies have also been substantially modified compared to the pre-crisis situation.

The present work will only provide a short overview of the main innovations introduced. Perhaps the most important one was brought about by the introduction of the so-called “Volcker Rule”. Named after the former chairman of the Federal Reserve, Paul Volcker, it limits the ability of banks to be involved in proprietary trading operations or to invest in hedge funds and private equity funds. It does not amount to a complete ban but reduces the substantially of their operating margins.138 It introduces the requirement for riskier derivatives to be cleared through CCPs.

The explosion of the 2007/2008 financial crisis had revealed the gaps in the architecture on financial supervision in the US. The Dodd Frank Act responds to this situation creating the Financial Stability Oversight Council (FSOC), with the mandate to identify systemic risks in financial markets and to respond to threats to stability in a timely fashion. However, Kern rightly warns that the FSOC does not have enforcement powers and can only issue recommendations.139

The Dodd-Frank Act also introduces reforms that affect the Federal Reserve activities. More stringent rules on banking supervision are introduced. New rules for the protection of consumers, particularly in the mortgages market have seen the light of the day because of the Dodd-Frank Act. Finally, this piece of legislation also introduces changes with regard to the

137 Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No: 111-203 (07/21/2010).
138 Banks can still invest up to the 3% of their capital in the activities just mentioned with the formal approval of their customers.
resolution of financial institutions in distress. The US has also committed to implement the standards set out in Basel with regard to capital adequacy, liquidity coverage and leverage.

2.6.2.2 Post-crisis financial regulation in the European Union

The crisis did not start in the European Union. However, the Old Continent was severely affected by the negative consequences of the financial meltdown for two main sets of reasons. First of all the high degree of interconnectedness of financial markets worldwide brought instability also in Europe. Secondly the European Union paid a high price for the lack of common effective legislation among its 28 Member States in financial markets in general and, more specifically, with regard to the resolution of financial institutions in distress.

The European regulators have put in place a strategy for the reform of financial markets that is in the process of being implemented at the time of writing.\textsuperscript{140} Essentially, there are four main stated objectives: the promotion of the stability and resilience of the banking sector; the completion and deepening of the European single market for financial services; the enhancement of transparency and disclosure in order to better protect investors and consumers and making the EU financial system more efficient. The ultimate goal pursued by the institutions of the EU is to realise a Banking Union which should consist of a single rulebook for all financial actor across the 28 Member States of the EU. To this end, EU institutions and Member States have agreed to establish a Banking Union based on a single supervisory mechanism and a single resolution mechanism.\textsuperscript{141}


\textsuperscript{141} More information is available on the website of the European Commission: \url{http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm} (last accessed on 8 September 2015) For more information on the road towards a European Banking Union and the theoretical foundations behind it, see Georges Zavvos, ‘Towards a European Banking Union - Legal and Policy Implications’, MIMEO, (2013), 23.
The European Union has adopted new legal instruments in order to comply with the international standards issued in the aftermath of the crisis with regard to capital adequacy and loss absorbency. In July 2013 the Capital Requirements Directive (CRD)\textsuperscript{142} and Regulation (the CRD IV package)\textsuperscript{143} entered into force. These instruments amend pre-existing rules or introduce new requirements on a number of important issues. For instance, they raised the level and quality of capital that financial institutions must hold, introduced systems in order to better control the increase of leverage in the banking sector, introduced requirements for the improvements of liquidity buffers, introduced requirements for banks to hold capital reserves that they can use in situations of stress (capital conservation buffers) and national regulators are allowed to introduce a discretionary buffer up to 2.5% of capital that the bank could be required to collect in periods of high credit growth. Finally, higher requirements have been introduced for systemically important financial institutions.

Another important piece of post-crisis piece of legislation is the Bank Recovery and Resolution Directive (BRRD).\textsuperscript{144} This new legal instruments requires all EU Member States to abide by a single rulebook for the resolution of banks and other financial institutions. The main and most revolutionary idea behind this reform is to shift the burden of the resolution of financial institutions in distress from taxpayers to private resources. Moreover, it introduces tools to more effectively deal with the complicated issue of cross-border resolution of banks.

The European Union has also sought to strengthen the stability and reliability of the financial market infrastructure. In this regard Brussels has remarkably adopted three new legal instruments: the Markets in Financial Instruments Directive (MiFID)\textsuperscript{145} and the Markets in


Financial Instruments Regulation (MiFIR),\textsuperscript{146} which together form the “MiFID II package”; the European Markets and Infrastructure Regulation (EMIR)\textsuperscript{147} and the regulation on Central Securities Depositors (CSDs).\textsuperscript{148}

One of the main lessons of the crisis is that those markets which deal with financial instruments other than equity shares are remarkably opaque. The MiFID II package aims, inter alia, to enhance transparency with new reporting requirements and to mitigate the risks connected to high frequency trading (HFT).

The EMIR introduced the requirement that standardised derivative contracts have to be cleared through central counterparties (CCPs). It also requires that over-the-counter (OTC) derivatives are traded in electronic trading platforms and that all data on European trade in derivatives have to be reported to officially recognised trade repositories and is made accessible to supervisory authorities.

The CSDs regulation on the other introduces higher standards in line with internationally agreed standards for the safety and the efficiency of securities trade. Remarkably, it introduces for the first time common EU rules on “short selling”.\textsuperscript{149} The new instruments aim to enhance transparency by obliging actors in financial markets to notify net short positions in government debt. Moreover, they impose restrictions on the possibility of proceeding with naked short selling instruments.


\textsuperscript{149} “Short selling” is a transaction in which the seller sells a security which it does not own with the intention of buying it back at a later point in time. “Naked short selling” is a similar transaction in which the seller has not borrowed the securities, nor has it ensured their borrowing before the main transactions takes place. They are highly risky contracts.
2.6.3 The evolution of the macroprudential toolbox in the aftermath of the crisis

The 2007/2008 crisis that shook the financial system on a global scale has revealed that the goal of the preservation of the integrity and the stability of the financial system was far from being achieved. The PCO itself did not provide definition of what a macroprudential tool is nor of what financial stability is. The latter concept, although the subject of extensive research over the years, has never enjoyed a unanimously accepted definition. Schinasi, for instance borrows the words of thirteen actors including academics, central bankers and national regulators alike and sets out with thirteen different definitions of “financial stability”.150

The evolution of the regulations and practices at the national and supranational levels gave birth to a whole new stream of literature on how to better safeguard financial stability and on what the most valuable tools to predict turmoil, anticipate disruptions and avoid the spread of negative externalities stemming from a failure in the financial system.151 In particular, as one might expect, a discussion is taking place regarding what tools actually worked, which could have worked better and what new instruments could be adopted in order to anticipate imbalances, prevent crises and, eventually, timely respond to situations of instability.

Despite the natural divergence of opinions in the literature as to how to best target such delicate issues, there seems to be a tendency in the aftermath of the 2007/2008 crisis to take into consideration the possibility of differentiating macroprudential tools to a greater extent and to address not only issues dealing with the strengthening of prudential supervision but also other aspects that have an impact on the stability of the financial system (and to reduce the intrinsic risk connected with financial activities).152

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In recent times a number of papers have sought to quantify the impact of new measures as well as the real diffusion of the tools that are commonly deployed.\textsuperscript{153} The present work attempts to list the most common tools and to briefly describe them in order to give an account of what measures the international community of regulators and scholars currently considers to be “prudential” tools in the domain of financial market regulation. Recalling that the PCO only provides a non-exhaustive list of measures this is a useful exercise in order to understand, at the present time, how the concept of “prudential” has evolved.

\textit{Capital Requirements (and Sectoral Capital Requirements):} This is probably the most common prudential tool under analysis and represents the first pillar of the new standards issued by the BCBS in the aftermath of the 2007/2008 financial crisis (Basel III). Essentially, it deals with the amount of capital that banks are required to hold by their financial regulators. The amount of capital to be held is typically expressed in terms of a proportion of common equity capital as compared to risk-weighted assets. Essentially, the aim of such measures is to ensure that financial institutions internalise the externalities deriving from the risky activities they participate in. Far from being just a microprudential tool, given the high decree of interconnectedness of financial institutions, raising capital requirements is also useful in order to avoid domino effects.

The BCBS, since the crisis, has modified and increased the capital requirements that financial institutions of its Members must respect. The BCBS conducts a periodical review of how its Members implement the standards and it appears that all BCBS Members will reasonably comply in a timely fashion with the requirements set to definitively enter into force in 2019.

\textit{Countercyclical Capital Buffers:} Under this measure, financial institutions are required, in addition to their minimum capital requirements, to build up an additional capital buffer during periods of economic growth. This measure allows financial institutions to have more capital to rely on in times of distress and to avoid situations of credit crunch which are poisonous for the rest of the economy and exacerbate financial crises. The BCBS set the countercyclical buffer in a range

\textsuperscript{153} Among the others, Cheng Hoon Lim et al., 'The Macroprudential Framework: Policy Responsiveness and Institutional Arrangements', (International Monetary Fund, 2013), 1 - 38.
between 0 and 2.5% but governments may well decide to go beyond that threshold which –it is worth stressing it- is only a recommendation.

*Maximum Leverage Ratios:* Leverage is an instrument financial institutions adopt to maximise returns and losses. Typically, it involves risky practices such as using borrowed funds to buy more of an asset at the risk that the borrowing costs may outweigh the returns in income from that asset. New Basel III rules define the leverage ratio as the ratio between the capital measure and the exposure measures, and fix a minimum requirement of 3% for the ratio so determined for the period 1 January 2013 – 1 January 2017.

*Time-varying / dynamic provisioning:* Dynamic provisioning is a tool mostly used by the Spanish regulator (and the Bank of India as well) to measure banks’ loan losses. Essentially, it requires banks to build up reserves to cover losses deriving from the concession of loans. Such a buffer will increase during years in which losses are less than expected whereas it will be drawn down in periods in which losses increase.

*Restrictions on distributions:* Through this measure the possibility to distribute dividends is limited in order to keep a sufficient amounts of capital during favourable economic times.

*Liquidity coverage ratio:* The second pillar of the innovations introduced by the new “Basel III” framework is the reform of the Liquidity Coverage Ratio (LCR), which is the ratio between high quality liquidy assets (specifically assets that can be easily converted into cash in private markets in a scenario of liquidity stress test lasting more than thirty calendar days, HQLA) and the total net cash outflows of the banks.

Since 2015 financial institutions, in order to comply with the Basel III requirements, will have to progressively increase the amount of HQLA in order to reach a LCR of 100% or more, according to the following table published on the website of the Bank for International Settlements154:

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154 More information is available at the following website: [http://www.bis.org/publ/bcbs238.htm](http://www.bis.org/publ/bcbs238.htm) (last accessed on 8 September 2015).
<table>
<thead>
<tr>
<th>Minimum LCR Requirements</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>60%</td>
<td>70%</td>
<td>80%</td>
<td>90%</td>
<td>100%</td>
</tr>
</tbody>
</table>

The aim of this new set of rules is to enhance the short-term resilience of banks’ risk profile. It pursues both a micro (short term resilience of banks’ risk profile) and a macro-prudential objective (avoidance of the spreading of negative externalities to other financial institutions and other sectors of the economy).

*Loan to Value Restrictions:* A loan-to-value (LTV) restriction is a tool deployed in order to limit the amount of money lent to clients. It is expressed in terms of a percentage of the value of the loan that can be awarded as compared to the value of the property (typically such loans are instrumental to help clients getting the necessary amount of money to conclude real estate contracts). New Basel III requirements introduce a ratio of 80% of average issuance. The aim of the instrument is to avoid situations in which borrowers are unable to pay back their loans, which was one of the causes of the present crisis which global financial institutions are slowly recovering from.

*Debt to Income Restrictions:* Along the same lines (and following the same rationale), some national jurisdictions put in place restrictions on borrowing based on a percentage on the income of the borrower in order to make sure that they are able to pay back the loan.

*Minimum margin requirements for non-centrally cleared derivatives:* The BCBS, together with the IOSCO, introduced a framework for margin requirements for non-centrally cleared derivatives. Quoting from the BIS website:

“All financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives will have to exchange initial and variation margin commensurate with the counterparty risks arising from such transactions. The framework has been designed to reduce systemic risks related to over-the-counter (OTC) derivatives markets, as well as to
provide firms with appropriate incentives for central clearing while managing the overall liquidity impact of the requirements.”

Use of central counterparties: Among the measures proposed by the G-20 there was also one according to which Members committed to ensure that all OTC contracts are cleared through central counterparties. They are systemically important as they reduce problems of coordination. However, there are also problems with regard to the concentration of risk within CCPs.

Disclosure requirements: One of the main issues with banking practice is the asymmetry of information between the various actors in the financial market. Disclosure requirements help address the issue and, in theory, make the task of the supervisors easier.

Reserve requirements: Many central banks (although it is not a universal practice) require financial institutions to hold a fraction of customers’ deposits as reserves that they cannot lend. Such reserves are typically either stored in the banks’ vaults or are in the form of deposits made to central banks. They may be considered as performing a prudential function as they force financial institutions to keep part of the deposits and not to use all of them for their operations.

Caps on foreign currency lending: Loans in foreign currency put both the borrower and the lender in a riskier situation. The former is exposed to the risks due to the fluctuations in the foreign exchange rate and, as a consequence, the latter faces higher credit risks.

Limits on net open currency positions or mismatches: Such tools are used to prevent situations in which liabilities exceed assets in a given currency.

Systemically Important Financial Institutions (SIFIs): One of the main issues during and after the start of the 2007/2008 financial crisis has been the so-called “too-big-to-fail” problem. Essentially, this relates to financial institutions that have grown too big and, due to their central

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155 Available at the following website: [http://www.bis.org/publ/bcbs261.htm](http://www.bis.org/publ/bcbs261.htm) (last accessed on 8 September 2015).

156 For example, the new Basel III framework for the leverage ratio is complemented by disclosure requirements for the banks that have to comply with the standards. Essentially, they have to make public the leverage ratio they apply in a timely fashion.
position in the financial markets, the fact that the social costs of their failure may outweigh the costs suffered by the banks themselves.

The Financial Stability Board (FSB), following a methodology developed by the BCBS, issued a list of so-called global systemically important banks (G-SIBs) in late 2011 which are required, among other things, to respect higher loss absorbency requirements.

**Capital Controls:** There is no unanimous definition of capital controls yet their use has been extensively advocated in the aftermath of the crisis and they are a recurring topic in economic literature. The concept of capital controls refers generally to measures that have the effect of influencing the cross-border movement of capital. For our present purposes an explanation of what capital controls are and what the measures typically put in place are from a Staff Discussion Note of the IMF is useful:

Capital controls limit the rights of residents or non-residents to enter into capital transactions or to effect the transfers and payments associated with these transactions. Typical measures include taxes on flows from non-residents, unremunerated reserve requirements (URR) on such flows, or special licensing requirements and even outright limits or bans. Measures may be economy-wide, sector-specific (usually the financial sector), or industry specific (for example, “strategic” industries). Measures may apply to all flows, or may differentiate by type or duration of the flow (debt, equity, direct investment; short-term vs. medium- and long-term). While this taxonomy is analytically useful, it bears emphasizing that the classification is not always clear-cut, and often there are only fine distinctions among the measures.\(^\text{157}\)

Different forums of international economic law deal with the issue of capital controls and regulate specific facets. Article VI (Capital Transfers), Section 3 of the Articles of Agreement (AA) of the IMF reads:

Section 3. Controls of capital transfers

Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2.

Another forum of international economic law where the issue is addressed is the Code of Liberalisation of Capital Movements of the Organisation for Economic Co-operation and Development (OECD). A relevant passage of the preamble reads:

The Code recognises that capital controls can play a role in specific circumstances. But because “beggar-thy-neighbour” approaches can have negative collective outcomes, countries have agreed under the Code to well-tested principles such as transparency, non-discrimination, proportionality and accountability to guide their recourse to controls.

The GATS itself provides a discipline for the movement of capital. The rationale for the GATS is to establish a forum for the progressive liberalisation of international trade in services, therefore the liberalisation of cross-border capital movement is not an objective in and of itself. However, cross-border movement of capital can either be an essential part of the service itself or may represent the way in which such a service is paid for. Therefore it is not surprising that the GATS provides for a discipline with regard to the limitation of the possibility for its Members to restrict cross border capital flows.

Article XI of the GATS (Payments and Transfers) prevents Members from restricting the cross border movement of financial flows for current account transactions relating to their specific commitments. The same provision, however, makes clear that this cannot prejudge the possibility of Members i) to adopt measures in compliance with their obligations under the IMF
AA and with what they negotiate and are requested to do by the Fund; and ii) to put in place measures in order to address serious balance-of payments and external financial difficulties, as per Article XI of the GATS.

In addition to the two exceptions listed in Article XI of the GATS it appears that the adoption of capital controls for current account transactions (as well as capital account transactions) can be justified under the general exceptions of Article XIV of the GATS. Moreover, there is increasing awareness that capital controls may serve as a tool to address negative externalities of turmoil in the financial system and as such they can be considered to be part of the “prudential” toolbox. However this is not straightforward given the concerns raised by some Members in various discussions in the WTO Committee on Trade in Financial Services as reported in the following section of the present chapter.\footnote{158}

2.7 Subsequent practice

As mentioned above the WTO judiciary has never been called to settle a dispute concerning the PCO. Only in one circumstance has the PCO made an appearance in WTO case law, in an obiter dictum. In the Panel Report on China – Electronic Payment Services Paragraph 2(a) of the GATS Annex on Financial Services is incidentally mentioned in the context of the explanation by the Panel of the right to regulate enjoyed by WTO Members.\footnote{159}

\footnote{158} Finally, it is worth recalling that the PCO, although it is a substantially catchall provision, can only be invoked in the field of financial services. It is still unclear what margin Members have to put in place capital controls in other sectors of the economy. For an analysis of these concerns, see Gari, 'Capital Controls, GATS Disciplines and the Need for a More Coherent Global Economic Governance Structure'.

\footnote{159} Panel Report, China – Measures Affecting Electronic Payment Services, WT/DS413/R, adopted 31 August 2012, para. 7.569: “China further appears to suggest that any interpretation of the term "FFIs" that would cover institutions other than foreign banks and finance companies would mean that non-bank foreign service suppliers with little industry experience could enter the Chinese market and begin accepting deposits or making loans. That is not the case, however. As indicated above, in accordance with section C of China’s mode3 market access entry, China may impose prudential authorization criteria. Additionally, as confirmed by the preamble to the GATS, China retains the right to regulate, and to introduce new regulations on the supply of services to meet domestic policy objectives. Articles VI:1 and VI:5 of the GATS further confirm that even in sectors in which a WTO Member has undertaken specific commitments, that WTO Member may, subject to certain disciplines, apply measures of general application affecting trade in services, including e.g. non-discriminatory licensing, qualification and technical requirements. Finally, paragraph 2(a) of the GATS Annex on Financial Services provides that, notwithstanding any other provisions of
This reading of the PCO is problematic. The provision is not self-interpreting and its language may appear to be rather self-cancelling, mainly due to the ambiguity enshrined in the last sentence (“Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement”). As such, it is important to understand, as the text is somewhat unclear, the scope of application of the PCO and what the legal function it performs in the WTO legal order. In the absence of case law it is a useful intellectual exercise to assess it has been understood by WTO bodies other than the judiciary and by the Members themselves.

2.7.1 The WTO Secretariat

In the first version of the Scheduling Guidelines, which dates back to 1993, Paragraph 2(a) of the Annex on Financial Services is recognised as being an exception, thus belonging to the same family as Article XIV of the GATS. Consequently it was deemed that it was not necessary to schedule prudential measures.\(^{160}\) The document was meant to represent a *vademecum* for negotiators with the aim of explaining how to make offers and requests and how to clearly write their initial commitments. In 2001, a second version of the Scheduling Guidelines was issued confirming the approach adopted in the first one.\(^{161}\) The Appellate Body of the WTO, however, clarified in the *US – Gambling* case that the Scheduling Guidelines can serve, at most, as supplementary means of interpretation as per Article 32 VCLT.\(^{162}\)

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2.7.1.1 The 2010 Secretariat Background Note on ‘Financial Services’

At the request of some Members the WTO Secretariat released a “Background Note” on financial services on 3 February 2010. This document classifies the PCO provision as an exception. This means that, in the view of the Secretariat, WTO Members can adopt measures inconsistent with their MFN obligations and specific commitments, as long as they are put in place for “prudential reasons”. In other words, prudential concerns are considered as overriding in importance of all other obligations and commitments of the GATS and its annexes.

The Secretariat stresses the “non-exhaustiveness” of the indicative list provided for in the first subparagraph of the PCO provision. It goes even further, assuming the evolutionary nature over time of the perception of “prudential measures”, thus expanding the scope of the provision and enhancing the uncertainty of its boundaries.

The background note seeks to explain the meaning of the final clause of the GATS PCO. The Secretariat classifies the sentence as an “anti-abuse” device. In other words, the GATS Prudential Carve-out maintains its large and unclear boundaries, as long as any measure taken for prudential purposes shall not be put in place just as a means to avoid the obligations of a WTO Member under the GATS. The document quotes two scholarly works in the attempt to explain the anti-abuse clause. Indeed both works describe it as an “obligation of good faith” Members have to comply with when overcoming the GATS obligations and commitments.

The document also deals with the delicate issue of the relationship between the PCO and other relevant exceptions. In the view of the Secretariat, the PCO differs substantially from the general rule for exceptions provided by the GATS. Article XIV of the GATS, although broad in terms, only covers violations of members’ obligations provided that they are "necessary" to the achievement

164 Ibid. para. 28.
165 Leroux, 'Trade in Financial Services under the World Trade Organisation'; Von Bogdandy and Windsor, 'Annex on Financial Services'.
of their aim. In contrast, measures adopted for prudential reasons need not meet any ‘necessity’ test nor any ‘least trade restrictive means’ test.\textsuperscript{166}

The document, moreover, reviews some of the measures adopted in the aftermath of the financial crisis in order to make a \textit{prima facie} analysis of their compatibility with GATS rules and, more specifically, whether they are covered by the PCO.\textsuperscript{167} According to the Background Note, measures such as capital adequacy measures, stronger supervisory powers and measures addressing ‘too-big-to-fail’ cases, although potentially altering one member’s commitments, are \textit{prima facie} genuinely motivated by prudential concerns. Therefore in theory they are able to benefit from the shelter provided by the PCO.

This background note, together with the scholarly works it quotes, represents the current mainstream understanding of the provision. We should be aware, however, of the limited formal legal value of a background note issued by the WTO Secretariat. According to the Panel report in \textit{Mexico–Telecoms}\textsuperscript{168} it can at most serve as a supplementary means of interpretation.

\subsection*{2.7.2 The PCO in the practice of WTO Members}

Notwithstanding the reading of the negotiating history and the fact that the way scholars have interpreted the provision suggests leaving national governments substantial leeway for amending regulations on financial services according to prudential concerns, there are still substantial concerns as to the degree of freedom that trading nations actually have. There are two indications of the uncomfortableness of WTO Members concerning the exact boundaries of the PCO. First of all, as a matter of relevant practice, a close look at the Schedules of Commitments by WTO Members reveals that some decided to introduce horizontal entries into their schedules in order to reaffirm their right to regulate according to prudential concerns. This practice has been highlighted by Mattoo and Wunsch-Vincent who have stated that:

\begin{itemize}
\item \textsuperscript{166} WTO Doc. S/C/W/312 and S/FIN/W/73, para. 31.
\item \textsuperscript{167} Ibid.
\item \textsuperscript{168} WTO Panel Report, \textit{Mexico – Measures Affecting Telecommunications Services (Mexico – Telecoms)}, WT/DS204/R, adopted 1 June 2004, para. 7.43.
\end{itemize}
Despite the existing right of Members to regulate, the inclusion of the prudential carve-out under this horizontal commitment or at the start of each GATS schedule (see the US initial offer, for example) would help to reassure national regulators that the objective is not to question their judgments but to target only blatantly protectionist measures – which is broadly the role of the prudential carve out in financial services. The advantage of this approach is that by accommodating regulatory precaution, it may make it easier for Members to make deeper and wider commitments. The disadvantage is that the value of those commitments will depend on the uncertain interpretation of the scope of the carve-out.169

A search of all the Schedules of Commitments on financial services reveals the following: the word “prudential” appears in the horizontal entries of twenty Schedules170 and reference to Paragraph 2 (a) of the GATS Annex on Financial Services is made in twenty-four Schedules.171 Although it would be presumptuous to draw conclusions from a limited number of Schedules, some tentative remarks can be made.


170 Albania, Australia, Austria, Bulgaria, China, Cyprus, EC-12, EC-15, Egypt, El Salvador, Ghana, Japan, Korea, Lao PDR, Malaysia, Poland, Romania, Russian Federation, Senegal, Viet Nam. To give one example, the following is an excerpt from the Lao PDR's Schedule of Specific Commitments (GATS/SC/150), among the most recent ones to be submitted: “Access by foreign services suppliers and the provision of new financial services within the scope of the commitments below and that have not yet been provided by the private sector in Lao PDR at the date of accession, may be subject to measures adopted for prudential reasons. Direct branching is not allowed. Financial institutions in Lao PDR must adopt a specific legal form. All the commitments are subject to entry requirements, domestic laws, rules and regulations and the terms and conditions of the Bank of Lao PDR, the Ministry of Finance and/or any other competent authority in Lao PDR, as the case may be, which are consistent with Article VI of the GATS and paragraph 2 of the Annex on Financial Services and do not impair the commitments undertaken herewith.”

Similarly, the following is taken from the Schedules of Specific Commitments of the European Union (formerly EC) (GATS/SC/31): “The admission to the market of new financial services or products may be subject to the existence of, and consistency with, a regulatory framework aimed at achieving the objectives indicated in Article 2.1 of the Financial Services Annex.”

171 Austria, Bahrain, Bulgaria, Cyprus, Czech Republic, EC-12, EC-15, Hungary, Israel, Japan, Korea, Lao PDR, Mauritius, Montenegro, New Zealand, Nepal, Poland, Russian Federation Senegal, Singapore, Slovak Republic, Slovenia, Sri Lanka, Turkey.
Firstly, one may actually think that such entries are of limited – if any - practical relevance. Adlung and others, for instance, refer to these entries as “foggy commitments”, since they contain simple references to provisions “that would apply in any event”. However, this practice can be justified, particularly in the field of financial services. In the absence of previous case law, or given the intrinsic obscurity of the boundaries of the provision, Members may not be confident about the extent to which the PCO covers all prudential policies, especially when they can discriminate between domestic and foreign services suppliers or may have the effect of limiting market access.

Additionally, the GATS is a complex agreement. The issue of opening-up the financial services market of a country involves the participation of a number of players (executives, parliaments, central banks, and so on). Not all such actors may necessarily be familiar with trade negotiations. As such, reaffirming the right to regulate according to prudential purposes in a horizontal entry in the Schedule may limit tensions among different actors in the domestic decision-making process.

Secondly, on various occasions both before and after the 2008 financial crisis different WTO Members have brought the issue before the relevant bodies of the Organization in order to have a discussion and clarify some aspects concerning the interplay between domestic policies and their compatibility with the PCO. This shall be the focus of the next subsection.

2.7.3 Proposals for reform by WTO Members and discussions in the Committee on Trade in Financial Services

The WTO is a living body with an active institutional life. Trading nations share their views on relevant issues and table proposals for discussion and a better understanding of the provisions of the Agreements. Since the PCO is not self-interpreting and in the absence of case law on the topic, it is interesting to provide an overview of the state of the art of the debate among WTO Members.

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on the issue and, in particular, the proposals that have been tabled from 2000 onwards to revise the PCO. In the following sections an account will be given in rigorous chronological order of the various proposals tabled.

2.7.3.1 The Australian proposal (2000)

During a meeting of the Committee on Trade in Financial Services (CTFS) in April 2000 Australia proposed a discussion among WTO Members in order to develop if not a definition at least a common understanding of the meaning of the expression ‘prudential regulation’.\(^{173}\) In order to do so the Australian delegation suggested using the core principles set up by the BCBS for banking, and the IAIS for insurance. The aim pursued by the Australian delegation was, explicitly, to clarify the scope of the provision and to understand where to draw the line between prudential and intolerable protectionist measures.

The Australian proposal did not attract much support among the other delegations with the remarkable exception of Japan. The EU and Switzerland did not oppose a discussion on the issue, whereas Malaysia stood firmly against the usefulness of the Australian proposal. According to the Malaysian delegation:

> The prudential carve-out was the result of a fine balance struck when the GATS was concluded and trying to define prudential regulation could upset that balance.\(^{174}\)

In subsequent meetings of the CTFS\(^ {175}\) parties debated the Australian proposal but it failed to gain momentum. The US delegation, although affirming that they would further examine the

\(^{173}\) WTO Doc. S/FIN/M/25, 'Committee on Trade in Financial Services - Report of the Meeting Held on 13 April 2000', para. 20.

\(^{174}\) Ibid., para. 22.

proposal, warned that the conclusion of a positive negotiation on the prudential carve-out was not easy and it was the result of a difficult compromise among different exigencies. Moreover – the argument of the US delegate was that there was no ‘compelling evidence’ that the PCO was being abused.\(^\text{176}\) However, the US advanced the possibility of enhancing transparency as they acknowledged a lack of it in the field.

The delegate of the Philippines, backing Malaysia, provided a further explanation of their position. It is worth, for the sake of completeness of the reconstruction of the debate, to quote the relevant passage from the minutes:

> The representative of the Philippines supported the statements made by Malaysia at the previous and present meeting. Looking at the provision contained in the Annex on financial services, his delegation found no need to define what measures for prudential reasons meant. A definition would be required if the phrase sought to be defined was so ambiguous or vague as to require interpretation from Members. However, the language contained in paragraph 2(a) of the Annex was quite clear. The grounds cited in that provision might be broad and comprehensive but it did not at all mean that they were ambiguous. Following the international law on interpretation of provisions in treaty language, where a phrase was not vague or ambiguous, Members should not endeavour to put in their own interpretation. *The fact that the grounds cited in the mentioned provision were general and comprehensive did not translate into vagueness or ambiguity.* Even if there was a wide discretion granted to Members in invoking that provision, his delegation believed that it was intentional. *In fact that provision sought to allow Members that discretion in case of certain contingencies, like those experienced by Asian countries in the past two years.* Therefore, his delegation would not want to see deliberations on the proposal taken forward, and hence supported the removal of the proposal from the agenda of subsequent meetings (Emphasis added).\(^\text{177}\)

The position expressed by the delegation of the Philippines reminds us of the terms of the bargain (broad carve-out but still justiciable) that was concluded during the Uruguay Round.

\(^{176}\) WTO Doc. S/FIN/M/26, para. 19.  
\(^{177}\) WTO Doc. S/FIN/M/27, para. 19.
Eventually the discussion came to an end at the November meeting of the CTFS when, among others, the US delegation reaffirmed the importance of the provision and clearly stood against further discussion on the topic.

2.7.3.2 Switzerland (2001): The ‘GATS 2000: Financial Services’ Communication

In May 2001 Switzerland issued a communication (“GATS 2000: Financial Services”) to the Council for Trade in Services. One section of the document was devoted to prudential regulation of financial services markets. The section started with a strong acknowledgment of the importance of prudential regulation:

The liberalization of trade in financial services must be accompanied by solid prudential regulation and supervision in order to ensure confidence in the system, and hence its smooth operation. Members must be given plenty of room for manoeuvre so that they can implement the necessary measures as soon as the problems arise (Emphasis added).

The Swiss proposal consisted of two main points. First, it encouraged the CTFS to keep abreast of the work of the relevant standard setting bodies in the field of financial services (BCBS, IAIS and IOSCO and the Joint Forum on Financial Conglomerates). Second, it recommended that the CTFS work on a more precise definition of the scope of the PCO of the GATS since this would improve transparency and prevent a disproportionate use of prudential regulatory schemes. The Swiss

178 WTO Doc. S/FIN/M/28.
179 Nevertheless Marchetti, ‘The GATS Prudential Carve-Out’ (p. 283) reports that Japan later promoted the collection of (at least) information from the relevant standard setting bodies and, in October 2001, BCBS, IAIS and IOSCO held a seminar at the initiative of WTO Members, outside the proceedings of the CTFS.
181 Quoting from Marchetti, ‘The GATS Prudential Carve-Out’. (p. 284, fn. 17): “It is interesting to note that, unlike the Australian and the Japanese ideas, the Swiss proposal was not discussed in the relevant WTO sectoral committee – the Committee on Trade in Financial Services – but in the group overseeing services negotiations in the DDA – formally called the Council for Trade in Services in Special Session”.
proposal was no more successful that the previous Australian proposal due to the same kinds of criticisms.

2.7.3.3 Barbados: Are domestic measures adopted in the aftermath of the crisis GATS compatible?

In February 2011 the delegation of Barbados submitted a Communication called “Unintended Consequences of Remedial Measures taken to correct the Global Financial Crisis: Possible Implications for WTO Compliance” to the CFTS.\textsuperscript{183} The document tabled by the Caribbean island aimed to shed light on the issue of compatibility of some of the measures adopted domestically by many countries across the world in response to the financial crisis with the rules of the GATS and, more specifically, those of the Annex on financial services.

Barbados asked the members of the CFTS whether the PCO should be reformed. In particular, the delegation expressed doubts as to the correct interpretation of the second part of the PCO. According to the delegate from Barbados the text of the provision could lead to an interpretation according to which all domestic measures incompatible with the GATS could be used as means to avoid a Member’s commitments or obligations. The CTFS discussed the issues raised by the document tabled by Barbados in a meeting held in April 2011.\textsuperscript{184}

Hong Kong, China was open to further discussion but firmly disagreed with Barbados about the interpretation of the second part of the PCO. Allowing for such an interpretation –in the view of the Hong Kong delegation- would render the PCO useless.\textsuperscript{185} Interestingly, the strongest opposition to the proposal to discuss the issues concerning domestic prudential measures came from developed countries. The representatives of the EU\textsuperscript{186}, Norway\textsuperscript{187}, the US\textsuperscript{188}, Canada\textsuperscript{189} and

\textsuperscript{183} WTO Doc. JOB/SERV/38, 'Committee on Trade in Financial Services - Communication from Barbados: "Unintended Consequences of Remedial Measures Taken to Correct the Global Financial Crisis: Possible Implications for WTO Compliance", 18 February 2011'.
\textsuperscript{184} WTO Doc. S/FIN/M/67, 'Committee on Trade in Financial Services - Report of the Meeting Held on 9 March 2011'.
\textsuperscript{185} Ibid., paras. 17 – 19.
\textsuperscript{186} Ibid., para. 21.
\textsuperscript{187} Ibid., para. 27.
\textsuperscript{188} Ibid., para. 28.
\textsuperscript{189} Ibid., para. 30.
Japan\textsuperscript{190} expressly stated that there had already been enough discussion and that it was necessary to keep the provision as broad as it was in order to allow WTO Members to adopt domestic measures and that a discussion on the potential reform of the PCOs was outside the mandate of the Doha Development Round.

The Korean delegation took a more nuanced stance, suggesting inviting the FSB to brief the CTFS on the latest developments on the issue.\textsuperscript{191} In contrast, Turkey\textsuperscript{192} and Argentina\textsuperscript{193} instead, were eager to discuss the issue further whereas Brazil,\textsuperscript{194} backed by China,\textsuperscript{195} warned that the wording of the PCO was unclear and countries feel uncomfortable when addressing the spread of financial crises. India took a more sceptical stance on the PCO due to the fact that in its view a broad interpretation of the provision may cover some measures that, in the medium term, could lead to situations of protectionism and moral hazard.\textsuperscript{196} Members also discussed the issue at other meetings but, given the significant opposition from developed countries, no concrete steps followed.

2.7.3.5 Ecuador: ‘Proposal for discussing progress in respect of macroprudential regulation and its relationship with GATS rules’.

In late June 2012, Ecuador submitted a communication to the CTFS in order to stimulate a discussion on the compatibility of some of the domestic measures adopted in various countries of the world in order to address the economic crisis.\textsuperscript{197} This communication followed the aforementioned debate and the refusal by most developed countries to hold a comprehensive discussion on financial services trade and the economic crisis. However the issue was a source of significant concern for the Ecuadorian delegation and they decided to insist before the CTFS. Ecuador succeeded in attracting support from associations and trade unions and as a result

\textsuperscript{190} Ibid., para. 32.
\textsuperscript{191} Ibid., para. 22.
\textsuperscript{192} Ibid., para. 23.
\textsuperscript{193} Ibid., para. 29.
\textsuperscript{194} Ibid., para. 31.
\textsuperscript{195} Ibid., para. 33.
\textsuperscript{196} Ibid., para. 24.
\textsuperscript{197} WTO Doc. S/FIN/W/84, Committee on Trade in Financial Services - Communication from Ecuador: "Proposal for Discussing Progress in Respect of Macro-Prudential Regulation and Its Relationship with GATS Rules", 26 June 2012.
interest in the issue increased outside the institutional context. The main aim for Ecuador was to ensure that all WTO Members had as much regulatory freedom as they needed to address macro-prudential concerns without risking their regulations been outlawed by WTO judges. In particular Ecuador asked to discuss whether measures for capital control were covered by the PCO, given that other international organisations had softened their positions on similar instruments.

The WTO CTFS held a meeting on 20 March 2013 during which Members debated the basis of the request made by Ecuador. Actually, the topic of the discussion was a bit broader, since it encompassed Members’ experience at large with macro-prudential policies. The aim of the meeting was that of allowing WTO delegations to exchange their experiences and views on the subject in an informal manner. There was no desire to proceed to an interpretation of the GATS rules or an elaboration of an exhaustive list of measures adopted in the domain of financial services in pursuance of macroprudential policy objectives.

Members discussed the policy options adopted in the aftermath of the 2008 financial crisis. The discussion is instructive in the sense that the reader of the minutes can look at how, despite the commonalities and the reference to international regulatory standards, the ideas concerning macroprudential instruments vary substantially from one country to the other.

Interestingly, some delegations took the floor to address the issue of the interplay between domestic rules on prudential measures and the GATS PCO. The Japanese delegate recalled his view on the provision:

He further said that the GATS Annex on Financial Services provided each country with the right to take measures for prudential reasons. On the other hand, the Annex also stated that

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198 114 associations and networks from all over the world signed a “Statement in support of Ecuador’s Proposal at the October Committee on Trade in Financial Services Meeting”. The text of the statement is available here: http://www.citizen.org/documents/sign-on-statement-in-support-of-ecuador.pdf (last accessed on 8 September 2015).

199 WTO Doc. S/FIN/M/76, 'Committee on Trade in Financial Services - Report of the Meeting Held on 20 March 2013'.

200 Ibid.
the measures should not be used as a means of avoiding the Member’s commitments or obligations under the GATS. This might be interpreted that, when taking prudential measures, Members should take care not to obscure the real purpose of WTO agreements, which was to achieve economic growth through vigorous trade.

A different issue was raised by the delegation of Korea. The representative acknowledged the high degree of flexibility provided by the PCO with regard to *ex ante* macroprudential tools. However, he expressed concerns about the extent to which *ex post* (mainly crisis-management tools) were covered by the carve-out and as such he encouraged the Committee to consider a discussion on the topic.

The last delegation to take part to the discussion on the PCO was the United States. The US representative, after briefly recalling the major changes in financial regulation in his country after the 2008 financial crisis, stated:

> The macro-prudential measures taken by the US were non-discriminatory in nature and consistent with its GATS obligations. In the US experience, the GATS had not presented a constraint on its ability to adopt macro-prudential measures in order to address systemic risks.

### 2.8 Interim conclusions - *Quieta non movere*

The last subsection of the present chapter shows the reluctance of the Members of the WTO to renegotiate the terms of the delicate compromise they agreed with the signature of the Annex on Financial Services of the GATS. Although to date not one Panel has ever been called to evaluate the consistency of a domestic measure in light of the PCO the dramatic evolution of national

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201 Ibid., para. 1.83.
202 Ibid., para. 1.88.
legislation following the 2007/2008 financial crisis may modify the situation and open the door to the first WTO cases. Such an event may find the interpreters unprepared given the lack of case law and the relatively scarce literature on the topic.

Moreover, a closer look at the negotiating history of the PCO together with the debate that is taking place within the CTFS shows that it can be hard to reconcile what Members agreed upon and still think of when they talk about the PCO and the way scholars have so far interpreted the latter. In particular, the negotiating history and the rationale of the provision do not straightforwardly lead to a classification of the PCO as an “exception”. The text of the provision itself – starting from the heading “Domestic Regulation” - should caution against straightforward conclusions when it comes to its interpretation.

The issue of the classification and the legal function performed by a provision of an international agreement is not a mere academic quandary. Grando reports how WTO case law has operated a distinction between specific rules that allow Members to be exempted from compliance with more generic rules. The author summarises this distinction by putting these provisions into two categories: “exceptions” and “provisions that exclude the application of other provisions”. In the case of exceptions the complainant in a dispute carries the burden of showing that a general rule has been violated and the respondent must demonstrate that it has complied with the requirements set forth in the defensive provision (a typical example of provisions belonging to this category can be found in Article XX of the GATT 1994 and Article XIV of the GATS). In the second case, to use Grando’s words:

(...) [T]he complainant has the burden of proving that the defendant does not fall under the situation or has not complied with the requirements of a provision which excludes the application of the general rule. If the complainant successfully discharges its burden of proof with respect to the excluding provision, it may then seek to establish a violation of the general rule (Emphasis in the original).

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203 Grando, Evidence, Proof and Fact-Finding in WTO Dispute Settlement (p. 152).
204 Ibid.
Such a distinction has huge implications with regard to the allocation of the burden of proof in the event of a dispute. Moreover, it also has an impact with regard to the degree of deference that WTO judges must pay to the regulating Members.

The mainstream understanding of the PCO is hard to reconcile with the negotiating history and the rationale for prudential regulation as well as the rationale behind the provision itself. As such this thesis seeks to advance, following an analysis of trends and evolution of trade negotiation on PCOs at the preferential level, a new approach which is more appropriate.
Chapter 3 - The preferential track

3.1 Preferential Trade Agreements under Article V of the GATS

Article V of the GATS (Economic Integration) allows WTO Members to negotiate and take part in agreements with their trading partners with the aim of further liberalising trade in services between them on the basis of more favourable conditions compared to those set out in the context of the WTO. Similar to the corresponding provision in the GATT 1994 – Article XXIV – Article V of the GATS imposes some conditions for WTO Members for the Preferential Trade Agreements (PTAs) to be compatible with the WTO. Essentially the conditions imposed upon trading nations are the following: (i) the agreement must have “substantial sectoral coverage” and (ii) the agreement must eliminate “substantially all discrimination” between the parties.

Both requisites are vaguely drafted as the text of the provision does not provide clarifications. In addition to the “substantial sectoral coverage” condition Footnote 1 of Article V of the GATS adds that:

> This condition is understood in terms of number of sectors, volume of trade affected and modes of supply. In order to meet this condition, agreements should not provide for the a priori exclusion of any mode of supply.

As such, as long as a PTA does not exclude from its coverage one specific mode of supply the first condition is satisfied. However the footnote leaves the interpreter with a higher number of vague concepts that are not any more clearly specified. For instance, we do not know the percentage of the volume of trade in services that must be affected in order for the condition to be satisfied.

With regard to the requirement to eliminate “substantially all discrimination” paragraph 1 of Article V of the GATS adds that Members should address it through the elimination of previously

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205 It should also be recalled that never the WTO judiciary has been called to interpret Article V of the GATS, therefore one cannot rely on case law in the quest for an explanation.
existing discriminatory measures and they should abstain from introducing new ones. In sum, it is a “standstill provision”.

Typically, recent PTAs contain disciplines for the regulation of both trade in goods and services. Interestingly, if one looks at the notifications of PTAs under Article V of the GATS together with those under Article XXIV of the GATT 1994 one finds that each and every Member of the WTO has in place at least one PTA with a trading partner. This explains why the WTO judiciary has not stepped in to clarify the vague conditions for the setting up of PTAs in the sense that Members probably do not have the incentive to challenge each other’s agreements for fear of cross complaints.206

Mavroidis has advanced some explanations with regard to the lack of disputes in the WTO system relating to the consistency of PTAs with the multilateral trading system.207 Of the reasons proposed by the author one of the most significant is that the various agents in the system may be risk-averse. For instance panellists, who are normally diplomats or trade delegates in the Geneva missions of other WTO Members, may not want to limit the possibilities for their country’s future preferential trade policy unless the evidence is clear. Furthermore, WTO litigation may be costly and not all WTO Members may have the capacity to bear the costs. It should also be always borne in mind that trade is part and parcel of international relations and consequently we cannot exclude the possibility that PTAs are not challenged because of concessions made on other squares of the international chessboard (for instance, at the United Nations).

206 Panels seldom dealt with the consistency of PTAs with the requirements set out in Article XXIV of the GATT 1994 (never Article V of the GATS was the benchmark for a judgment). In the GATT years, two non-adopted panel reports did so: GATT Panel Report, European Community – Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region, L/5776, 7 February 1985, unadopted (EC-Citrus); GATT Panel Report, EEC – Import Regime for Bananas, DS38/R, 11 February 1994, unadopted (EEC-Bananas II). There is only one genuine case dealing with the issue under analysis: Appellate Body Report, Turkey – Restrictions on Imports of Textile and Clothing Products, WT/DS34/AB/R, adopted 19 November 1999, DSR 1999:VI, 2345 (Turkey-Textiles). In the latter case, the Appellate Body (paras. 42-63) found that the adoption of quantitative restrictions were not necessary for the formation of a customs union between Turkey and the European Union, hence such violations were not justified under Article XXIV of the GATT 1994.

207 Petros C. Mavroidis, 'If I Don’t Do It, Somebody Else Will (or Won’t)', Journal of World Trade, 40/1 (2006), 187-214.
Finally, one other piece of information must be added to this discussion. On December 2006, the General Council of the WTO adopted a decision on the "Transparency Mechanism for Regional Trade Agreements". This new transparency mechanism has de facto substituted the review mechanism for PTAs in the WTO Committee on Regional Trade Agreements (CRTA). The new rules require signatories to PTAs to notify them after which other WTO Members may ask questions of the latter and the relevant responses will be circulated at least three days before the meeting of the CRTA (a written record of the questions and answers will be kept at the WTO Secretariat and uploaded on the Regional Trade Agreements Database of the WTO website). This new system has the potential to enhance the transparency with regard to PTAs in a world in which WTO Members may have more disincentives than incentives to challenge the WTO consistency of PTAs.

3.1.1 PTAs in services: Are they really an ‘exception’?

PTAs were originally thought of as exception to the multilateral disciplines governing trade in services. However, over the years PTAs have become the norm in the context of international trade. Moreover the 2011 World Trade Report, the annual publication prepared by the Economic Research Division of the WTO, shows a constant increase of intra-PTA trade over the years.

During the twenty years that have passed since the entry into force of the WTO (1 January 1995), the number of PTAs notified to the WTO Secretariat under Article V GATS has constantly increased, reaching the impressive number of 122 agreements as of December 2014.

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208 WTO Doc. WT/L/671, 18 December 2006.
209 Available at the following website: http://rtais.wto.org (last accessed on 8 September 2015).
210 "We find that the dollar value of trade between members of preferential trade agreements has indeed grown faster than the world average since 1990, and as a result the share of intra-PTA trade in world trade has increased from 18 per cent in 1990 to 35 per cent in 2008." See World Trade Organization, World Trade Report 2011 - the WTO and Preferential Trade Agreements: From Co-Existence to Coherence (Geneva: WTO, 2011) (p. 64).
211 The European Union and its subsequent enlargements, notified to the WTO Secretariat under Article V of the GATS, are not comprised in these figures. The EU, in fact, is a sui generis organisation, much different from traditional PTAs. Rather than just addressing barriers to trade, it aims to create a single market. Balassa, in 1961, pointed to different stages of economic integration, with PTAs and CUs being the shallowest and a complete economic integration being, on the contrary the strongest. See Bela Balassa, 'The Theory of Economic Integration (Homewood, Illinois: Richard D. Irwin Inc., 1961). More recently, André Sapir, on the occasion of the 50th anniversary of Balassa’s seminal work, published an interesting review essay. See André Sapir, 'European Integration at the Crossroads: A
This graphic suggests a trend that led to a boom in the number of notifications after the year 2000 and that continues today. Moreover these numbers provide for a key to understanding the developments in the context of international trade in services.

The GATS was conceived of as an “incomplete” agreement. Several provisions of the main agreement make explicit reference to future negotiations on delicate issues such as subsidies and domestic regulations to name only two. Moreover, services were a key ingredient in the negotiating recipe of the talks launched in Doha in 2001 for the first multilateral round of negotiations to take place within the realm of the young multilateral organisation governing

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international trade. The promise of progressive liberalisation under the GATS, however, was soon broken or, at least, ran into more difficulties than previously expected at the time of the agreement. After a first stage in which preferential agreements mainly took place on a regional basis (that is, between neighbouring countries) at the turn of the new century the system experienced a boom in such agreements as shown by the record of notifications.

Without the ambition of being exhaustive, it is interesting to attempt to highlight the possible explanations for this phenomenon. There is robust literature with regard to the rationale for the signing of PTAs in general. Research dealing specifically with services PTAs is slightly less popular, yet some efforts have been made in order to explain why countries sign such agreements.

Various factors contribute towards explaining the constant increase in the number of notifications of PTAs. First of all, quantitative studies demonstrate that, on average, Members did not commit to open up their markets to foreign services and foreign service suppliers to any significant extent more than prior to the entry into force of the GATS. Second, since the market for services is traditionally a highly regulated one, it can be more natural to open markets for trade on a bilateral basis vis-à-vis commercial partners with a comparable level of regulation as opposed to grant National Treatment and Market Access to all other WTO Members in the scheduled sectors. Third, services are only one part – although a highly relevant part - of the commercial balance of a country. A trading nation might therefore find itself in the position to make concessions in the services sectors in order to have more favourable conditions in the

212 See Doha WTO Ministerial Declaration, WTO Doc. WT/MIN(01)/DEC/1, adopted on 14 November 2001, para. 15: “The negotiations on trade in services shall be conducted with a view to promoting the economic growth of all trading partners and the development of developing and least-developed countries. We recognize the work already undertaken in the negotiations, initiated in January 2000 under Article XIX of the General Agreement on Trade in Services, and the large number of proposals submitted by members on a wide range of sectors and several horizontal issues, as well as on movement of natural persons. We reaffirm the Guidelines and Procedures for the Negotiations adopted by the Council for Trade in Services on 28 March 2001 as the basis for continuing the negotiations, with a view to achieving the objectives of the General Agreement on Trade in Services, as stipulated in the Preamble, Article IV and Article XIX of that Agreement. Participants shall submit initial requests for specific commitments by 30 June 2002 and initial offers by 31 March 2003.”

213 For an overview of the debate on the economic rationales for PTAs, see Petros C. Mavroidis, Trade in Goods (2 edn., Oxford: OUP, 2012) (pp. 194 and ff.).

market for goods or vice versa. Since PTAs tend to be “comprehensive”, to use a term very much in vogue, and this can indeed contribute towards explaining the current situation.

There are gains from trade and incentives to enhance the possibilities of cross-border trade in financial services. However ‘trust’ plays an important role and cultural similarities may contribute towards explaining why countries that share linguistic or historical roots are more eager to negotiate trade agreements with each other.\textsuperscript{215} As a consequence it is not surprising that Members are more willing to make more concessions to commercial partners they deem more trustworthy, on a bilateral basis, rather than expanding the scope of their multilateral commitments.

Additionally, there are of course idiosyncratic approaches. The European Union, in particular, does not negotiate PTAs solely in order to increase opportunities for trade for its producers and to lower the prices and requirements for the import of goods and services in its domestic market. The 2014 agreement with Ukraine (as well as others) was clearly not concluded solely for commercial purposes but was also conceived as a tool for the pursuit of political and strategic objectives in the region. On a similar note, it is fair to say that Mexico joined the negotiations of the North American Free Trade Agreement (NAFTA) not only for economic reasons but also as a means to signal to the rest of the world that it was able to sit at the same table with the traditionally more stable North-American partners. On the contrary, political reasons may also explain why countries do not negotiate trade agreements with others. For example the People’s Republic of China does not conclude agreements with governments who recognise Taiwan.

3.1.2 Financial services in PTAs

In Chapter 2 we saw how financial services have been both a driver for the launch of the talks for a multilateral agreement on trade in services as well as a source of political conflict both within

\textsuperscript{215} On this notion see Luigi Guiso, Paola Sapienza, and Luigi Zingales, ‘Cultural Biases in Economic Exchange?’, \textit{The Quarterly Journal of Economics}, 124/3 (2009), 1095-131. For an application of this concept to the domain of trade in services, see Juan A. Marchetti and Petros C Mavroidis, ‘I Now Recognize You (and Only You) as Equal: An Anatomy of (Mutual) Recognition Agreements in the GATS’.
domestic jurisdictions (due to conflicts of competences between trade officials on one side and treasury and central banks representatives on the other) as well as between negotiating teams due to the fact that not all countries that were participating to the Uruguay Round talks were willing or ready to open up their markets for financial services.

Although it is impossible to provide a suitable explanation for all the PTAs in services as to the inclusion (or the exclusion) of disciplines on financial services, it is perhaps useful to provide some figures and to identify some recurring patterns. Out of the 122 PTAs notified under Article V of the GATS until September 2014, 27 do not set out disciplines on financial services, nine incorporate the GATS rules on financial services and 86 provide for a specific chapter or annex on financial services.

TABLE 3.2: Chapters on financial services in PTAs (Elaboration on data from WTO RTA Database)

<table>
<thead>
<tr>
<th></th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>NO FS</td>
<td>27</td>
</tr>
<tr>
<td>Reference to GATS rules</td>
<td>9</td>
</tr>
<tr>
<td>YES FS</td>
<td>86</td>
</tr>
</tbody>
</table>

These numbers can be expressed in percentages, leading to the following figures: 70.49% of the notified PTAs contain specific disciplines on financial services, 7.37% make reference to the existing discipline in the GATS and 22.13% of the agreements do not cover financial services.

Given that the overwhelming majority of the PTAs provide for specific disciplines on financial services it may be worth understanding the reasons why trading nations decide to liberalise trade in financial services at the preferential level (at an arguably deeper level than the GATS,
although various studies suggest that this is not always the case). Stephanou cites several reasons that governments may have for the inclusion of specific disciplines on financial services in PTAs. We will borrow them as a starting point of our analysis.

i) “[T]he existence of offensive interests in this sector and of asymmetric bargaining powers between the negotiating counterparts”: Typically, it is in the interest of the more developed party in the negotiation to secure market access for its domestic suppliers of financial services in the counterpart’s jurisdiction. Sometimes the issue of financial services is used as a powerful negotiating chip: either financial services are part of the negotiating package or no agreement will see the light of the day. However, liberalisation of trade in financial services may (in theory as well as in practical terms) also be in the interest of less advanced parties to the negotiations, as it can serve as a tool to import technology and knowhow.

ii) Trade agreements as a tool to ‘lock in’ unilateral concessions or to advance the government’s agenda: Among the theories that contribute towards explaining why governments sign trade agreements the so-called “commitment theory” is one of the most popular. Essentially, the theory explains why governments may want to use the excuse of an international trade agreement in order to deter domestic pressure from lobbies and to lock in their trade liberalisation agenda. However, it must be borne in mind that various scholars and commentators have expressed scepticism with regard to this explanation for trade agreements. For instance Mavroidis argues that commitment theory is more relevant in the attempt to explain why trading nations may be in favour of the building up of legal institutions such as the WTO or the NAFTA. Moreover, for some trading nations, further liberalisation of financial services may be the price to pay to enter such clubs.

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216 Marchetti, for instance, writes: "Not all bilateral commitments match the level of ambitions espoused by the plurilateral request on financial services mad pursuant to the Hong Kong Ministerial Declaration". See Marchetti, 'Financial Services Liberalization in the WTO and PTAs' (p. 332).


218 For an application of this theory to PTAs, see Kyle Bagwell and Robert W. Staiger, The Economics of the World Trading System (Cambridge, MA: MIT Press, 2002) (pp. 121-122).

219 Srinivasan, in particular, is not persuaded that “commitment theory” provides a reasonable justification for trade agreements, because it explains he considers the link between a domestic distortion and an international commitment in order to address it a weak one. See Thirukodikaval N. Srinivasan, 'Nondiscrimination in GATT/WTO: Was There Anything to Begin with and Is There Anything Left?', World Trade Review, 4/01 (2005), 69-95.

220 Mavroidis, Trade in Goods (pp. 16 and ff.).
iii) Strategic or political reasons: There can be also explanations which do not fully pertain to the domain of economics. A trading nation may embark in the negotiations of agreements on financial services because of the will to prove that it is a solid economy, and therefore considers it important for its reputation to be linked in international agreements on trade in financial services with wealthy partners or for other political considerations that one cannot foresee.

These reasons can contribute to a fair approximation of what can be the reasons for a trading nation to sign a trade agreement containing disciplines on financial services. However, it is important to stress that the explanation provided is not satisfactory as it is exposed to many counterarguments and critiques.

Three more considerations, however, may assist those in search of a meaning for trade agreements on financial services. First of all, one explanation derives directly from the text of Article V of the GATS. The provision, as we saw before, requires PTAs to have substantial sectoral coverage without clarifying the depth of the commitments that Members have to agree on in order for such agreements to be in compliance with WTO law. Therefore the introduction of specific disciplines on trade in financial services does not mean much in and of itself since they have to be read together with what was inserted in the schedules of specific commitments. From a “black letter law” perspective Members have a strong incentive to include financial services in their PTAs, irrespective of the depth of the commitments they are willing or able to make.

However, commitments on financial services under the GATS have not gone much deeper than the pre-existing practice. In particular, those commitments were meaningful in some areas (particularly with regards to Mode 3 trade) but not so much in other fields. Consequently Members may find it attractive to pursue a more proactive trade policy agenda at the bilateral or regional level.221

Third, despite the deregulation that took place in the banking sector in the nineties and that, together with other factors, played a role in causing the 2007/2008 financial crisis, financial

221 See Marchetti, 'Financial Services Liberalization in the WTO and PTAs' (p. 317).
services still remain a heavily regulated market and are undergoing a process of “re-regulation”, as shown in the previous Chapter.

### 3.2 Prudential carve-outs in PTAs

Out of the 86 PTAs that contain disciplines on financial services, 82 contain a prudential carve-out or specific provisions dealing with prudential measures in financial services. This means that 95.34% of the PTAs on financial services have a prudential carve-out or a similar provision, a figure that is revealing of the importance of the matter in and of itself.

#### TABLE 3.3: Prudential Carve-outs in PTAs (*Elaboration on data from WTO RTA Database*)

<table>
<thead>
<tr>
<th>PCO</th>
<th>No PCO</th>
</tr>
</thead>
<tbody>
<tr>
<td>82</td>
<td>4</td>
</tr>
</tbody>
</table>

The only four PTAs without a PCO are the European Economic Area (EEA), China – Hong Kong, China, China – Macao, China and Iceland – Faroe Islands. An intuitive explanation for the absence of PCOs in the latter four agreements probably lies in their depth. The EEA concerns the expansion of the EU single market to the European Free Trade Association (EFTA) countries. It is a case in which the domestic law of a country is made applicable to the preferential trading

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222 The European Economic Area is an international agreement, entered into force on 1 January 1994 that constitutes a single market between the Member States of the European Union and the Members of the EFTA.
partners. This may also explain the lack of PCOs in two agreements that involve China and two of its “satellite-States” and the agreement between Iceland and Faroe Islands. There is no official explanation or existing literature to date which could help in clarifying this issue.

An analysis of the PCOs in all PTAs in services notified to the WTO Secretariat allows us identify recurring patterns and to check the state of play of the issue in post-Uruguay Round trade negotiations. Before looking into the figures, some clarifications must be made with regard to the methodology applied and the choice of the categories.

### 3.2.1 The methodology applied for the elaboration of data on PCOs

In order to proceed with a taxonomy of PCOs in PTAs, it is necessary to clarify the distinctive patterns that allow differentiation between the different versions of the provision at the preferential level, for the sake of the present work. Eight elements were considered in the present study.

1) **Scope of application.** PCOs are classified according to their scope of application. Four different options are considered: “Agreement”, when the PCO applies notwithstanding any other obligation under the whole treaty under examination; “Part”, when the PCO only refers to the articles of the chapter or the annex on financial services; “Various chapters”, when it applies to the provisions of the chapter or annex on financial services as well as other selected chapters dealing with trade in services or investment but not the whole agreement; “Not specified”, when the wording of the provision does not shed light on the issue. This element, however, should not be overestimated. The disciplines set up in Chapters or Annexes on financial services only kick in when there is trade in financial services, according to the services and service suppliers traded under one of the modes covered by the agreement at issue.

2) **Content.** Two main ways are identified in which PTAs deal with the coverage of their PCOs. Most of them apply the technique of the non-exhaustive list of prudential objectives, familiar with the prototype that can be found in the GATS Annex on Financial Services. They can mostly be
divided into two main families: those which follow a list of two groups of measures, similar to the text of Paragraph 2 of the Annex on Financial Services of the GATS (“the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier” and “to ensure the integrity and the stability of the financial system as a whole”); and those which follow a list of three groups of measures, the main example in this regard being Article 1410 of the NAFTA (“(a) The protection of investors, depositors, financial market participants, policyholders, policy claimants, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service provider; (b) the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers; and (c) ensuring the integrity and stability of a party's financial system”). This work has also identified outliers with regard to this feature – namely PCOs that merely refer to “prudential measures” without providing with an indicative list. However, the fact that they are limited in number makes it unnecessary to classify them as a category in their own right. Also in this case, differences among the various PCOs should not be emphasised, as lists of prudential reasons are typically non-exhaustive.

The following six elements are more important since they actually amount to requisites that Parties to the agreements have to meet in order to avail themselves of the PCO.

3) *Reasonableness*. PCOs are subdivided according to whether they require measures adopted for prudential purposes to be “reasonable”. This requisite first appeared in Article 1410 of the NAFTA and characterises the category drafted around the North-American agreement. In this respect this study distinguishes between those PCOs which contain a “reasonableness test” and those which do not.

4) *Necessity test*. Necessity tests are common in international economic law, in the domains of both trade and investment. Essentially they require Members to enact measures that are “no more burdensome than necessary” to achieve the stated aim. The requirement, in the WTO legal system, is typical of some of the exceptions listed in Article XX of the GATT 1994 or Article XIV of the GATS. In particular, Article XIV of the GATS requires that, when a violation of the Agreement occurs, Members wishing to invoke the exceptions for the protection of public morals or public
order (let. (a)), the protection of human, animal or plant life or health (let. (b)), the securement of the compliance with laws or regulations which are not inconsistent with the GATS (let. (c)), have to prove that the measures under scrutiny were the least trade restrictive among the available alternatives. It is therefore a test that contributes to determining the legal function of the PCO. This study distinguishes between those PCOs which have a “necessity test” and those which do not.

5) **National Treatment.** National Treatment is one of the two variations of the principle of non-discrimination in international trade law (the other being Most-Favoured Nation). It requires the regulating Member to accord foreign services or foreign service suppliers treatment no less favourable than that granted to like services and service suppliers of national origin. In the case of PCOs in PTAs the concept of National Treatment is used to refer to those provisions that require Members to provide similar treatment to like domestic and foreign services and service suppliers with regard to measures adopted for prudential reasons. This work makes a distinction between PCOs that include a National Treatment clause and those which do not.

6) **“Chapeau” language.** Many commentators have drawn a parallel between the final clause of Paragraph 2(a) of the Annex on Financial Services of the GATS and the language of the chapeau of the general exceptions provisions of the GATT 1994 and the GATS. The chapeau of Article XIV of the GATS reads as follows:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures (...)

This study verifies whether similar language is contained in PCOs and to what extent this is a recurring feature in provisions for prudential measures in PTAs.

7) **GATS PCO Final clause.** Another feature for the differentiation of PCOs is whether they provide language similar (or identical) to that adopted in the final clause of the PCO (“Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means
of avoiding the Member’s commitments or obligations under the Agreement”). As ambiguous and vague it may be it is nonetheless a recurring feature in PTAs. This is, *en passant*, also revealing of the importance that a coherent interpretation of the provision in the WTO may have also outside the jurisdiction of the latter. The present study analyses whether a similar clause is provided by preferential PCOs.

8) *Standards*. The present study verifies how many PCOs refer to internationally agreed standards as benchmarks for the lawfulness of prudential measures. Moreover, it identifies the standard setting bodies to which the PCOs refer.

Finally, the study classifies PCOs according to the legal function that their respective treaties assign to them. In this respect, PCOs are classified as: “Exceptions” if they are drafted in a way similar to the relevant exceptions in international trade treaties (in other words if they include a necessity test, a national treatment requirement or language similar to that of the *chapeau* of the General Exceptions provisions in the GATT 1994 and the GATS); “Scope”, if they are meant to be “provisions that exclude the application of other provisions” or “Unclear” if the language of the provision does not put the interpreter in the position of being able to understand what legal function the PCO performs.
3.2.2 The types

TABLE 3.4: Types of Prudential Carve-Outs in Preferential Trade Agreements (Elaboration on Data from the WTO RTA Database)

For the purpose of the present work, five different categories of PCOs were identified plus a residual family called “other”. In order to come up with robust results it was decided to consider those PCOs whose distinctive patterns could be identified in more than two agreements as a category. The different categories that were identified are the following: GATS-like, NAFTA-like, EFTA third parties-like, US-post2004 and EU 2014.

3.2.2.1 GATS-like

The first and most popular category of PCOs is that which follows the pattern of Paragraph 2(a) of the Annex on Financial Services of the GATS. We report it again here in order to make the reading easier:

2. Domestic Regulation
Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement.

The PCOs that fall under this category are those provided by the following agreements:

Southern Common Market (MERCOSUR); New Zealand – Singapore; EU - Former Yugoslav Republic of Macedonia; Japan – Singapore; EU – Chile; Thailand – Australia; Thailand - New Zealand; India – Singapore; Korea - Republic of Singapore; Japan – Malaysia; EU – Albania; Chile – Japan; EU – Montenegro; Pakistan – Malaysia; Japan – Indonesia; Brunei Darussalam – Japan; China - New Zealand; Japan – Philippines; Japan – Switzerland; Japan – Vietnam; Korea - India; EU - Serbia; New Zealand – Malaysia; Hong Kong, China - New Zealand; India – Japan; Japan – Peru; EU - Central America; Hong Kong, China – Chile; Eurasian Economic Union.

There are variations on the theme but these affect other residual aspects that do not alter the structure of the PCOs and allow us to consider all of them as part of the same category.

Contrary to the what is provided under the corresponding provision in the Annex on Financial Services of the GATS, some preferential PCOs do not refer to “any other provisions of the Agreement” but limit their coverage either to the Chapter, Annex or Protocol on financial services223 or to various chapters disciplining trade in services.224

MERCOSUR, EU-Chile and Hong Kong, China - Chile, for instance, include a “reasonableness test” in the relevant provision. In the absence of a more stringent requirement than this, the efficacy of this clause is only limited to the duty of the regulating Member to prove, in the event of a dispute,

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223 MERCOSUR, Japan – Singapore, EU – Chile, Japan – Malaysia, Pakistan – Malaysia, Japan – Indonesia, Brunei Darussalam – Japan, China - New Zealand, Japan – Philippines, Japan – Switzerland, Japan – Vietnam.

224 Chile – Japan, India – Japan, Japan – Peru.
whether a “genuine link” is established between the domestic measure and the prudential objective it aims to pursue.

The PCO in the Japan – Switzerland PTA, in contest, contains a reference to internationally agreed standards, contrary to the original provision of the GATS that, as explained in the previous Chapter, does not do so. Paragraph 2 of Article VI (*Domestic Regulation*) of the Annex on Financial Services of the agreement mentioned above provides:

2. Each Party shall make its best endeavours to ensure that the Basel Committee’s “Core Principles for Effective Banking Supervision”, the standards and principles of the International Association of Insurance Supervisors and the International Organisation of Securities Commissions’ “Objectives and Principles of Securities Regulation” are implemented and applied in its Area.

The language is hortatory rather than dispositive and – although in the same Article as the PCO – it is not in and of itself a condition for lawfulness of prudential measures under the bilateral trade agreement. However, its inclusion in Article VI confers upon the paragraph at issue at least the value of “context” in the interpretation of the provision. A deviation from standards when enacting prudential measures does not amount to a violation of Article VI. However, standards may constitute a useful benchmark for the allocation of the burden of proof in the event of a dispute: there must be a presumption of lawfulness of measures adopted following the recommendations of BCBS, IAIS and IOSCO and then, in case the regulating Member wants to move to a higher level of protection than that under the standards previously mentioned, it must show why its choice is still prudential and not protectionist.

There is also another requirement according to which three outliers were identified although they were nevertheless classified as “GATS-like” because the intrinsic structure of the provision was not altered. The PCOs in the EU – Chile, the EU – Central America and the Hong Kong, China - Chile FTAs contain an indicative list of three groups of prudential purposes according to which Members are free to regulate notwithstanding their obligations or commitments. Contrary to the wording of the prototypical provision in the GATS, Article 125 (*Prudential Carve out*) of the FTA
between EU and Chile and Article 195 (*Prudential Carve out*) of the EU-Central America FTA read, in the relevant part, as follows:

(a) the protection of investors, depositors, financial market participants, policy-holders, or persons to whom a fiduciary duty is owed by a financial services supplier;
(b) the maintenance of the safety, soundness, integrity or financial responsibility of financial services suppliers; and
(c) ensuring the integrity and stability of a Party’s financial system.

This language is the same as that adopted in the PCO under the chapter on financial services of NAFTA. However, since both provisions provide a final clause whose content is along the lines of the last provision of the PCO in the Annex on Financial Services of the GATS, the two PCOs mentioned above are nevertheless considered to be part of the “GATS-like” category.

The provisions falling under this category are typically drafted as “provisions that exclude the application of other provisions” rather than exceptions. None of them includes one of the three limitations the occurrence of which would lead this study to confer upon the PCO the status of exception (namely: a Necessity Test, National Treatment or Chapeau language).

### 3.2.2.2 NAFTA-like

Another category of PCO is that which first appeared in Paragraph 1 of Article 1410 (Exceptions) of the North American Free Trade Agreement. It reads as follows:

**Article 1410: Exceptions**

1. Nothing in this Part shall be construed to prevent a Party from adopting or maintaining reasonable measures for prudential reasons, such as:
(a) the protection of investors, depositors, financial market participants, policyholders, policy claimants, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service provider;
(b) the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers; and
(c) ensuring the integrity and stability of a Party's financial system.

This type of PCO appears in nine FTAs:

North American Free Trade Agreement (NAFTA); Colombia – Mexico; Panama - El Salvador (Panama - Central America); Panama - Chinese Taipei; Panama - Costa Rica (Panama - Central America); Panama - Honduras (Panama - Central America); Panama - Guatemala (Panama - Central America); Panama - Nicaragua (Panama - Central America); Peru – Mexico.

The first distinctive feature that is worthy of note after the lengthy discussion of the GATS PCO in the previous Chapter is the absence of the ambiguous and circular final clause that is common to the category made famous by the WTO. The PCOs in this category typically apply the Chapters on financial services of their respective agreements ("Nothing in this Part (...)”).

There are also deviations from the original category in this case. In particular, seven of the PCOs belonging to the category under analysis do not provide a “reasonableness” requirement. With regard to coverage, almost all PCOs in the present category apply to the measures of the Chapter on Financial Services of the respective agreement, except for the PCO in Colombia – Mexico which refers to the whole Agreement and the PCO in Peru – Mexico which makes reference to various chapters on trade in services of the Agreement. Given the relative importance of these two features, that these are slight variations on the same theme and do not alter the meaning and function of the provision, it has been decided to list them in the NAFTA-like categories of PCOs anyway.

225 Panama - El Salvador (Panama - Central America), Panama - Chinese Taipei, Panama - Costa Rica (Panama - Central America), Panama - Honduras (Panama - Central America), Panama - Guatemala (Panama - Central America), Panama - Nicaragua (Panama - Central America), Peru – Mexico.
Given the importance of the NAFTA in the realm of preferential agreements, the interpreter of the provision has access to a series of studies and documents that may provide some clarification with regard to how the chapter on financial services was negotiated and what the initial positions were. Moreover, contrary to the rest of the provisions analysed in the present work, the NAFTA PCO was effectively invoked in a dispute. A caveat must be added here however: NAFTA documents and case law are only strictly relevant within NAFTA, and the conclusions drawn from the consultation of the latter should not be exported to other PTAs that, although following the patterns set up by the NAFTA, are obviously autonomous and independent from it.

**Negotiating History and Rationale**

According to Cameron and Tomlin there are three main factors that shaped the negotiations of the NAFTA: i) asymmetry of powers, ii) contrasting domestic institutions and iii) differences in the management alternatives.\(^{226}\) All three factors played a role in the negotiations of the chapter on financial services of the Agreements.

The first substantive proposals for the opening up of markets in financial services in the North Atlantic were put forward at the end of December of 1991 following pressure mainly from domestic industry in the United States. The negotiating teams in the domain of financial services were composed of officials from the Treasury Department for the United States and from the Finance Department for Canada. The negotiating team of Mexico consisted of officials from various branches of the government as well as from the central bank although it was led by a trade official.\(^{227}\)

Officially there were tensions at the beginning of these negotiations due to the fact that Mexico opposed any negotiation on financial services whereas the United States made it clear that in the absence of substantial liberalisation in that sector there would be no NAFTA at all. In reality, the Mexican negotiators were privately reassuring their counterparts, confirming that they were willing to proceed with unilateral liberalisation and that a trade agreement would have helped


\(^{227}\) Ibid., (p. 98).
them selling the change domestically more easily.\textsuperscript{228} There were also frictions between Canada and the United States due to the fact the former tried to push Washington to allow Canadian financial institutions to establish branches in the United States, which would have required the modification of the Glass-Steagall Act.\textsuperscript{229}

At the Dallas meeting in February positions moved towards convergence. Mexico had abandoned its fight for a permanent cap on foreign equity and accepted the principle of National Treatment. Canada and the United States had not reached a solution regarding the possibility of Canadian banks establishing branches in the territory of the United States.

In August of 1992 the seventh and final round for the negotiations took place at the Watergate complex in Washington D. C. By the time of the final round tensions had diminished. What was finally agreed on was the composition of the panels. Parties reached a deal according to which the provisions on dispute settlement would also apply to the domain of financial services but that the judges should be appointed from a roster of financial experts. This was due mainly to the resistance by the United States to have trade experts sitting on panels dealing with financial services issues.

\textit{Law}

The NAFTA approach towards financial services differs from that of the Annex on Financial Services of the GATS. The latter is characterised by the fact that it sets out a rule-based framework for the liberalisation of cross-border trade in financial services.\textsuperscript{230} On the other hand, the NAFTA Chapter on Financial Services focuses more on the way financial institutions are to be treated and has a less flexible structure, although it is “more comprehensive”.\textsuperscript{231}

\textsuperscript{228} Anecdotal evidence suggests that Mexico had just reprivatized its banks at the time of the negotiations of the Agreement.

\textsuperscript{229} Interestingly, the issue was already debated during the negotiations of the FTA between Canada and the United States. More detailed information on the negotiating positions can be found in Cameron and Tomlin, \textit{The Making of NAFTA - How the Deal Was Done} (p. 99).

\textsuperscript{230} Jeffrey Simser, 'Financial Services under NAFTA: A Starting Point', \textit{Banking & Finance Law Review}, 10 (1994-1995) (pp. 201 and ff.).

Various provisions of the Agreement deal with prudential measures and their interplay with trade rules in addition to the PCO account given above. Paragraphs 2, 3 and 4 of Article 1406 (*Most-Favored-Nation Treatment*) of the Agreement provide a discipline for the recognition by a Party of prudential measures of another Party (or even a non-Party). Such recognition can be accorded unilaterally, achieved through harmonisation or can be the subject of an agreement between the governments involved. The provision then requires that in case recognition occurs the Party that unilaterally accorded recognition must provide “adequate opportunity” to another Party requesting similar treatment to demonstrate it is in a comparable situation. *Mutatis mutandis* the same applies in the case a “latecomer” requires to join an already existent mutual recognition agreement.

Article 1407 (New Financial Services and Data Processing) sets out the requirements for the regulators in case suppliers of new financial services want to access their market. First of all, the provision contains an obligation for the Parties to allow access to the market to new financial services which are similar to those already authorised to circulate in the domestic jurisdiction. However, since financial service markets are typically heavily regulated at the domestic level, it is often the case that a financial service supplier needs an authorisation to operate in the market. In such a situation Article 1407 requires supervisory bodies to make a decision in a reasonable time and allows them to refuse authorisation only for “prudential reasons”.232

Article 1415 (Investment Disputes in Financial Services) provides for a filter mechanism with regard to investment disputes in which the prudential defence is invoked. If the Party that invokes the provision requires, the Tribunal shall refer the matter in writing to the Financial Services Committee for a decision and may not proceed while the decision is still pending before the latter. The Financial Services Committee is composed of State officials of the Parties of NAFTA which are domestically responsible for financial services.233 The Committee, in the event a claim under Article 1410 is referred to it, shall decide if the PCO is a valid defence against the claim brought about before the Tribunal. The decision issued by the Committee and transmitted to the

232 It is worth noting that prudential measures are only defined in Article 1410(1) by means of a non-exhaustive list, hence supervisory bodies still enjoy substantial autonomy in the authorizing processes.

233 The Committee is disciplined in Article 1412 (Financial Services Committee).
Tribunal is binding on the latter. In case the Committee does not issue its decision in 60 days, the complainant (be it the investor or the Party of the investor) can request the establishment of a specific arbitral panel, whose composition should follow the requirements set out in Article 1414.234 Again in this case the report issued by this arbitral tribunal shall be binding on the Tribunal before which the original dispute is pending. Where the Financial Services Committee has issued a decision in 60 days and a request for the establishment of a panel was not made in the ten following days the original Tribunal can proceed and decide on the matter.

**Standards**

The Chapter on Financial Services of NAFTA does not make reference to regulatory standards.235

**Case law**

In 2006 an Arbitral Tribunal236 constituted under Chapter Eleven of the NAFTA issued an award that, for the first and only time in history thus far, touched upon the NAFTA PCO, albeit only in an *obiter dictum*. Fireman’s Fund, a wholly owned subsidiary of Allianz America, a Delaware based corporation fully owned by Allianz AG of Munich, issued a complaint against Mexico in relation to expropriation of its property. The plaintiff also claimed that Mexico had aided national companies in purchasing debentures denominated in Mexican pesos and by doing so had discriminated against it. The award declared the issue of whether the measures were in line with the requirements of the NAFTA PCO moot because the tribunal had not found the challenged measures to constitute expropriation under the NAFTA.

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234 Like in the case of the GATS, the NAFTA provides for specific rules as regards the composition of the panels that are called to decide on issues related to trade in financial services. Article 1414 (*Dispute Settlement*). The Parties to the NAFTA must agree by consensus on a roster of maximum fifteen individuals. The individuals in the roster must be experts in financial services law or practice and be chosen on the basis of “objectivity, reliability and sound judgment”, besides meeting the conditions set out in Article 2009 (b) and (c), namely being independent and comply with the Code of Conduct established by the NAFTA Free Trade Commission.

235 Schefer affirms that international standards like those set up by the BCBS can be of relevance in the evaluation of whether measures adopted for prudential reasons are reasonable or not. However, the same author points out that standards are no *panacea* and that they have objective limits, therefore their role as benchmark in the event of a dispute cannot be pushed too far. See Nadakavukaren Schefer, *International Trade in Financial Services: The NAFTA Provisions* (pp. 232 and ff.).

236 Fireman’s Fund Insurance Company v Mexico, ICSID Case No. ARB(AF)/02/01, Award (17 July 2006).
The decision deals with the analysis of Article 1410(1) of the NAFTA in paragraphs 156 – 168. First of all the Tribunal qualifies the provision as “exception”, following the heading. However it does so in a non-technical fashion, in the sense that it only clarifies that the provision may kick in in order to justify domestic measures which, at first sight, may be considered in violation of other provisions of the Agreement.\footnote{Fireman’s Fund Insurance, para 159.} The Tribunal also dismissed the arguments of the complainant according to which were a measure to be found not to be reasonable it would give rise to a presumption of liability. Moreover, the Tribunal also did not accept the interpretation advanced by the plaintiff according to which a measure whose effects would amount to a discrimination between national and foreign service suppliers would not be considered reasonable according to Article 1410(1) of the NAFTA. Quoting a passage from the decision:

The Tribunal, noting that the exception applies to all provisions of Part Five (“Investments, Services and Related Matters”) of the NAFTA applicable to Financial Services, including the National Treatment article (Article 1405), concludes that Article 1410(1) permits reasonable measures of a prudential character even if their effect (as contrasted with their motive or intent) is discriminatory. The Tribunal rejects the contention that a measure discriminatory in effect is \textit{eo ipso} unreasonable.\footnote{Fireman’s Fund Insurance, para 162.}

Subsequently the Tribunal, quoting a passage from a scholarly work by Olin L. Wethington, negotiator for the United States of the Chapter on Financial Services of the NAFTA, went on to affirm that the objective of the provision is twofold. On the one hand the NAFTA PCO establishes a “regulatory prerogative” to ensure the integrity of the financial system. On the other hand, the provision prevents abuses of such a prerogative, which could mainly take place in the form of arbitrary measures connected with, \textit{inter alia}, individual firm applications or licensing requests. In a nutshell, the Tribunal agrees with the author that the NAFTA PCO permits substantial regulatory autonomy in the domain of financial services with one caveat: backhanded avoidance of national treatment and other obligations could not be tolerated.\footnote{Fireman’s Fund Insurance, paras 163 – 165.}
To what extent “backhanded avoidance of national treatment” differs substantially from the concept of “discrimination” is a complicated question to pose. One may guess that the former relates to attempts to circumvent trade obligations, but neither the text of the law nor case law shed more light on the issue. This notwithstanding, as stated above, the Tribunal did not test the consistency of the challenged measures with the PCO because it had not found those measures to constitute expropriation under the relevant obligations of the NAFTA.

**Analysis**

The description of the NAFTA PCO, put in the context of the relevant discipline on financial services of the Agreement, reveals that despite the differences in structure and wording the provision does not substantially differ from the GATS. The function performed by the provision is, substantially, that of giving regulators a wide margin of discretion in addressing micro and macro-prudential concerns. In particular the very idea of “integrity and stability” of the financial system is, in and of itself very wide and leaves space for domestic sovereignty with regard to the policy choices regulators consider appropriate.

Furthermore, notwithstanding the heading of the provision (*Exception*), a closer look at the provision indicates that no stringent conditions are required for the successful invocation of the prudential defence. The only real condition that must be satisfied before the PCO can operate is the requirement according to which measures adopted for prudential reasons must be “reasonable”. This requirement has not yet been scrutinised in case law and the only arbitral tribunal that has so far analysed the PCO did not clarify its meaning. However, NAFTA case law clarifies that the PCO allows discriminatory behaviour.

Can the “reasonableness” requirement be seen as a “proportionality test”? In the absence of authoritative interpretation of the test in case law, it is complicated to provide a conclusive answer. Trachtman explored the issue in an article published in 1996 at the dawn of the first experiences of inclusion of financial services in trade agreements. The author correctly points

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out that the NAFTA introduces a “necessity test” in the general exception provision dealing with cross-border trade in services.\footnote{Article 2101(2) of the NAFTA (General Exceptions).} In order to be justified under the exception, measures must not be unjustifiably discriminatory and should not represent a disguised barrier to trade (similar to what is required by the \textit{chapeau} of the exception provisions in the GATT 1994 and the GATS). Such language is, therefore, not alien to the legal system set up by the Agreement.

Trachtman argues:

\begin{quote}
This exception for any reasonable prudential measures might be a basis for discipline of prudential measures, or might be an avenue of defection from NAFTA financial services obligations. It would be a source of discipline if the “reasonableness” requirement is read as a proportionality requirement: the trade restriction must be proportionate to the prudential regulation benefit. For this to be the case, it is necessary for the dispute resolution process to be active, and in effect, to play a legislative-type role.\footnote{Trachtman, ‘Trade in Financial Services under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis’ (p. 90).}
\end{quote}

The author himself acknowledges that it was at least difficult to foresee such a role for the dispute settlement system of the NAFTA. It is also worth considering that the situation envisaged by Trachtman is also not likely to materialise because of structural obstacles that are difficult to overcome. First and foremost, as was clarified \textit{supra}, at least in the case of investment arbitration panels, upon request of the Party whose measure is challenged in the dispute the Tribunal must refer the matter to the Financial Services Committee. Article 1412 of the NAFTA, which is the provision disciplining the composition and powers of the body, is not entirely clear. It seems that there is no fixed number with regard to the members of the Committee and the provision only requires that the “principal representative” of one Party is an official of the Party’s authority which is responsible for financial services.\footnote{Annex 1412.1 of the NAFTA clarifies which are the competent authorities for the three Parties: for Canada, the Department of Finance; for Mexico, the Secretaría de Hacienda y Crédito Público; for the United States of America, the Department of the Treasury for banking and other financial services and the Department of Commerce for insurance services.} Moreover, the Agreement does not set out the rules of procedure of such a committee, the voting system or its exact composition (not even how many members).
Second, financial services are still considered to be a sensitive issue, and only one arbitral Tribunal to date has dealt with the NAFTA PCO, not even deciding on the matter because it was in an obiter dictum.\textsuperscript{244} We have experienced a financial crisis and a bank run, but not exactly a rush to courts to put under judicial scrutiny the regulatory development that ensued in the domain of financial services worldwide.

Third, when an Agreement distinguishes between rules to be applied to the generality of the cases and \textit{lex specialis} that applies when it comes to particular subject, the operation of borrowing concepts and requirements from one pot to the other is not recommended or, at most, should be done with caution. Therefore, it is at least doubtful that the proportionality requirements set out in Article 2101(2) of the NAFTA equates to a “reasonableness” test as provided by the PCO.

What is the meaning of the word “reasonable” in the NAFTA PCO? Contrary to National Treatment, for instance, according to which the standard of treatment for the foreign service supplier is determined on a relative basis (the treatment accorded to domestic like service suppliers), the reasonableness principle sets out an “absolute” standard of treatment to be determined on the basis of what the provision specifically requires.

Continental European and American scholarship differs with regard to the identification of the principle of “reasonableness”. For European lawyers the issue of “reasonableness” is traditionally connected to the “proportionality test” developed in German administrative law and familiar to the most important continental European legal orders.

According to Ortino, it is possible to distinguish between “substantive” and “procedural” requirements.\textsuperscript{245} With regard to the substantive dimension, German constitutional theory has identified three different sets of tests, in order of intensity: “Suitability test”, “Necessity test” and

\textsuperscript{244} See the discussion on the Fireman’s Insurance Fund dispute \textit{supra}.
“Proportionality test”\textsuperscript{246} Under the “Suitability test” (which can be also described as a “means/ends test”) the question is whether the measure adopted by the government is an effective means to achieve the aim pursued by the administration. It is an absolute test, in which the measure under scrutiny is evaluated autonomously, without any inquiry as regards the strength of the correlation between the means and the end\textsuperscript{247} or a comparison with other theoretically available measures. The second test is the “Necessity test”, according to which the scope of the scrutiny is to evaluate whether other less intrusive and trade restrictive means are available.\textsuperscript{248} The “Proportionality test”, finally, requires an investigation as to whether the costs imposed by the measure outweigh its benefits or not, thus representing the most stringent test in the sequence. All three tests, are referred to, in literature, as classifiable in the realm of the proportionality/reasonableness principle.

Which applies to the NAFTA PCO? It is possible to attempt to articulate an explanation. The test which most comfortably fits the case at hand is the first test as the provision does not place emphasis on the issue of the “restrictions to trade” which usually appears in exception provisions in trade agreements (and in Article 2101 NAFTA) and does not do so here. The \textit{Fireman’s Insurance Fund} award acknowledges that a measure can be at the same time discriminatory and reasonable and that under the “reasonableness” requirement only measures that are manifestly not linked with a prudential objective and imply backhanded avoidance of obligations or commitments can be targeted.\textsuperscript{249} Analyses with regard to the evaluation of costs and benefits are not required nor are evaluations with other less restrictive means.

Those more familiar with US law, however, may link the reading of the “reasonableness test” introduced in the PCO of the NAFTA to the homonymous test developed under US administrative law. In 1984, the US Supreme Court issued a historic decision in \textit{Chevron U.S.A., Inc. v. Natural

\textsuperscript{247}Ortino, 'From 'Non-Discrimination' to 'Reasonableness': A Paradigm Shift in International Economic Law?' (p. 34).
\textsuperscript{248}The issue will be developed in greater detail in the next Chapter, with a focus on the evolution of the jurisprudence of the WTO on the subject.
\textsuperscript{249}See the summary of the relevant passages of the judgment \textit{supra}.
In which a new standard of review for the interpretation of statutes by agencies was established: the so-called “Chevron doctrine”.251

The Chevron doctrine consists of two phases. First, the courts applying it have to ask themselves whether a statute interpreted by the agency clearly addresses the situation of fact and law brought about before them. If the answer to this first question is negative and the statute is silent or ambiguous, the court proceeds to the final stage of the analysis, which consists of the answer to the question as to whether the interpretation advanced by the agency was “reasonable” or “permissible”. The Chevron doctrine can be read in the sense that it amounts to a power shift from courts to agencies. Courts are asked to be deferential towards the administration and to step in only in case the interpretations advanced by agencies are patently unreasonable or lead the latter to exercise powers that go beyond their competences.

If we transfer this concept to the realm of trade law, it emerges that, in sum, it does not differ much from what is required for under the final clause of the PCO under the GATS. However, the “reasonableness test” under the NAFTA, probably also because it derives from the US legal tradition hence there are solid references to it in the literature and in case law, seems to be better structured and easier to be understood.252

Conclusions on NAFTA

In the absence of specific conditions that Members must meet in order to be entitled to benefit from the PCO, notwithstanding the heading of the provision, it is hard to consider the provision under analysis as being an “exception”. Rather, it seems that we are in the realm of “provisions that exclude the application of other provisions” since the only real condition upon Members is that measures adopted or maintained for prudential measures ought to be “reasonable”.

252 For a discussion on the Chevron doctrine and the possibility to import it in the realm of international trade, see Steven P. Croley and John H. Jackson, 'WTO Dispute Settlement Procedure, Standard of Review and Deference to National Governments', *The American Journal of International Law*, 90/2 (1996), 193-213.
3.2.2.3 US-post 2004

The provision, as it first appeared in the US – Singapore FTA reads:

Article 10.10 (Exceptions)

1. Notwithstanding any other provision of this Chapter or Chapters 9 (Telecommunications), 14 (Electronic Commerce), or 15 (Investment), including specifically Article 9.15 (Relationship to Other Chapters), and in addition Article 8.2.2 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by an investor of the other Party or a covered investment, a Party shall not be prevented from adopting or maintaining measures for prudential reasons\(^{10-5}\) including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Agreement referred to in this paragraph, they shall not be used as a means of avoiding the Party’s commitments or obligations under such provisions.

\(^{10-5}\) It is understood that the term “prudential reasons” includes the maintenance of the safety, soundness, integrity or financial responsibility of individual financial institutions or cross-border financial service suppliers.

This third recurring category of PCOs was conventionally named “US-post 2004” because it first appeared in the trade agreements signed by the US in 2004 and because it seems to be a recurring provision in all the Chapters on Financial Services in the FTAs concluded by the US with their commercial partners ever since. This category of PCO appears in the following eighteen Agreements:


First of all, one of the distinguishing features of this type is that it covers provisions of the Chapter on Financial Services as well as provisions in other Chapters disciplining trade in services (from telecommunications to e-commerce). In this respect only the Panama – Peru FTA differs by expanding the coverage of the provision to the whole agreement. With regard to the content of the PCOs, all the FTAs falling in this category refer to the traditional two categories of prudential reasons as they were codified in Paragraph 2(a) of the Annex on Financial Services of the GATS. All the previously mentioned Agreements (US – Colombia and US – Panama being the only exceptions) provide for a vague final clause identical in wording to that provided by the PCO in the GATS. Apart from these differentiations the agreements falling in the category under analysis show an impressive record of consistency with a limited number of outliers. Considering the fact that this is the second largest category in the study these results are quite remarkable.

None of these agreements introduces more stringent requirements for the prudential shelter to operate. It is fair to conclude that these PCOs perform the functions of “provisions that exclude the application of other provisions” without substantial conditions to be met by Parties to the agreement that may want to benefit from them. In this regard, despite the differences in wording, it does not differ substantially from the PCO in the Annex on Financial Services of the GATS.

3.2.2.4 EFTA with third parties

The first example of this category of PCOs appeared in the FTA between EFTA and Mexico and reads:

Article 36 - Prudential carve-out

1. Nothing in this Section shall be construed to prevent a Party from adopting or maintaining reasonable measures for prudential reasons, such as:
(a) the protection of investors, depositors, policy-holders, policy-claimants, persons to whom a fiduciary duty is owed by a financial service supplier, or any similar financial market participants; or
(b) the maintenance of the safety, soundness, integrity or financial responsibility of financial service suppliers; or
(c) ensuring the integrity and stability of a Party's financial system.

2. These measures shall not be more burdensome than necessary to achieve their aim, and shall not discriminate against financial service suppliers of another Party in comparison to its own like financial service suppliers.

The fourth family of PCOs owes its name to the fact that it is commonly present in the FTAs signed by EFTA with third parties. This category of PCO (variations of which will also be examined) appears in five FTAs besides that between EFTA and Mexico:

EFTA – Singapore, EFTA – Korea, EFTA – Colombia, EFTA – Ukraine, Ukraine – Montenegro, EFTA – Central America (Costa Rica and Panama).

Characteristic features of the current category under analysis are that they all require measures adopted or maintained for prudential reasons to be “reasonable” and not more burdensome than necessary to achieve their prudential goal (so-called “necessity test”). Moreover, all PCOs in this category refer to measures adopted inconsistent with the discipline set up in the Chapter on Financial Services of the Agreement they belong to (we shall remember, in this regard, that the GATS PCO applies “notwithstanding any other provisions of the Agreement”\(^\text{253}\)). The degree of variation in this category is higher when compared to the other ones identified in this study. In short, all of the agreements comprised in this family have some peculiarities.

- EFTA – Mexico. The PCO in EFTA-Mexico differentiates between three different classes of prudential measures, like in the NAFTA prudential carve-out. Moreover, it requires that prudential measures do not discriminate between foreign financial services suppliers and like domestic ones (National treatment of prudential measures).

\(^{253}\) Emphasis added.
- EFTA – Singapore. The PCO in this agreement again contains a classification of the indicative prudential measures in three different categories. Moreover, it adds a sentence which is identical in wording to the so-called *chapeau* of the “General Exceptions” provision in the GATS (Article XIV): “These measures (...) shall not constitute a means of arbitrary or unjustifiable discrimination against financial service suppliers of another Party in comparison to its own like financial service suppliers, or a disguised restriction on trade in services”.

- EFTA – Korea. The PCO in EFTA-Korea deviates from the example provided at the beginning of the section insofar as it provides for two rather than three classes of prudential reasons in the pursuance of which Members can deviate from their obligations and introduces a vague circular statement similar to the final clause of the PCO in the Annex on Financial Services of the GATS.

- EFTA – Colombia. The PCO in the FTA between EFTA and Colombia requires Members not to discriminate between foreign financial services suppliers and domestic like services suppliers in the enactment or maintenance of prudential measures. Another distinctive feature can be found in Paragraph 3 of Article 6 (*Domestic Regulation*) of the treaty, which makes direct reference to internationally agreed standards and reads as follows:

3. Each Party shall make its best endeavours to ensure that the Basel Committee’s “Core Principles for Effective Banking Supervision”, the standards and principles of the International Association of Insurance Supervisors and the International Organisation of Securities Commissions’ “Objectives and Principles of Securities Regulation” are implemented and applied in its territory.

- EFTA – Ukraine, Ukraine – Montenegro and EFTA – Central America (Panama and Costa Rica). These three PCOs are treated jointly because they are identical in all aspects. They are extremely relevant for the sake of the present work because they are the only provisions among those which were analysed in which all the distinctive features explained at the beginning of the present section appear. Quoting from the PCO in EFTA- Ukraine:

    Article 5 - Domestic Regulation
1. Notwithstanding any other provisions of this Chapter, a Party shall not be prevented from adopting or maintaining reasonable measures for prudential reasons, including for:

(a) the protection of investors, depositors, policy-holders, policy-claimants, persons to whom a fiduciary duty is owed by a financial service supplier, or any similar financial market participants; or

(b) ensuring the integrity and stability of that Party’s financial system.

Where such measures do not conform with the provisions of this Chapter, they shall not be used as a means of avoiding that Party’s commitments or obligations under this Chapter.

2. Measures referred to in paragraph 1 shall not be more burdensome than necessary to achieve their aim or constitute a disguised restriction on trade in services, and shall not discriminate against financial services or financial service suppliers of another Party in comparison to the Party’s own like financial services or like financial service suppliers.

3. Each Party shall make its best endeavours to ensure that the Basel Committee’s “Core Principles for Effective Banking Supervision”, the standards and principles of the International Association of Insurance Supervisors and the International Organisation of Securities Commissions’ “Objectives and Principles of Securities Regulation” are implemented and applied in its territory.

As we can see the provision requires that prudential measures are reasonable, necessary and non-discriminatory. Moreover, there is a final clause identical to the one in the PCO of the Annex on Financial Services of the GATS as well as a sentence similar to the chapeau of Article XIV of the GATS (General Exceptions). Finally, the provision makes explicit reference to the standards set up by BCBS, IAIS and IOSCO.

In sum, given the presence of more requirements compared to the situation in the category previously analysed, the provisions in this category can be classed as “exceptions”.

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On 27 June 2014 the European Union signed Association Agreements with Georgia, the Republic of Moldova and Ukraine. All three agreements provide for identical PCOs. The PCO in the Agreement between EU and Ukraine reading as follows:

Article 126 - Prudential carve-out

1. Each Party may adopt or maintain measures for prudential reasons, such as: 
   (a) the protection of investors, depositors, policy-holders or persons to whom a fiduciary 
       duty is owed by a financial service supplier; 
   (b) ensuring the integrity and stability of a Party's financial system. 
2. These measures shall not be more burdensome than necessary to achieve their aim, and 
   shall not discriminate against financial service suppliers of the other Party in comparison to 
   its own like financial service suppliers. 

3. Nothing in this Agreement shall be construed to require a Party to disclose information 
   relating to the affairs and accounts of individual consumers or any confidential or proprietary 
   information in the possession of public entities. 

4. Without prejudice to other means of prudential regulation of cross-border trade in financial 
   services, a Party may require the registration of cross-border financial service suppliers of the 
   other Party and of financial instruments. 

These PCOs follow the traditional classification of the indicative list of prudential objectives in 
two subcategories, similar to that provided for in the PCO in the Annex on Financial Services of 
the GATS. They all require prudential measures to be non-discriminatory and no more 
burdensome than necessary to achieve their aim. 

Another peculiarity of these three agreements can be found in the way they address the standard 
of treatment for branches and representative offices of juridical persons of another Party. The
relevant provision in the EU – Ukraine Agreement (identical in wording to those that appear in the agreements that the EU signed with Georgia and the Republic of Moldova) reads as follows:

Article 91 - Standard of treatment for branches and representative offices

1. The provisions of Article 88 of this Agreement do not preclude the application by a Party of particular rules concerning the establishment and operation in its territory of branches and representative offices of legal persons of the other Party not incorporated in the territory of the first Party, which are justified by legal or technical differences between such branches and representative offices as compared to branches and representative offices of companies incorporated in its territory or, as regards financial services, for prudential reasons.

2. The difference in treatment shall not go beyond what is strictly necessary as a result of such legal or technical differences or, as regards financial services, for prudential reasons.

Prudential reasons, in this case, can justify a higher regulatory burden for foreign companies willing to establish a branch or a representative office in the host country, provided that the measures enacted or maintained are not more burdensome than necessary to achieve their aim. The presence of a necessity test and a national treatment obligation allow us to classify the provisions under this category as “exceptions”.

3.2.2.6 Other

Not all PCOs analysed in the current study fall under the categories mentioned above. In fact, there are some genuine outliers. It is important to also take account of these, as there are some remarkable deviations from the typical structures of PCOs as presented in the previous sections.

EFTA

Article 31 of the EFTA reads as follows:

Article 31 - Financial market regulation
1. In respect of financial services, this Chapter does not prejudice the right of the Member States to adopt measures necessary for prudential grounds in order to ensure the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed, or to ensure the integrity and stability of the financial system. These measures shall not discriminate against natural persons, companies or firms of the other Member States in comparison to its own natural persons, companies or firms.

The PCO in the EFTA Agreement differs substantially from the category, which is typical of the agreements between the latter and third countries. This provision, whose coverage is confined to other provisions dealing with trade in financial services, belongs to the category of exceptions. It requires prudential measures to be necessary and not to discriminate between foreign services suppliers and like domestic competitors. With regard to the structure of the provision, it includes the traditional bifurcation of examples of legitimate prudential goals originally set up in Paragraph 2(a) of the Annex on Financial Services of the GATS. This PCO is classified as an “exception”.

\textit{Australia – New Zealand (ANZCERTA)}

The PCO in the ANZCERTA agreement reads as follows:

\textbf{Article 5 - National treatment}

1. Each Member State shall accord to persons of the other Member State and services provided by them treatment no less favourable than that accorded in like circumstances to its persons and services provided by them.

2. Notwithstanding paragraph 1 of this Article, the treatment a Member State accords to persons of the other Member State may be different from the treatment the Member State accords to its persons, provided that:
   (a) the difference in treatment is no greater than that necessary for prudential, fiduciary, health and safety or consumer protection reasons; and
(b) such different treatment is equivalent in effect to the treatment accorded by the Member State to its ordinary residents for such reasons.

3. The Member State proposing or according different treatment under paragraph 2 of this Article shall have the burden of establishing that such treatment is consistent with that paragraph.

4. No provision of this Article shall be construed as imposing obligations or conferring rights upon either Member State with respect to Government procurement or subsidies.

This PCO is, among the provisions that have been analysed in this work, the one with the strictest requirements for the invoking Member. This is probably due to the depth of the trade agreement it belongs to. Market integration between Australia and New Zealand is historically deep given the geographical proximity between the two countries as well as the cultural roots they have in common. In addition they have proven to be deeper than other FTAs in aspects in which trade agreements are not traditionally very strong such as free movement of professionals, for instance. As such it comes as no surprise that they are also more advanced with regards to the way both jurisdictions deal with prudential policies.

First of all, the PCO is contained in the provision on National Treatment and this in itself is a peculiarity. Second, prudential aims are among the reasons (together with fiduciary, health, safety and consumer protection aims) that can allow Members to deviate from the obligation to give the same treatment to domestic and foreign like service suppliers alike. However, such deviation must be necessary and be put in place in order to restore equivalence in treatment between residents and foreigners from the preferential counterpart. This alone reveals that the structure of the provision is rather that of an “exception”. Further, the provision is the only one among those that were examined in this work where the burden of proof as regards the satisfaction of the conditions in order to invoke the provision is explicitly allocated to the regulating Member. This implies a radically different approach to the majority of the PCOs.

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analysed in the present work as in this case the provision aims to circumscribe to the highest possible extent the regulatory autonomy of the Members to the PTA in order to preserve their obligations and commitments.

**East African Community**

The relevant provision in the Agreement reads:

**Article 25 - General Exceptions**

1. The free movement of capital may be restricted upon justified reasons related to:
   (a) prudential supervision;
   (b) public policy considerations;
   (c) money laundering; and
   (d) financial sanctions agreed to by the Partner States.

2. Where a Partner State adopts a restriction under paragraph 1, the Partner State shall inform the Secretariat and the other Partner States and furnish proof that the action taken was appropriate, reasonable and justified.

The East African Community (EAC) is an intergovernmental agreement between Burundi, Kenya, Rwanda, the United Republic of Tanzania and the Republic of Uganda. Strictly speaking the EAC Agreement does not contain a PCO, but only a provision according to which Members can restrict the free movement of capital for, *inter alia*, policy reasons belonging to the realm of prudential supervision. The regulating Member has the duty to inform the Secretariat not only of the actions taken but also of the appropriateness and reasonableness of the latter together with an obligation to provide a justification in that regard. The provision was classified as “exception” because it imposes conditions as well as the burden of proof on the regulating party.

**Singapore - Australia**
The PCO in the FTA between Singapore and Australia has some peculiar aspects. It reads as follows:

Article 3 - Prudential and Regulatory Supervision

1. Nothing in this Agreement shall be construed to prevent a Party from taking measures for prudential reasons, including measures for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of a Party's financial system. Where such measures do not conform with the provisions of this Agreement, they shall not be used as a means of avoiding the Party's commitments or obligations under this Agreement.

2. These measures shall not constitute a means of arbitrary or unjustifiable discrimination against financial service suppliers of the other Party in comparison to its own like financial service suppliers, or a disguised restriction on trade in services. Each Party shall endeavour to ensure that these measures are not more burdensome than necessary to achieve their aim.

3. Nothing in this Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

The first part of the provision is similar to the PCO in the Annex on Financial Services of the GATS. The second paragraph then adds a requirement similar to the chapeau of the general exceptions in the GATT or the GATS. Moreover, the provision contains a hortatory requirement (“Each party shall endeavor\textsuperscript{255} to ensure (...)”) not to enact measures more burdensome than what is necessary to achieve their prudential aim. This provision was classified as “exception”.

\textit{Japan – Mexico}

Article 110 - Exceptions

\textsuperscript{255} The original text of the provision is in American-English.
Notwithstanding the provisions of this Chapter, Chapter 7 and Chapter 8, a Party shall not be prevented from adopting or maintaining measures for prudential reasons with respect to financial services, including for the protection of investors, depositors, policy holders, policy claimants or persons to whom a fiduciary duty is owed by a financial institution or a cross-border financial service supplier, or to ensure the soundness, integrity and stability of a Party’s financial system.

This PCO would ideally belong to a “GATS-like minus” category. The provision restricts the coverage to the Chapters on Investment, Cross-border Trade in Services and Financial Services. For the rest it maintains the structure of the PCO in the Annex on Financial Services of the GATS with the notable exclusion of the ambiguous final clause, account of which has been given above. Given the absence of relevant requirements, this PCO was classified as a “scope provision”.

**EU – CARIFORUM States EPA**

Article 104 of the EU – CARIFORUM States EPA reads:

**Article 104 - Prudential carve-out**

1. The EC Party and the Signatory CARIFORUM States may adopt or maintain measures for prudential reasons, such as:
   (a) the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier;
   (b) ensuring the integrity and stability of their financial system.

This provision does not clarify its coverage or provide conditions according to which prudential measures can be adopted. As for the indicative list of legitimate prudential objectives that a party can pursue, it repeats the traditional division of two categories that first appeared in the Annex on Financial Services of the GATS. This PCO was also classified as a “scope provision”.

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ASEAN – Australia – New Zealand

Article 3 of the Annex on Financial Services of the FTA between ASEAN, Australia and New Zealand reads as follows:

Article 3 Domestic Regulation

1. Notwithstanding any other provision of this Agreement, a Party shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system or to ensure the stability of the exchange rate subject to the following:

(a) where such measures do not conform with the provisions of this Agreement, they shall not be used as a means of avoiding the Party’s commitments or obligations under this Agreement;

(b) for measures to ensure the stability of the exchange rate such measures shall be no more than necessary and phased out when conditions no longer justify their institution or maintenance; and

(c) for measures to ensure the stability of the exchange rate such measures shall be applied on a most-favoured-nation basis.

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7 The measures to ensure the stability of the exchange rate shall not be adopted or maintained for the purpose of protecting a particular sector

The provision includes measures enacted in order to ensure the stability of the exchange rate in the indicative list of prudential objectives in the pursuance of which Members may deviate from their obligations or commitments under the agreement. However, with regard to this latter category of prudential objectives, the conditions for the lawful invocation of the PCO are stricter. These measures have to be necessary to achieve their aim. Then, a procedural requirement provides that they must be phased out when the change of conditions does not justify their
permanence into force and they should be applied on a most-favoured-nation basis. Finally, footnote n. 7 adds that such measures cannot be adopted as a means of protecting a market sector. With regard to the other categories of prudential objectives, the only real condition for their invocation is a requirement similar in wording to the final clause of Paragraph 2(a) of the Annex on Financial Services of the GATS. This PCO is a provision of a “hybrid” nature as it works as a “scope provision” for some measures, and as an “exception” for others.

EU – Korea

Article 7.38 - Prudential carve-out

1. Each Party may adopt or maintain measures for prudential reasons, including:
   (a) the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier; and
   (b) ensuring the integrity and stability of the Party's financial system.

2. These measures shall not be more burdensome than necessary to achieve their aim, and where they do not conform to the other provisions of this Agreement, they shall not be used as a means of avoiding each Party's commitments or obligations under such provisions.

3. Nothing in this Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual consumers or any confidential or proprietary information in the possession of public entities.

4. Without prejudice to other means of prudential regulation of cross-border trade in financial services, a Party may require the registration of cross-border financial service suppliers of the other Party and of financial instruments.

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Any measure which is applied to financial service suppliers established in a Party's territory that are not regulated and supervised by the financial supervisory authority of that Party would be deemed to be a prudential measure for the purposes of this Agreement. For greater certainty, any such measure shall be taken in line with this Article.
The PCO in the FTA between the EU and Korea does not clarify its coverage at the beginning. The provision contains the traditional division of the indicative list of prudential measures and adds to the wording of the recurring last clause of the PCO of the Annex on Financial Services of the GATS a necessity-test. Finally, the last paragraph of the provision allows a Party to the Agreement to require the registration of cross-border financial service suppliers of the other Party as well as financial instruments. Although this cannot be considered as odd, since it is common practice across jurisdictions to require registration for all financial institutions both domestic and foreign for them to be able to operate, this is the only case in which it appears in the context of the PCO.

The language in the footnotes of the provision is extremely interesting. Footnote 39 essentially establishes a “presumption of prudence” for measures applied to services or service suppliers that are not regulated and supervised by the competent authorities of the territory of the other Member. It then adds that “for greater certainty” such measures shall be taken in line with the requirements of the provision but opens the door to a potentially unlimited power for the regulating countries. In contrast Footnote 40 affirms that the protection of the integrity of financial institutions taken singularly is indeed a legitimate prudential objective. This PCO was classified as an “exception”.

EFTA – Hong Kong, China

Article 5 - Domestic Regulation

1. Notwithstanding any other provisions of Chapter 3 of the Agreement, a Party shall not be prevented from adopting or maintaining measures for prudential reasons, including for:
   (a) the protection of investors, depositors, policy-holders, policy-claimants, persons to whom a fiduciary duty is owed by a financial service supplier, or any similar financial market participants; or
   (b) ensuring the integrity and stability of that Party’s financial system.
Where such measures do not conform with the provisions of Chapter 3 of the Agreement, they shall not be used as a means of avoiding that Party's commitments or obligations under Chapter 3 of the Agreement.

2. Each Party shall make its best endeavours to ensure that the Basel Committee’s “Core Principles for Effective Banking Supervision”, the standards and principles of the International Association of Insurance Supervisors and the International Organisation of Securities Commissions’ “Objectives and Principles of Securities Regulation” are implemented and applied in its Area.

3. Nothing in Chapter 3 of the Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

The first part of the provision reflects the wording of the PCO of the Annex on Financial Services of the GATS, although with a narrower coverage, as it applies notwithstanding the provisions of the Chapter on Trade in Services of the Agreement. The second paragraph explicitly refers to standards issued by relevant standard setting bodies in the domain of financial markets and asks Members to make their best endeavours in order to implement them in the domestic jurisdictions. For these characteristics this PCO was classified as a “scope provision”.

**Malaysia – Australia**

The PCO in the Agreement between Malaysia and Australia reads:

**Article 5 – Prudential and Regulatory Supervision**

1. Notwithstanding any other provisions of this Agreement, a Party shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier or financial institution, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Agreement, they shall not be used as a means of avoiding the Party’s commitments or obligations under this Agreement.
2. These measures shall not constitute a means of arbitrary or unjustifiable discrimination against financial service suppliers or financial institutions of the other Party in comparison to its own like financial service suppliers or financial institutions, or a disguised restriction on trade in services.

3. Nothing in this Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

This PCO adds to the traditional language of the PCO of the Annex on Financial Services of the GATS a requirement similar in wording to the *chapeau* of Article XIV of the GATS. The presence of such requirement is the reason why this is classified as an “exception”.

**EU – Colombia and Peru**

Article 154 - Prudential Carve-Out

1. Notwithstanding other provisions of this Title or Title V (Current Payments and Movements of Capital), a Party may adopt or maintain for prudential reasons, measures such as:
   (a) the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier;
   (b) ensuring the integrity and stability of its financial system.

2. Measures referred to in paragraph 1 shall not be more burdensome than necessary to achieve their aim, and shall not discriminate against financial services or financial service suppliers of another Party in comparison to its own like financial services or like financial service suppliers.

3. Nothing in this Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.
4. Without prejudice to other means of prudential regulation of the cross-border supply of financial services, a Party may require the registration or authorisation of cross-border suppliers of financial services of another Party and of financial instruments.

The PCO in the Agreement between the EU, Colombia and Peru has many peculiarities. First of all the coverage of the provision is limited to the chapters on trade in financial services and current payments and movements of capitals of the FTA. Moreover, the wording of the provision differs from the traditional introduction to the indicative list of prudential "reasons". It allows Parties to adopt or maintain for prudential reasons an indicative list of classes of “measures”. The result, however, is not different. The second paragraph of the provision adds a necessity-test as well as a National Treatment requirement. This provision is classified as “exception” in the present work.

Switzerland – China

Article 11 - Domestic Regulation

1. Notwithstanding any other provisions of this Chapter, a Party shall not be prevented from adopting or maintaining reasonable measures for prudential reasons, including for:
   (a) the protection of investors, depositors, policy-holders, policy-claimants, persons to whom a fiduciary duty is owed by a financial service supplier, or any similar financial market participants; or
   (b) ensuring the integrity and stability of that Party's financial system.
   Where such measures do not conform with the provisions of this Chapter, they shall not be used as a means of avoiding that Party’s commitments or obligations under this Chapter. Such measures shall not constitute a disguised restriction on trade in services and shall not discriminate against financial services or financial service suppliers of the other Party in comparison to the Party's own like financial services or like financial service suppliers.

The PCO in the Agreement between Switzerland and China builds on the pattern established in the Annex on Financial Services of the GATS. It deviates from the original template to the extent that the coverage of the provision is limited to other provisions of the Chapter on trade in financial services and adds a National Treatment requirement and obliges Members not to enact
prudential measures as means of introducing disguised restrictions to trade. For these reasons this provision is classified as an “exception”.

Japan – Thailand

Article 109 - Prudential Measures and Measures to Ensure the Stability of the Macroeconomy or the Exchange Rate

1. Notwithstanding any other provisions of this Chapter, a Party shall not be prevented from taking:
   (a) measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by an enterprise supplying financial services, or to ensure the integrity and stability of the financial system; or
   (b) measures to ensure the stability of the macroeconomy or the exchange rate.

   Note: The measures referred to in subparagraph (b) above include measures relating to monetary policy or measures to deter speculative capital flows. Such measures shall be no more than necessary to meet the objectives of ensuring the stability of the macroeconomy or the exchange rate. Measures to ensure the stability of the macroeconomy or the exchange rate do not cover measures relating to promotion or protection of a particular sector.

2. Where such measures do not conform with the provisions of this Chapter, they shall not be used as a means of avoiding the Party’s commitments or obligations under this Chapter.

The PCO in the FTA between Japan and Thailand is sui generis. First of all, it shrinks the coverage of the provision to the sole Chapter on Trade in Financial Services. Second and most notably it adds to the traditional indicative list of prudential reasons two more legitimate policy goals according to which Parties are allowed to deviate from their obligations or commitments: namely the stability of the macroeconomy or the exchange rate. The note to the first paragraph requires measures adopted in order to pursue monetary policy or to avoid speculative capital flows to be no more burdensome than necessary to achieve their goal of leading to the stability of the

256 It is important to note how vague this wording is. It is almost impossible to objectively draw a line between profit seeking and speculative capital flows. Most likely, the negotiating governments wanted to keep regulatory freedom in order to intervene in the event of “runs” against national currencies.
macroeconomy or the exchange rate. Then, more generally, the final sentence of the provision requires that all the measures are not put in place solely to promote a particular market sector. The final clause of the PCO under analysis is similar to that in the PCO of the Annex on Financial Services of the GATS. This PCO contains different elements with regard to the particular classes of obligations that a Member may deviate from in pursuance of prudential objectives. Therefore, it is classified as a provision of a “hybrid” nature.

ASEAN - Korea

2. Prudential Measures, Exchange Rate and Financial Stability

(a) Notwithstanding any other provisions of this Agreement, a Party shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier; to ensure the integrity and stability of the financial system; or to ensure the stability of the exchange rate¹, including to prevent speculative capital flows, subject to the following:

(i) where such measures do not conform with the provisions of this Agreement, they shall not be used as a means of avoiding the Party’s commitments or obligations under this Agreement;
(ii) for measures to ensure the stability of the exchange rate including to prevent speculative capital flows, such measures shall be no more than necessary, and phased out within one year or when conditions no longer justify their institution or maintenance; and
(iii) for measures to ensure the stability of the exchange rate including to prevent speculative capital flows, such measures shall be applied on a Most-Favoured-Nation basis.

(b) Nothing in this Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

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¹ The measures to ensure the stability of the exchange rate including to prevent speculative capital flows shall not be adopted or maintained for the purpose of protecting a particular sector.

The PCO in the Agreement between ASEAN and Korea also adds the objective of ensuring the stability of the exchange rate (including those measures aiming to prevent speculative capital
flows) to the list of prudential goals typically contained in other PCOs. The provision adds extra-requirements for measures adopted in order to ensure the stability of the exchange rate: they must be necessary to achieve their aim and phased out within one year after the elapse of the conditions that justified their imposition. Moreover measures adopted for the stability of the exchange rate have to be adopted on a MFN basis and must not be imposed with the sole purpose of protecting a particular market sector. Like the previous provision, this provision is “hybrid” in nature.

3.3 Results of the analysis

In addition to the attempt to classify the provisions according to different categories, it is also important to break down the figures in order to have a sufficiently clear view of the evolution of trade law in relation to prudential measures in financial services.

Scope of application: nineteen PCOs apply in derogation to any other provision of the agreement, 31 to the chapter, part or annex on financial services, 24 to various but not all chapters, one to the obligations on free movement on capital, one to the discipline on national treatment and six do not specify their ambit of application. Since financial services link to the rest of the economy, this distinction is not essential. It was kept, however, for the sake of completeness of the exposition.

Content: The overwhelming majority of PCOs (63) follow the traditional catalogue of examples of prudential reasons set out by the prototype contained in the GATS. On the contrary, sixteen PCOs are based on a list of three categories of reasons similar to the pattern provided by Article 1410 of the NAFTA. Three PCOs deviate from the two main options followed around the world: the PCO in the East African Community PTA covers measures adopted in pursuance of “justified reasons related to prudential supervision”, the ANZCERTA PTA simply refers to “prudential measures” and the PCO in the ASEAN – Australia – New Zealand PTA adds to the traditional list measures enacted “to ensure the stability of the exchange rate”.

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**Reasonableness:** This requirement, according to which measures adopted in order to attain prudential goals have to be reasonable appears in fourteen agreements whereas it does not in the remaining 68 agreements that contain a PCO.

**Necessity test:** It is not common for PCOs to provide a necessity test. 64 PCOs do not contain such a requirement whilst fifteen do. Three PCOs submit the availability of the PCO to the respect of a necessity test only with regard to a specific category of prudential measures. The PCO in the ASEAN – Australia – New Zealand introduces a necessity test for measures adopted in order to ensure the stability of the exchange rate. The same provision in the ASEAN – Korea PTA requires that measures enacted for the stability of the exchange rate or the prevention of speculative capital flows are no more burdensome than necessary to achieve their aim. Finally, the PCO in the Japan – Thailand PTA introduces a necessity test for measures pursuing the stability of the macroeconomy and the exchange rate.

**National treatment:** Twelve out of 82 PCOs require prudential measures not to discriminate between domestic services and service suppliers and like foreign services and service suppliers.

**Chapeau language:** A limited number of PTAs (seven) have introduced such language in the PCOs whereas 75 out of 82 have not introduced a similar wording.

**GATS PCO final clause:** The final clause of the GATS PCO is more successful than other requirements that constitute the subject of this analysis. 58 PCOs contain a similar wording.

**Standards:** Only six PCOs out of 82 make reference to standards. However, standards are not referred to as benchmarks for legality of prudential measures but there is only a generic and hortatory call for Parties to make their best endeavours to implement internationally agreed standards in their jurisdictions. The standards typically referred to are those issued by BCBS, IAIS and IOSCO.257

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257 For an overview on the composition and functioning of these standard-setting bodies see Chapter 2.
Legal function: Based on the criteria set out above preferential PCOs have been classified as “Exceptions” (if they include either a “necessity test”, or a “national treatment requirement” or language similar to that of the chapeau of Article XX of the GATT 1994), “Scope” provisions (if parties invoking the PCO do not have to comply with substantial requirements in order to avail of it) or “Hybrid” if they present features of both categories applying to different sets of measures. Only seventeen PCOs can be classified as “exceptions”. Three PCOs are of a hybrid nature and 62 (the 75.6% of the total), instead, can be considered as being “provisions that exclude the application of other provisions (or “scope” provisions).

In previous sections this work provided an overview of the different categories of PCOs that can be found in PTAs. It is now time to take these PCOs in turn and to try to answer to some more delicate questions.

The first question is whether some categories of PCO are more common after the 2007/2008 financial crisis. In order to do so, trends of the different categories of PCOs year after year are analysed, looking at the date in which the relevant PTAs have been signed. The date of the signature rather than at the date of entry into force of the agreements is determinative since the former refers to the time in which negotiations were concluded whereas the latter may also happen at a much later point in time, after lengthy ratification processes at the domestic level. The two main results of this investigation are that the GATS-like category is still the most used worldwide, also at the preferential level, and that the trend is constant. The second result is that there is an increasing number of PTAs that recur to tailor-made PCOs (the residual category “Other”) than before.

Two caveats must be stated here. First of all we are dealing with small numbers. There are not thousands of agreements and as such it is complicated to identify trends. Second, the number of PTAs signed is not homogeneous through the years and as such these conclusions must be taken with a high degree of caution.
TABLE 3.5: Trends of categories of preferential PCOs over time

The second question is whether PCOs at the bilateral level tend to be stricter or more lenient than the example set up in the PCO of the Annex on Financial Services of the GATS.

A "PCO restrictiveness index" is constructed in order to present these data in the most coherent fashion possible. We identified six requirements: reasonableness; necessity test; national treatment; "Chapeau of Article XX GATT" language; GATS PCO final clause; reference to international standards. Each requirement was assigned a value of 1 or 0 depending on whether or not it features in the PCO analysed. The decision was taken not to assign different values to different features in order not to arbitrarily set a hierarchy of restrictiveness among the various requirements. The average of these data was then calculated in order for each PCO to be assigned a value in a range from 0 to 1 (in a scale from 0 to 1, each requirement is given a value of approximately 0.17, rounded to the closest decimal point):
No requirements: 0.00
1 requirement: 0.17
2 requirements: 0.33
3 requirements: 0.50
4 requirements: 0.67
5 requirements: 0.83
6 requirements: 1.00

Keeping in mind that according to this scale, the PCO of the GATS would have a restrictiveness index of 0.17 the numbers show that the majority of PCOs at the bilateral level have the same value. Summing up those PCOs with a restrictiveness index of 0 to those with an index of 0.17 the chart shows that 70.73% of all bilateral PCOs have either one or no requirement to be satisfied for the prudential defence to be lawfully invoked by a government.

TABLE 3.6 - PCO Restrictiveness Index

<table>
<thead>
<tr>
<th>PCO Restrictiveness Index</th>
<th>Frequency</th>
<th>Cumulative %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00</td>
<td>11</td>
<td>13.41%</td>
</tr>
<tr>
<td>0.17</td>
<td>47</td>
<td>70.73%</td>
</tr>
<tr>
<td>0.33</td>
<td>15</td>
<td>89.02%</td>
</tr>
<tr>
<td>0.50</td>
<td>4</td>
<td>93.90%</td>
</tr>
<tr>
<td>0.67</td>
<td>2</td>
<td>96.34%</td>
</tr>
<tr>
<td>0.83</td>
<td>0</td>
<td>96.34%</td>
</tr>
<tr>
<td>1.00</td>
<td>3</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

We can also graphically see how many bilateral PCOs are stricter than the GATS and how many are more lenient. In the graphic below the red line corresponds to the restrictiveness index of the PCO of the Annex on Financial Services of the GATS (0.17) and a scattered plot has been created with all other bilateral PCOs, distributed by year of signature of the respective agreements.
Each of these requirements were then analysed in order to identify possible trends over time. In other words, these requirements were analysed in order to verify how often these requirements have appeared in bilateral PCOs over the last twenty years. The figures are broken down by year and are cumulated in order to establish trends.
All of these trends appear to be relatively homogeneous with the remarkable exception of the final clause of the PCO in the GATS, which appears in 58 different PCOs.

3.3.1 Conclusions on the analysis of PCOs in PTAs

The main aim of this analysis to keep track of the evolution of the formulation of PCOs in PTAs in order to understand what lessons could be learned at the multilateral level. In particular, the most delicate issue with regard to the examination of the defences for prudential measures in trade agreements is that pertaining to the legal function that they perform. The argument is crucial because the classification of a provision in one way or another has an impact with regard to the allocation of the burden of proof in the event of a dispute as well as the deference that adjudicators are required to pay to domestic regulators. There is a net prevalence of PCOs (62
out of 82) performing the function of “scope provisions” or – more appropriately – “provisions that exclude the application of other provisions”. This means that there is a general tendency in trade agreements to consider financial regulation to be the reserved domain of States and prudential concerns to be of overriding importance when confronted with trade liberalisation obligations. Only a minority of PCOs are drafted in a way that makes them work as exception, due to the introduction of stricter requirements that parties have to respect in order to make use of the prudential defence. Three requirements are considered for the purposes of this study as being indicators of a different legal function for the PCO: necessity test, national treatment and the introduction of a test similar to the chapeau of Article XX of the GATT 1994 and Article XIV of the GATS. Only seventeen PCOs contain at least one of such requirements. The way these provisions are drafted, however, shows that trading nations have the legal arsenal to address the issue differently if they wish to do so. The fact that the overwhelming majority of the PCOs are drafted in a peculiar way, in contrast to traditional exception-type provisions in trade agreements is perhaps an indication that the PCO in the Annex on Financial Services of the GATS is not accidentally ambiguous, but is deliberately drafted in this manner for fear that governments would not be able to control the spreading of financial turmoil any longer or that stricter rules would lead to regulatory chills and put them in a situation of inability to intervene to address the shortcomings in financial markets for fear of complaints before international judges.

### 3.4 Current negotiations

In order to complete the analysis, it is important to focus on current negotiations on trade in financial services. After almost two decades since the entry into force of the Annex on Financial Services of the GATS and given the experience acquired by all WTO Members in the negotiation of PTAs (and the evolution of trade rules that took place at the preferential level, account of which was given in the previous section), it is important to understand how prudential concerns are addressed at a time of dramatic changes for the international trade landscape.
Two main elements make the current situation different with regard to previous negotiations of trade agreements. First of all, these agreements are negotiated in the aftermath of what was probably the most severe financial crisis in the history of modern world. In particular, the interconnectedness of financial systems worldwide made it easier for the crisis to find transmission channels and to spread its consequences to various jurisdictions and some commentators have spoken out again trade agreements for allegedly forcing States to water down their rules on financial markets. In this respect, it is interesting to recall a passage from the conclusions of the “Stiglitz Commission’s Report”:

[T]hreats have been exacerbated by financial market integration. Countries that have fully opened their capital accounts, have engaged in financial market liberalization, and have relied on private finance from international capital markets are among those likely to be most adversely affected. Many countries have come to rely on foreign banks, some from countries that were poorly regulated and followed inappropriate macroeconomic policies and that now find their capital badly impaired. These institutions are now repatriating capital, with adverse effects on developing countries. The difficulty is compounded by the fact that many developing countries have entered into free trade agreements (FTAs), bilateral investment treaties (BITs) and World Trade Organization commitments that enshrine the policies of market fundamentalism noted above and further limit their ability to regulate financial institutions and instruments, manage capital flows, or protect themselves from the effects of financial market protectionism.258

Second, in the following sections the present work will give an account of negotiations of agreements that differ substantially from those that were examined in the previous section of this chapter. This section analyses the negotiations on the PCO in a preferential agreement on trade in services between 23 like-minded Members of the WTO with the aim of advancing the liberalisation agenda of the GATS (the Trade in Services Agreement, TiSA); a “mega-regional” agreement (the Trans-Atlantic Trade and Investment Partnership (TTIP) between the EU and the US and the EU-Canada Comprehensive Economic and Trade Agreement (CETA). These

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negotiations will affect a larger number of consumers across the world and come at a time where some lessons on trade rules can be considered to be learnt, therefore it is interesting to understand how the issue of the interplay between prudential regulation and financial services trade liberalisation is being dealt with.

Unfortunately at the time of the submission of the present work no sufficient information on the negotiations of two other megaregional agreements (the Trans-Pacific Partnership (TPP) between the US and eleven countries in Asia and Oceania and the Regional Comprehensive Economic Partnership (RCEP) between ASEAN Members and the States with which ASEAN already has PTAs in place) is available.

3.4.1 The negotiations of the PCO in the Trade in Services Agreement

The negotiations for a preferential agreement on trade in services were launched in 2013. Talks are taking place among 25 Members of the WTO with the EU counting as one (the so-called “Really Good Friends of Services”, RGFS). In strict legal terms this agreement could qualify as a PTA according to the principles set out in Article V of the GATS. However the intention of the parties is more ambitious. Some of the RGFS want to negotiate a plurilateral agreement which is in principle compatible with the structure of the GATS with the aim of leaving the door open for latecomers to eventually join.

Plurilateral agreements are covered under Annex 4 of the WTO Agreement. Article II.3 of the WTO Agreement clarifies that they only create obligations for those Members that have accepted

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259 Australia, Canada, Chile, Chinese Taipei (Taiwan), Colombia, Costa Rica, the European Union, Hong Kong, Iceland, Israel, Japan, Liechtenstein, Mauritius, Mexico, New Zealand, Norway, Pakistan, Panama, Paraguay, Peru, Republic of Korea, Switzerland, Turkey, the United States, and Uruguay.


261 To date, these agreements are the Agreement on Civil Aircraft (CA) and the Agreement on Government Procurement (GPA). The WTO General Council, by consensus, decided to eliminate the International Dairy Agreement (IDA) (see WTO Docs. IDA/8 of September 30, 1997, and WT/L/252 of December 17, 1997) and the
them and not for those who decided to remain outside. Article X.9 of the WTO Agreement requires Members to agree by consensus in case they want to add another agreement to the list. For a plurilateral agreement to be valid and recognised under WTO law, therefore, all WTO Members, including those that are not parties to it, have to agree. This requirement will probably not be met easily since there have already been some resistance regarding who ought to be brought to the negotiating table.\textsuperscript{262} It would be difficult to imagine that a WTO Member excluded from the negotiations of a plurilateral agreement would not oppose its enlistment under Annex 4 of the WTO Agreement. Moreover, there are institutional problems that deserve careful attention.\textsuperscript{263}

Negotiations are taking place at the moment of the submission of this thesis. The RGFS are meeting regularly in Geneva, outside the WTO, and the negotiations are not public. However, some information is circulating with regard to the structure of the Agreement and parts of its content. According to some rumours a future TiSA would adopt a “negative list” approach with regard to National Treatment commitments\textsuperscript{264} whereas it would keep the GATS structure with regard to Market Access.\textsuperscript{265} This in itself would not represent a problem in the context of an Article V of the GATS PTA. Questions would arise with regard to the compatibility with the already existing structure of the GATS, should RGFS manage to find a way into the WTO for their creature.

\textsuperscript{262} See the press release issued by the European Commission reporting the intention by the former EU Commissioner for Trade earlier in 2014 in support of the Chinese application to join the negotiations. The communiqué acknowledges that “[t]he debate over China’s participation has been difficult, however, due to concerns expressed by some TiSA participants”. (\url{http://europa.europa.eu/rapid/press-release_IP-14-352_en.htm}, last accessed on 8 September 2015).

\textsuperscript{263} For a detailed analysis of the pros and cons connected to the choice of the “plurilateral track”, see Bernard M. Hoekman and P. C. Mavroidis, ‘Embracing Diversity: Plurilateral Agreements and Trade in Services’, \textit{World Trade Review}, 14/1 (2015), 101 - 16.

\textsuperscript{264} That is, Members have to specifically list those subsectors and modes of supply in which they are not willing to make commitments according to which they will treat foreign services and service suppliers in a non-discriminatory way when compared to national like services and service suppliers.

With regard to specific disciplines on sectoral negotiations little information is available at this stage. However, in the summer of 2014 Wikileaks, the international non-profit organisation founded by Julian Assange, leaked the draft text of the Chapter on Financial Services of the TiSA warning against a treaty that aims to “further deregulate global financial services markets”.

The Chapter adopts a hybrid approach along the lines of what was anticipated before with regard to Market Access and National Treatment requirements. It also adds a standstill clause according to which parties to TiSA agree to lock in the current levels of liberalisation.

Article X.17 of the Chapter on Financial Services of the TiSA, as leaked in the summer of 2014, reads:

Article X.17: Prudential Measures

1. Notwithstanding any other provision of the Agreement, a Party shall not be prevented from [PA, EU: taking] [US: adopting or maintaining] measures for prudential reasons, including for:

(a) the protection of investors, depositors, [PA, US financial market users], policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier; or

(b) to ensure the integrity and stability of a Party’s financial system.

2. Where such measures do not conform with the provisions of this Agreement, they shall not be used as a means of avoiding the Party’s commitments or obligations under the Agreement.

The current text of the PCO in TiSA clearly draws inspiration from Paragraph 2(a) of the Annex on Financial Services of the GATS and carries with it all the connected interpretative problems that were raised in the previous chapter. It adds, on the side of the “stability” of the financial system, the objective of ensuring its “integrity”. However the two concepts are so intertwined...
that the distinction does not seem to be meaningful. As a final note on the draft text of the PCO of the TiSA it must be recalled that the circulated document represents the current state of the art of the negotiations on the topic and that it is not sure yet that – assuming the treaty will see the light of the day – this will be the definitive formulation of the provision.

3.4.2 The negotiations of the PCO in the Trans-Atlantic Trade and Investment Partnership

The talks for the negotiation of a comprehensive PTA between the EU and the US were launched in July 2013. At the time of the submission of this thesis it is not clear whether the negotiations will reach a successful conclusion. With regard to financial services, in particular, the situation is even more complicated.

As already explained in Chapter 2, reforms in financial market regulations in the main domestic jurisdictions were coordinated at the international level by means of recommendations or standards. The bodies that issued such documents such as, for instance, the G20 or the BCBS cannot be considered fully-fledged international organisations and, most of all, their recommendations are not legally binding, despite the fact they are actually implemented at the domestic level. Furthermore, given the fact that such requirements are usually written in terms of “minimum standards” or “obligations of result”, implementation at the domestic level has not usually led to the same results in the EU and the US, with different approaches followed. Therefore many voices particularly in the private sector have pointed to the opportunity to address this regulatory divergence between the two shores of the Atlantic through means of regulatory cooperation or mutual recognition.

Positions with regard to the inclusion of financial services in the TTIP remain distant between the two Parties. On the one hand, the representatives of the US have repeatedly insisted that they would not allow trade agreements to limit the ability of the administration to regulate financial

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270 For an explanation of the different approaches adopted by the EU and the US in the aftermath of the crisis, see Chapter 2.

markets. On the other hand, the European Union, as it always does in its negotiations with preferential trading partners, is insisting on having an agreement as comprehensive as possible and on tackling barriers that limit the access to the US market for European financial institutions.272

Negotiations are not yet concluded and the documents of the negotiations are not all publicly available. Although a substantial deal on financial services seems to be unlikely to see the light of the day, talks are taking place between the two delegations with regard to the introduction of measures addressing the issue of regulatory cooperation between the two jurisdictions.273

In particular, the EU is pushing for the establishment of a framework for regulatory cooperation according to the following principles:

- Joint work to ensure timely and consistent implementation of internationally-agreed standards for regulation and supervision.
- Mutual consultations in advance of any new financial measures that may significantly affect the provision of financial services between the EU and the US and to avoid introducing rules unduly affecting the jurisdiction of the other party.2
- Joint examination of the existing rules to examine whether they create unnecessary barriers to trade.
- A commitment to assessing whether the other jurisdiction’s rules are equivalent in outcomes.274

2Unless there are overriding prudential reasons.

273 Corporate Europe Observatory, a non-governmental organization, has published the leak of the EU proposal on "Regulatory Cooperation on Financial Services in TTIP". The text is available here http://corporateeurope.org/sites/default/files/attachments/regulatory_coop_fs - ec_prop_march_2014-2_0.pdf (last accessed on 8 September 2015).
Negotiations on disciplines on trade in services continue between the two parties. Although financial services are not, at the time of the submission of the present work, on the negotiating agenda, talks on the general chapter on trade in services continue and at the start of 2014 a German newspaper leaked the text of the provisional chapter on trade in services.\textsuperscript{275} It contains a PCO that reads as follows:

\textbf{Article 52 Prudential carve-out}

1. Each Party may adopt or maintain measures for prudential reasons, such as:
   (a) the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a financial service supplier;
   (b) ensuring the integrity and stability of a Party's financial system.
2. These measures shall not be more burdensome than necessary to achieve their aim.
3. Nothing in this Agreement shall be construed to require a Party to disclose information relating to the affairs and accounts of individual consumers or any confidential or proprietary information in the possession of public entities.

The provision clearly follows the pattern set out in the Annex on Financial Services of the GATS. The only relevant difference in the structure of the carve-out is the introduction of a necessity-test. This variation contributes to make the PCO in the future TTIP (assuming this will be the final text) look like an exception-type provision, contrary to the interpretation of the GATS PCO that the present work advocates.

\textbf{3.4.3 The negotiations of the PCO in the EU-Canada Comprehensive Economic and Trade Agreement}

In 2014 Canada and the European Union concluded the negotiations of the CETA. The Agreement is not yet legally binding since it is now under legal review and will only enter into force after the

\textsuperscript{275} The German newspaper \textit{Die Zeit} leaked the Chapter on Trade in Services on 27 February 2014. The text is available here \url{http://www.bilaterals.org/?eu-us-FTA-ttip-eu-draft-proposal&lang=en} (last accessed on 8 September 2015).
ratification process is completed.\textsuperscript{276} It is a very important agreement for several respects. Canada performed relatively well in the recent financial crisis. It is considered, among commentators, as the developed country whose financial system was hit less severely by the financial turmoil that the US and the EU have experienced.\textsuperscript{277}

The agreement presents some very important innovations with regard to the discipline on trade in services and, more specifically, on financial services and the deference that should be paid to national regulators in the field of prudential measures. The rules on services adopt a “negative-listing approach”, that is that National Treatment, Market Access and Most Favoured Nation obligations apply to all services except those specifically indicated by the Parties. Moreover, Canada and the EU have committed to full transparency with regard to non-conforming measures in the financial services sector. The latter will be listed in the parties’ schedules in order to be easily identified.\textsuperscript{278}

From an institutional perspective as well the CETA contains important elements for the current analysis. The Agreement introduces a Financial Services Committee, whose composition and functions are set out in Article 17 of the Chapter on Financial Services. The Committee, which will decide by consensus, will be composed of representatives of domestic authorities that are in charge of financial services. The Article clarifies that, in the case of Canada, the delegate to the Committee shall be an official from Finance Canada. There is no corresponding classification for the EU but anecdotal evidence suggest that this was due to the fact that, at the time of the conclusion of the agreement, the EU Commission was undergoing reorganisation with different allocation of staff and competences and with the creation of new directorate-generals. Most likely this information will be added at the end of the legal-review process. This information is relevant

\textsuperscript{276} Information as regards the process are available at \url{http://ec.europa.eu/trade/policy/in-focus/ceta/} (Last accessed on 8 September 2015).

\textsuperscript{277} Bordo et al. claim that Canada was better prepared to face the outbreak of the 2007 and 2008 financial crisis for reasons that have mainly to do with the structure of its financial system. In fact, the composition of Canadian financial market, so their argument goes, can be described as an “oligopoly”, with large banks involved more in traditional and less risky activities then, for example, their equivalent in the United States. See Michael D. Bordo, Angela Redish, and Hugh Rockoff, 'Why Didn't Canada Have a Banking Crisis in 2008 (or in 1930, or in 1907, Or...)?', \textit{NBER Working Paper Series} (http://www.nber.org/papers/w17312.pdf, 2011, last accessed on 8 September 2015), 1 - 40.

\textsuperscript{278} Lang and Conyers stress that, on the Canadian side, both federal and local non-conforming measures will be listed. Andrew Lang and Caitlin Conyers, 'Financial Services in EU Trade Agreements', \textit{Study for the ECON Committee of the European Parliament} (2014), 1 - 47 (p. 16).
as it proves, once again, that the division of competences and tasks between trade departments and finance departments in this area is always a delicate matter and that the latter are typically not willing to give up their regulatory prerogatives.

The Committee will meet annually and will be in charge of the supervision of the implementation of the Chapter, the conduct of a dialogue in order to enhance knowledge as regards regulatory developments in the domain of financial services and to foster cooperation on the implementation of internationally agreed standards and, last but not least, the implementation of the “filter mechanism” in investor-state disputes.

CETA is relevant for the current analysis as it introduces three innovative elements when compared to the other agreements (an account of which was given in the previous pages): (i) The PCO deviates from the main categories identified; (ii) The Agreement provides for a filter mechanism in investor-state disputes concerning prudential measures, similar to what is provided for by NAFTA; (iii) There is an Annex providing guidance on the application of the PCO.

(i) The PCO in CETA

The PCO in the Agreement between Canada and the EU reads:

**Article 15: Prudential Carve-Out**

1. Nothing in this Agreement shall prevent a Party from adopting or maintaining reasonable measures for prudential reasons, including:

   (a) the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owed by a Financial Institution, or cross-border financial service supplier or financial service supplier;

   (b) the maintenance of the safety, soundness, integrity or financial responsibility of a financial Institution, cross-border financial service supplier or financial service supplier; or

   (c) ensuring the integrity and stability of a Party's financial system.
2. Without prejudice to other means of prudential regulation of cross-border trade in financial services, a Party may require the registration of cross-border financial service suppliers of the other Party and of financial instruments.

3. Subject to Article X (National Treatment) and Article Y (Most Favoured Nation Treatment), a Party may, for prudential reasons, prohibit a particular financial service or activity. Such a prohibition may not apply to all financial services or to a complete financial services sub-sector, such as banking.

The structure of the provision appears similar to the PCO in NAFTA at first sight. Paragraph 1 of the PCO in CETA reflects the formulation of Article 1410 of NAFTA, including the “reasonableness” requirement that was explained supra. The provision then adds the possibility for a Party to require the registration of financial instruments and financial service suppliers of the other one. Finally, the PCO authorises Parties to prohibit a particular financial service or activity for prudential purposes. However, such a prohibition cannot apply to all financial services or to an entire subsector (as an example, the provision makes reference to the “banking” subsector). This is, in all aspects, an important evolution of trade law in the domain of prudential policy. In particular, it is a powerful tool to address the distortions that the boom of new financial instruments may cause, as regulators are often unprepared to the technological shocks and are usually in the position of chasing new financial instruments in order to exercise their regulatory powers. The possibility to intervene in particularly opaque market is not uncontested across all jurisdictions and as such this innovation is substantial in nature.279

The provision seems to belong to the realm of “provisions that exclude the application of other provisions” rather than to that of exceptions. No particular conditions, apart from a not better qualified “reasonableness requirement” along the lines of the wording of the PCO in NAFTA, must be respected by Parties when they deviate from their obligations in pursuance of prudential goals.

279 Sometimes not even the operators in financial markets are aware of the instruments they are working with. The story of the boom of high frequency trading is particularly telling of how regulators struggle to catch up with financial innovation. A good account of the story is provided by Michael Lewis, Flashboys - Cracking the Money Code (London, UK: Allen Lane, 2014) 274.
(ii) The filter mechanism in investment disputes on financial services

Article 20 (Investment Disputes in Financial Services) of the Chapter on Financial Services of the CETA provides for a peculiar discipline with regard to the invocation of the prudential shelter in investment disputes. The issue is not new in the domain of trade agreements as NAFTA also provides for a similar filter mechanism.\textsuperscript{280}

The provision sets out a special discipline.\textsuperscript{281} Essentially, the most important elements are the following: a) unless the parties agree otherwise, when Article 15.1 is invoked the tribunal shall be

\begin{itemize}
  \item \textsuperscript{280} See supra.
  \item \textsuperscript{281} Article 20: Investment Disputes in Financial Services
  1. The provisions of [Investor-to-State Dispute Settlement] apply, as modified by this Article and Annex XXX, to: investment disputes pertaining to measures to which this Chapter applies in which an investor claims that a Party has breached Articles X.12 (Investment – Transfers), X.11 (Investment – Expropriation), X.10 (Investment - Compensation for Losses), X.9 (Investment – Treatment of Investors and of Covered Investments), X.15 (Investment – Denial of Benefits), X.3 (Financial Services - National Treatment) or X.4 (Financial Services - Most-Favoured Nation Treatment); or investment disputes commenced pursuant to [Investor State Dispute Settlement] in which Article 15.1 has been invoked.
  2. Unless the disputing parties agree otherwise, in the case of an investment dispute under sub-paragraph 1(a), or where the respondent invokes Article 15.1 within 60 days of the submission of a claim to arbitration under Article X-8 [Submission of a Claim to Arbitration], the Tribunal shall be constituted from the list established under Article X [Financial Services – Dispute Settlement]. Where the respondent invokes Article 15.1 within 60 days of submission of a claim, with respect to an investment dispute other than under sub-paragraph 1(a), the time period applicable to the constitution of the Tribunal under Article X-10 [Constitution of the Tribunal] shall commence on the date the respondent invokes Article 15.1. In the event that the disputing parties are unable to agree on the composition of the Tribunal within the time frame laid down in Article X-10 (Constitution of the Tribunal) either disputing party may request the Secretary-General of ICSID to select the arbitrators from the list established under Article X-19 (Financial Services – Dispute Settlement). In the event that disputing parties are unable to constitute the Tribunal from the list, or that the list has not been established under Article X [Financial Services – Dispute Settlement] on the date the claim is submitted to arbitration, the Secretary-General of ICSID shall select the arbitrators from the individuals proposed by one or both of the Parties in accordance with Article X-19 [Financial Services –Dispute Settlement].
  3. The respondent may refer the matter in writing to the Financial Services Committee for a decision as to whether and, if so, to what extent the exception under Article 15.1 is a valid defence to the claim. Such a referral cannot be made later than the date the Tribunal fixes for the respondent to submit its counter-memorial. Where the respondent refers the matter to the Financial Services Committee under paragraph 3 the time periods or proceedings specified in [Investor-to-State-Dispute Settlement] shall be suspended.
  4. In a referral under paragraph 3, the Financial Services Committee or the CETA Trade Committee as the case may be, may make a joint determination on whether and to what extent Article 15.1 [Prudential Carve-Out/Exceptions] is a valid defence to the claim. The Financial Services Committee or the CETA Trade Committee as the case may be, shall transmit a copy of any joint determination to the investor and the Tribunal, if constituted. If such joint determination concludes that Article 15.1 is a valid defence to all parts of the claim in their entirety, the investor shall be deemed to have withdrawn its claim and proceedings shall be discontinued in accordance with Article X (Discontinuance). If such joint determination concludes that Article 15.1 is a valid defence to only parts of the claim, the joint determination shall be binding on the Tribunal with respect to those parts of the claim, the suspension of the timelines or proceedings in paragraph 4 shall no longer apply, and the investor may proceed with any remaining parts of the claim.
\end{itemize}
constituted from the list provided for under the provision that requires that financial services disputes shall be adjudicated by experts selected from a specific list; b) the respondent in the dispute may refer the matter in writing to the Financial Services Committee as to whether and, if so, to what extent the defence under Article 15.1 of the Agreement constitutes a valid counterargument for the claim raised by the complainant; c) if the Committee accepts the arguments raised by the respondent, the claim shall be considered to be dismissed (totally or partially) and the rest of the dispute shall proceed before the original panel; d) the Committee has three months to render its decision, otherwise the investor may proceed with its claim; e) in case the respondent does not raise the defence in its first intervention in the proceedings, it shall not be prevented from doing so at a later stage; f) finally, the Tribunal shall not draw adverse inferences from the lack of agreement on a joint determination of the matter by the Financial Services Committee or by the CETA Trade Committee.

(iii) **Understanding between Canada and the EU Guidance on the application of Article 15.1 (Prudential Carve-out) and Article 20 (Investment Disputes in Financial Services).**

The CETA contains also an Annex the function of which is to provide guidance in the application of the PCO as well as of Article 20 of the Chapter on Financial Services (an account of which was given above). The Understanding has preamble in which the parties acknowledge the relevance of prudential regulation and commit to act in good faith. It recalls procedural issues concerning the application of Article 20 which was the object of this analysis above. The document then sets out principles which as clearly stated in the text, are not exhaustive:

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5. If the CETA Trade Committee has not made a joint determination within 3 months of referral of the matter by the Financial Services Committee, the suspension of the time periods or proceedings referenced in paragraph 4 shall no longer apply and the investor may proceed with its claim.

6. At the request of the respondent, the Tribunal shall decide as a preliminary matter whether and to what extent Article 15.1 [Prudential Carve-Out/Exceptions] is a valid defence to the claim. Failure of the respondent to make such a request is without prejudice to the right of the respondent to assert Article 15.1 [Prudential Carve-Out/Exceptions] as a defence in a later phase of the arbitration. The Tribunal shall draw no adverse inference from the fact that the Financial Services Committee or the CETA Trade Committee has not agreed on a joint determination in accordance with Annex XXX.
**Appropriate level of prudential regulation:** Each party is free to set out its appropriate level of prudential regulation. It is clarified, importantly, that such level can be higher than that set out in international forums. This innovation is meaningful as it provides clarity with regard to the margin of manoeuvre that regulators enjoy in this domain. Moreover, it introduces concepts that are familiar to other fields of trade law. In fact, “appropriate level” recalls the expression “adequate level of protection” introduced in Article 2.2 of the SPS Agreement of the WTO. Contrary to the latter, however, in the context of CETA there are not stringent procedural requirements to be met in order for a party to deviate from internationally agreed standards in the setting out of its appropriate level of prudential regulation. This can be explained because the concept of “adequate level of protection” under Article 2.2 of the SPS Agreement requires a scientific risk assessment to be conducted, whereas this is not the case in the context of the PCO under CETA. Moreover, CETA does not list the relevant standards in the field, as opposed to what happens in the context of the WTO SPS Agreement.

**Relevant considerations:** When dealing with the PCO, adjudicators must give consideration to the information available as well as to the urgency of the situation at the time in which the measure was issued.

**Deference:** The Understanding acknowledges the highly specialised nature of prudential regulation and requires adjudicators to defer “to the highest degree possible” to the laws and regulations of the Parties’ jurisdictions as well as to the determinations made by domestic authorities with regard, for example, to risk assessment and other factual determinations. Given the high level of asymmetry of information in this domain, the Understanding acknowledges that domestic authorities are in a better position to evaluate the situations of potential danger for financial institutions and the financial system taken as a whole.

**Indicators of lawfulness/unlawfulness:** The Understanding provides indicators with regard to the possibility of benefitting from the PCO in the event of a dispute. A measure should be considered in compliance with Article 15.1 – according to the principle set out in the Understanding – if it has a prudential objective and it is not manifestly disproportionate to the attainment of its stated aim. On the contrary a Party cannot take advantage of the discipline set out in the PCO when it enacts a regulation that amounts to a disguised restriction on foreign investment or an arbitrary
and unjustifiable discrimination towards foreign investors which are in a situation comparable to that of like domestic ones. The Understanding then introduces language similar to that adopted by the *chapeau* in the exceptions provisions of the GATT 1994 and the GATS.

**Presumption of lawfulness:** A measure, provided that it does not amount to a disguised restriction and that it does not discriminate arbitrarily and unjustifiably among investors in comparable situations, shall be deemed to be in compliance with Article 15.1 in four cases: when the measure is in line with international standards on prudential regulation; when it is adopted in pursuance of the resolution of a financial institution that is no longer viable or likely to be no longer viable; when it pursues the recovery of a financial institution under stress or to the management of the latter; when it is approved in response to a systemic financial crisis in order to preserve or restore financial stability. This is a rather broad list of measures and, more particularly, the last element paves the way for an extension of the situations in which a respondent, in the event of a dispute, can usefully invoke the PCO.

Finally, a section entitled *Periodic Review* concludes the Understanding. According to this last section, the Financial Services Committee, by agreement of both Canada and the EU may amend the Understanding and shall review the understanding at least once every two years. Moreover, so this last section continues, the Financial Services Committee may develop a “common understanding” on the application of the PCO based on the discussions within that body as well as the developments taking place in the context of international forums.
Chapter 4 – The suggested approach

4.1 Introduction

Chapter 2 gave an account of the interpretation advanced by scholars with regard to the scope of application and the legal function of the PCO of the Annex on Financial Services of the GATS. The current mainstream approach with regard to the PCO of the GATS classifies it as an exception-type provision, and sees the last sentence of the PCO as being comparable to the *chapeau* of Article XX of the GATT 1994 and Article XIV of the GATS. Such an interpretation may be reassuring for some international trade scholars as it links the interpretation of the PCO to that of well known provisions, thus making the former less of an unexplored territory. However, there are solid textual, historical and economic reasons that cast doubt on the extent to which the mainstream understanding is a correct one.

The aim of this work, after the overview of the state of the art of the literature on the topic in Chapter 2 and the analysis of the PCOs in all the PTAs notified to the WTO Secretariat in Chapter 3, is to propose an alternative approach to the interpretation of the PCO of the GATS which is more loyal to the negotiating history and the rationale of the provision.

4.2 The problems with the current interpretation

The vast majority of those scholars who have ventured into the interpretation of the PCO have insisted on the notion according to which the latter should be considered a provision performing the same legal function as that assigned by the treaties to “general exceptions”.\(^{282}\) At first sight, however, this reading of the PCO appears problematic and this is the first indicator that leads us to believe that, in all likelihood, there are other unexplored routes that should be explored in an attempt to provide an explanation which is more in line with the negotiating history and the

\(^{282}\) See the review of the literature in Chapter 1.
economic rationale behind one of the cornerstones of the discipline on financial services in the GATS.

The structure of the PCO differs substantially from that of the paradigmatic GATS exception – Article XIV. The latter has the following three features:

(i) It opens with a *chapeau*, which, like that of Article XX of the GATT 1994 addresses “(...) the manner in which [the questioned measure] is applied”\(^{283}\) – in other words it requires that measures be applied in a non-arbitrary or unjustifiably discriminatory fashion, or that they do not constitute a disguised restriction to trade in services;

(ii) it provides for an exhaustive list of the policy objectives covered, and;

(iii) at least for the policy objectives included in subparagraphs a) b) and c), it requires that a necessity test be met, that is, that measures ought not to be more burdensome than necessary to achieve their objective.

These features do not generally apply to the PCO. Actually, the structure of the latter appears to be radically different from that of the exception-type provisions of the WTO Agreements, and these differences, together with other aspects that will be examined later in this Chapter, contribute to construct the PCO in a way that is different from the traditional mainstream interpretation. Deviating from an “exception-type” interpretation scheme has implications with regard to the allocation of the burden of proof in the event of a dispute and the degree of deference that WTO judges will have to pay *vis-à-vis* regulators.

Each of the three elements mentioned above will be analysed in turn.

4.2.1 The Chapeau

The discussion carried out in Chapter 2 highlighted how some commentators have seen similarities between the *chapeau* of Article XIV of the GATS and the final sentence of the PCO. It is worth providing the texts of the two parts here in order to make a proper comparison and to see if they both should be construed as exceptions. The implications deriving from a positive answer to the question are potentially huge, since this may lead to the importation of established case law on the *chapeau* in the interpretation of the PCO. It would not be the first time that WTO judges have relied on established case law under other agreements in order to clarify the meaning and standard of review of different provisions.284

The *chapeau* of Article XIV of the GATS reads as follows:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures (...)

The last sentence of the PCO, in turn, reads:

Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement.

Whilst the wording of the *chapeau* points to a hierarchy in legitimate policy objectives that can be pursued lawfully, the final clause of the PCO, in contrast, addresses the issue of the possible circumvention of trade obligations without a genuine prudential goal pursued by the regulation.

284 The criticisms made by Mavroidis of the Appellate Body’s case law on the Agreement on Technical Barriers to Trade (TBT) are illustrative in this regard. See Petros C. Mavroidis, ’Driftin’too Far from Shore–Why the Test for Compliance with the TBT Agreement Developed by the Wto Appellate Body Is Wrong, and What Should the Ab Have Done Instead’, *World Trade Review*, 12/03 (2013), 509-31.
The interpreter is assisted by extensive case law on the meaning of the requirements of the chapeau as well as on the specific function it performs. The Agreements of the WTO are living agreements and our understanding of the balance of the Members’ rights and obligations becomes clearer over time because of the work conducted by the WTO courts. It is important, therefore, to give account to the evolution of the jurisprudence with regard to the chapeau in order to understand what its terms exactly mean and what its function really is.

Two are the main sources of concern with regard to the importation of the ideas and the concepts expressed in the chapeau of the General Exceptions provisions of the GATT 1994 and the GATS in the PCO. The first concerns the non-negligible differences in the wordings of the two expressions, while the second relates to the problems that may arise should the WTO judiciary accept this comparison and import lock-stock-and-barrel the case law that was just referred to in the analysis of the consistency of a measure with the chapeau.

4.2.1.1 The chapeau in WTO case law

The Appellate Body in US – Gambling found that a set of measures adopted by the United States aiming at the prohibition of online gambling, provisionally justified under Article XIV (a) of the GATS on the grounds that they were necessary to protect public morals, were in fact inconsistent with the requirement of the chapeau. The Appellate Body did not find evidence of discrimination in favour of domestic suppliers in the application of the measures at issue but outlawed the scheme on the grounds that, potentially, some provisions could be read as allowing domestic suppliers to provide remote betting services for horse racing. Quoting the Appellate Body report in its relevant parts (paras. 371 and 372):

[...] We have found instead that those measures satisfy the "necessity" requirement. We have also upheld, but only in part, the Panel’s finding under the chapeau. We explained that the only inconsistency that the Panel could have found with the requirements of the chapeau stems from the fact that the United States did not demonstrate that the prohibition embodied

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in the measures at issue applies to both foreign and domestic suppliers of remote gambling services, notwithstanding the IHA—which, according to the Panel, "does appear, on its face, to permit" domestic service suppliers to supply remote betting services for horse racing. In other words, the United States did not establish that the IHA does not alter the scope of application of the challenged measures, particularly vis-à-vis domestic suppliers of a specific type of remote gambling services. In this respect, we wish to clarify that the Panel did not, and we do not, make a finding as to whether the IHA does, in fact, permit domestic suppliers to provide certain remote betting services that would otherwise be prohibited by the Wire Act, the Travel Act, and/or the IGBA.

Therefore, we modify the Panel's conclusion in paragraph 7.2(d) of the Panel Report. We find, instead, that the United States has demonstrated that the Wire Act, the Travel Act, and the IGBA fall within the scope of paragraph (a) of Article XIV, but that it has not shown, in the light of the IHA, that the prohibitions embodied in these measures are applied to both foreign and domestic service suppliers of remote betting services for horse racing. For this reason alone, we find that the United States has not established that these measures satisfy the requirements of the chapeau. Here, too, we uphold the Panel, but only in part. (*Footnotes omitted*)

The Appellate Body interprets the *chapeau* of Article XIV of the GATS in light of the longer and more established case law of Article XX of the GATT 1994. It first clarified so in *US – Gambling*, where it stated that the two provisions set out general exceptions to the provisions of the respective agreements in a comparable fashion. Both provisions aim at allowing Members to pursue legitimate identified objectives, following the requirements set out therein.\(^{286}\)

The same judgment, following the consolidated jurisprudence on Article XX of the GATT 1994, reads the discipline provided by Article XIV of the GATS as one that requires a "two-tier analysis".\(^{287}\) The idea, was first expressed in the landmark *US – Gasoline* report of the Appellate Body, which explained the test as follows (p. 22):

> In order that the justifying protection of Article XX may be extended to it, the measure at issue

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must not only come under one or another of the particular exceptions - paragraphs (a) to (j) - listed under Article XX; it must also satisfy the requirements imposed by the opening clauses of Article XX. The analysis is, in other words, two-tiered: first, provisional justification by reason of characterization of the measure under XX(g); second, further appraisal of the same measure under the introductory clauses of Article XX. 288

Ever since, the Appellate Body has given the *chapeau* an important function in the analysis of the compatibility of the various domestic measures that were subjected to its scrutiny in order to verify the compatibility with the requirements of Article XX of the GATT 1994. The idea is the following: when a measure is found to be in violation of one or more provisions of the GATT 1994, for it to be justified under Article XX of the GATT 1994 it has first to pass one of the tests provided for the availability of one of the justifications enlisted in the non-exhaustive list of legitimate policy objectives provided for by letters (a) to (j) of the provision under analysis. After this first step is completed the measure has to pass the test under the *chapeau*.

The *chapeau*, according to the interpretation advanced by the Appellate Body and constantly repeated in the following judgments, focuses on the way the measure is applied. The Appellate Body has clarified what this condition means in *US – Gambling*289:

> The focus of the chapeau, by its express terms, is on the application of a measure already found by the Panel to be inconsistent with one of the obligations under the GATS but falling within one of the paragraphs of Article XIV. By requiring that the measure be applied in a manner that does not constitute “arbitrary” or “unjustifiable” discrimination, or a “disguised restriction on trade in services”, the chapeau serves to ensure that Members’ rights to avail themselves of exceptions are exercised reasonably, so as not to frustrate the rights accorded other Members by the substantive rules of the GATS.

The Appellate Body has also distinguished between the burden of proof under the specific exceptions of the provision and the burden of proof under the chapeau. Since *US – Gasoline* it has

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clarified that the burden of demonstrating that a measure that was provisionally found to be consistent with one of the exceptions in the body of Article XX of the GATT 1994 does not constitute an abuse of such an exception.\textsuperscript{290}

In other terms, the *chapeau* serves the necessary role of striking a balance between the possibility of a Member deviating from its obligations in pursuit of other (legitimate) interests and the competing claim of other WTO Members to have their rights preserved and not disproportionately harmed by the unilateral action of the regulating government. Concretely, this line of equilibrium is substantiated by the requirements that the measures are not applied in a manner that would constitute “arbitrary discrimination between countries where the same conditions prevail”; “unjustified discrimination between countries where the same conditions prevail” or “a disguised restriction to international trade”. This is consonant with the original idea of the GATT in the 1940s, that trade liberalisation does not trump social preferences as long as the latter are “genuine” and there is no abuse of right.

It is important, at this stage, to review how the concepts of “arbitrary or unjustifiable discrimination” and “disguised restriction on trade” have evolved over the years. In *US-Gasoline*, the Appellate Body made it clear that the three requirements are necessary terms of the same equations, and that one cannot make a rigid distinction between the three requirements and read them in isolation. The Appellate Body clarified that:

> "Arbitrary discrimination", "unjustifiable discrimination" and "disguised restriction" on international trade may, accordingly, be read side-by-side; they impart meaning to one another. It is clear to us that "disguised restriction" includes disguised discrimination in international trade. It is equally clear that concealed or unannounced restriction or discrimination in international trade does not exhaust the meaning of "disguised restriction." We consider that "disguised restriction", whatever else it covers, may properly be read as embracing restrictions amounting to arbitrary or unjustifiable discrimination in international trade taken under the guise of a measure formally within the terms of an exception listed in Article XX. Put in a somewhat different manner, the kinds of considerations pertinent in deciding whether the application of a particular measure amounts to "arbitrary or

\textsuperscript{290} Appellate Body Report, *Us – Gasoline* (p. 22).
unjustifiable discrimination", may also be taken into account in determining the presence of a "disguised restriction" on international trade. The fundamental theme is to be found in the purpose and object of avoiding abuse or illegitimate use of the exceptions to substantive rules available in Article XX.²⁹¹

The Appellate Body, in *US-Shrimp*²⁹² clarified the scope of application and the function of the *chapeau* in more detail. In particular, the judgment clarified that the policy goal of the measure under analysis cannot provide the justification under the standards of the *chapeau* because that particular scrutiny is reserved to the test under one of the ten specific policy objectives in the exhaustive list set out in the body of Article XX of the GATT 1994.

In this case, the Appellate Body ventured into a deeper analysis of the issue. The WTO judiciary took a long detour in order to clarify its understanding of the test of the *chapeau*. To begin with, the Appellate Body put the analysis of the *chapeau* against the background of the preamble of the WTO Agreement, in the context of a dispute that concerned issues related to the protection of the environment and the ecosystem. In the words of the Appellate Body the preamble, insofar as it reflects the intentions of the negotiators of the WTO, "(...) must add colour, texture and shading to our interpretation of the agreements annexed to the WTO Agreement".²⁹³

The Appellate Body identifies the *chapeau* as a test according to which each of the exceptions listed in paragraphs (a) to (j) of Article XX of the GATT 1994 has to be considered to be limited and conditional.²⁹⁴ In other words, the *chapeau* represents the last test that domestic measures in compliance with the requirements of one of the paragraphs of Article XX of the GATT 1994 have to meet. In order to back this interpretation of the *chapeau*, the Appellate Body decided to seek confirmation in the negotiating history of the provision. In so doing, the judges reveal that there was an initial proposal, tabled by the United States, according to which the exceptions should be made available to the Members of the GATT 1947 without any other condition to be satisfied. In the discussion that followed, other Members (including Belgium and the Netherlands) took other

positions and, in the end, the United Kingdom advanced a position of compromise on which the
negotiating teams agreed. The parties agreed that Article XX of the GATT 1947 should provide for
an exhaustive list of limited and conditional exceptions to the obligations provided for in the
Agreement.295

The Appellate Body went on with the clarification of its understanding of what the *chapeau*
means for the architecture of the GATT 1994. According to the judges, the language of the
introductory sentences of Article XX of the GATT 1994 is in essence, “one expression of the
principle of good faith”, and, more in detail, the very aim of the *chapeau* should be that of
avoiding situations in which Members may abuse their rights to deviate from their substantive
obligations.296 Then, in what is arguably one of the most often quoted (although not exactly the
clearest) passages of WTO jurisprudence, the Appellate Body famously stated:

> The task of interpreting and applying the chapeau is, hence, essentially the delicate one of
> marking out a line of equilibrium between the right of a Member to invoke an exception under
> Article XX and the rights of the other Members under varying substantive provisions (...). The
> location of the line of equilibrium, as expressed in the chapeau, is not fixed and unchanging;
> the line moves as the kind and the shape of the measures at stake vary and as the facts making
> up specific cases differ. *(Emphasis added)*297

The Appellate Body points out that the focus under the chapeau should consist of scrutiny of the
*application* of the measure, the rationale of which was already assessed in the analysis under one
of the ten paragraphs of Article XX of the GATT 1994 beforehand. However, the Appellate Body
makes it clear that the analysis under the *chapeau* should not be seen as exclusively dealing with
procedural aspects, since substantive requirements also come under scrutiny.298

The issue in the *US-Shrimp* dispute concerned a requirement by the administration of the United
States according to which, for shrimp to be sold in the US market, they had to be fished with a

295 See Appellate Body Report, *US-Shrimp*, para 157 (and the footnotes) for the details of the discussion during the
negotiations of the GATT 1947.
particular technique that involved the use of specific nets (Turtle Excluder Devices, TEDs). The measure was already found to be in compliance with the requirements of Article XX (g) of the GATT 1994 ("the protection of natural exhaustible resources"), but it was outlawed because it failed to pass the test under the *chapeau*. The problem there was that the United States was, *de facto*, imposing on other WTO Members the burden of adopting exactly the same regulatory program as the one imposed on US fishing companies and they were not given the possibility to adopt others that were comparable in their effects.299

The main problem for the Appellate Body, therefore, consisted of the imposition of a rigid and unbending requirement that, although non-discriminatory on the face of it (because it was imposed on US companies and foreign companies alike), caused *de facto* disproportionate effects and imposed an excessive burden on foreign firms that were put in a position where they could not export shrimp to the US.300

The Appellate Body addressed the issue with clear and unequivocal words. It is worth reporting another key passage from the judgment, as it will be useful in the analysis of the difference between the *chapeau* of Article XX of the GATT 1994 and the final clause of the PCO:

(...) [I]t is not acceptable, in international trade relations, for one WTO Member to use an economic embargo to *require* other Members to adopt essentially the same comprehensive regulatory program, to achieve a certain policy goal, as that in force within that Member's territory, *without* taking into consideration different conditions which may occur in the territories of those other Members. (Emphasis in the original text).301

The judges found that the applicants were right in pointing to the rigidity of the US measure with specific regard to two issues: the measure did not allow all foreign exporters to the US to enter negotiations with the administration; moreover, it did not allow for shrimp fished through means as efficient as TEDs to enter the US market.

Essentially, the absence of flexibility in the application of the measure led the Appellate Body to find in favour of the applicants in the case that the measures adopted by the United States were inconsistent with the requirements of the *chapeau* of Article XX of the GATT 1994 because they amounted to an arbitrary and unjustifiable discrimination between countries where the same conditions prevailed.

Another important case in the *chapeau* saga is *Brazil-Retreated Tyres*.³⁰² Brazil had imposed a restriction on imports of remoulded tyres in order to protect the environment and to avoid the spreading of diseases connected to the particular processes adopted in the treatment of used pneumatics. However, Brazil had also introduced an exemption for imports of retreated tyres from MERCOSUR countries following a decision by an arbitral tribunal under MERCOSUR law. The measure was challenged before WTO courts and gave the Appellate Body another occasion to put forward its understanding of the *chapeau*.

The Panel had justified the difference in treatment between tyres from MERCOSUR and tyres from other parts of the world on the basis of the limited volumes on that particular type of good among MERCOSUR countries.³⁰³ In its appellant submission, the European Union challenged the conclusions of the Panel report, calling into question the availability of a ruling from a MERCOSUR tribunal as a legitimate justification for the imposition of a discriminatory application of a measure and arguing that, following the ruling, Brazil could have lifted the import ban *vis-à-vis* all importers.³⁰⁴

The Appellate Body did not accept the existence of a decision by a MERCOSUR tribunal as a legitimate justification for the discrimination between MERCOSUR countries and third countries. It ruled as follows:

(...) In our view, the ruling issued by the MERCOSUR arbitral tribunal is not an acceptable rationale for the discrimination because it bears no relationship to the legitimate objective pursued by the Import Ban that falls within the purview of Article XX(b), and even goes

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against this objective, to however small a degree. Accordingly, we are of the view that the MERCOSUR exemption has resulted in the Import Ban being applied in a manner that constitutes arbitrary or unjustifiable discrimination.305

The case under analysis here is also important because it clarified that the terms “arbitrary” and “unjustifiable” of the chapeau are not tantamount to “capricious” or “random”. According to the Appellate Body, rational behaviour from the legislator may also lead to arbitrary or unjustifiable discrimination because it may be based on a decision which may be totally unconnected from the rationale of the measure or may even contradict it.306

Finally, the Appellate Body had the opportunity to analyse the chapeau of Article XX of the GATT 1994 in the EC-Seal Products307 judgment rendered in the spring of 2014. The European Union had approved a regulation whereby it imposed an import ban on seal products with limited exceptions. One of these exceptions – the famous “Inuit Community exception” (IC exception) – allowed seal products that were the result of hunts conducted by indigenous communities of Greenland following traditional methods, providing that the ultimate purpose of the harvesting was the subsistence of the local community. The same possibility, however, was not conceded to the indigenous communities of Canada and Norway, whose governments challenged the regulatory scheme approved by the European Union before the WTO courts. The Appellate Body found the regulatory scheme to comply with the requirements set forth in Article XX(a) of the GATT 1994 because it was considered to be a necessary measure for the protection of public morals.

However, the measure did not meet the test under the chapeau. The Appellate Body asked itself the question of whether the same conditions prevailed within the European Union and the other countries that lamented discriminatory treatment. It found out that the European Union failed to sufficiently explain what made the conditions of the Inuit communities of Greenland so different.

305 Appellate Body Report, Brazil Retreated Tyres, para. 228.
306 Appellate Body Report, Brazil Retreated Tyres, para. 232.
from that of the indigenous communities of Canada as to lead to different treatment.\footnote{Appellate Body Report, \textit{EC-Seals Products}, para. 5.317.} The last instance of the WTO judiciary found that the scheme was construed in a way to make it, \textit{de facto}, available only to Greenland and that this circumstance was not due to the inaction of Canadian exporters to seek authorisation.\footnote{Appellate Body Report, \textit{EC-Seals Products}, para. 5.333-5.334.} The Appellate Body concluded as follows:

In sum, we have identified several features of the EU Seal Regime that indicate that the regime is applied in a manner that constitutes a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, in particular with respect to the IC exception. First, we found that the European Union did not show that the manner in which the EU Seal Regime treats seal products derived from IC hunts as compared to seal products derived from "commercial" hunts can be reconciled with the objective of addressing EU public moral concerns regarding seal welfare. Second, we found considerable ambiguity in the "subsistence" and "partial use" criteria of the IC exception. Given the ambiguity of these criteria and the broad discretion that the recognized bodies consequently enjoy in applying them, seal products derived from what should in fact be properly characterized as "commercial" hunts could potentially enter the EU market under the IC exception. We did not consider that the European Union has sufficiently explained how such instances can be prevented in the application of the IC exception. Finally, we were not persuaded that the European Union has made "comparable efforts" to facilitate the access of the Canadian Inuit to the IC exception as it did with respect to the Greenlandic Inuit. We also noted that setting up a "recognized body" that fulfills all the requirements of Article 6 of the Implementing Regulation may entail significant burdens in some instances.

For these reasons, we find that the European Union has not demonstrated that the EU Seal Regime, in particular with respect to the IC exception, is designed and applied in a manner that meets the requirements of the chapeau of Article XX of the GATT 1994. It follows that the European Union has not justified the EU Seal Regime under Article XX(a) of the GATT 1994.\footnote{Appellate Body Report, \textit{EC-Seals Products}, paras. 5.338-5.339.}
4.2.1.2 The problems with the parallelism between the last clause of the PCO and the *chapeau* of Article XX of the GATT 1994

The very idea behind the introduction of a separate test of consistency of the domestic measures under the *chapeau* is a judicial construction with limited, if any, links with the text of the provision and its negotiating history. It is not surprising, therefore, that its meaning and functions are being called into question by recent literature.\(^{311}\) However, as this work is not mainly concerned with the interpretation of the *chapeau* of the exception-provisions of the GATT 1994 and the GATS, it is necessary to turn our attention to analysing the main problems concerning the parallelism with the final clause of the PCO that has been advocated by some international trade scholars.

### i. The wording

The *chapeau* deals with the application of a measure that was previously found to be in compliance with one of the paragraphs of the body of the provision (either Article XX of the GATT 1994 or Article XIV of the GATS). It requires that the measure under scrutiny, in its application, should not lead to arbitrary or unjustifiable discrimination between countries where the same conditions prevail or to a disguised restriction to trade. None of these three terms appears in the last clause of the PCO, not even in a different fashion or through the use of synonyms.

One may think, at first sight, that the terms “applied” (in the *chapeau*) and “used” (in the PCO) are to be considered as similar. They should both deal, in principle, with the application of the measures and not just with the ways in which they are designed and drafted. This distinction is a very subtle one, however, and the case law has been problematic in this regard.\(^{312}\) This latter

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\(^{312}\) Especially, the Appellate Body Report in *EC-Seals* is problematic in this regard.
issue will be dealt with in the following subsection, when the issue of measures pursuing a double objective will arise with regard to recent developments in the WTO case law.

**ii. The case law**

The most important issue here is that of avoiding the risk that the WTO judiciary would import “lock-stock-and-barrel” the case law on General Exceptions into the interpretation of the PCO. There are warning signs to this extent in the cases that have been analysed in the previous pages, and they shall be made explicit in the following sections.

The case law on *General Exceptions* has made it clear that the latter perform a strategic function in the legal system of the WTO, namely that of “marking out a line of equilibrium” between the right of a Member to deviate from its trade obligations in order to pursue other legitimate policy objectives and the rights of other Members of the international trade community not to see their rights frustrated by arbitrary measures that, while on their face are cosmetically designed in order to sound legitimate are, in reality, instruments that conceal protectionist behaviour. In order to do so the drafters of the exceptions used specific concepts (“arbitrary or unjustifiable discrimination between countries where the same conditions prevail” and “disguised restriction to trade”). The WTO judiciary has gone one step further in this regard by stating that the terms used in the *chapeau* are to be read side by side as imparting meaning to each other so as to compose, in the end, a single test.

The Appellate Body has developed its jurisprudence on the issue, drifting from the shore of the principle of good faith – in its *abus de droit* acceptation - and scrutinising in detail the policy choices made by the regulators. In one case, the Appellate Body seems to have even put into question, following the arguments of the complainant, the effectiveness of the defensive strategy of the respondent in the case before a regional court, the implementation of the decision of which led the defending government to adopt a regulatory scheme that was afterwards struck down for lack of compliance with the *chapeau*. It must be recalled, moreover, that such a “line of equilibrium” depends mostly on the conditions set up in the relevant subparagraph of the
exception – Article XX of the GATT 1994 – that, in origin, could justify the derogation from the obligations under the relevant trade agreement.

The jurisprudence of the Appellate Body, however, reveals a tendency to scrutinise the details of the instruments deployed by the regulators in order to address legitimate policy goals, sometimes questioning the real aim behind the adoption of particular pieces of legislation. Put in another form, the WTO adjudicators seem to have allowed governments considerable autonomy with regard to the connection between the measures enacted and their capability of being encompassed by one of the paragraphs of Article XX of the GATT 1994 or Article XIV of the GATS. However, it seems that WTO judges have been much stricter in the analysis of the choice of the means for the achievement of the legitimate non-trade policy objectives namely pursued by the defendants in the disputes.313 This second tier of analysis has been noticeably conducted under the *chapeau* and has led to a more pervasive analysis of the policy strategies adopted domestically. The last instance of the WTO judiciary, moreover, has made it clear on several occasions that the burden of proving that the measures adopted meet the requirements of the *chapeau* rests on the respondent in the dispute.

This conclusion, however, derives mainly from the context against the background of which the *chapeau* should be read. The meaning of the latter is informed by the tests required by the various paragraphs in Article XX of the GATT 1994 and Article XIV of the GATS, which provide for limited and conditional exceptions. Importing the case law on the *chapeau* in the analysis of the PCO may tilt the balance that was carefully struck in the negotiations of the Annex on Financial Services of the GATS in favour of the interests of the Members challenging the measures rather than the regulating governments.

To make the picture clearer, it must be recalled that, for instance, the Appellate Body outlawed some measures adopted by the US administration that restricted the imports of shrimp only to those fished using particular devices. The judges found that the measure, although in principle

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313 The thorough analysis provided in Alan O. Sykes, 'Economic "Necessity" in International Law', *MIMEO* (http://ssrn.com/abstract=2572632, 2015), 1 - 34 (p. 10) is illustrative in this regard.
compliant with Article XX (g) of the GATT 1994,\textsuperscript{314} could not pass the test under the *chapeau* because it imposed a “single, rigid and unbending requirement” on importers to adopt the same scheme applicable to US companies with “little or no flexibility”\textsuperscript{315}. In the compliance proceedings of the same dispute, furthermore, the Appellate Body clarified that there was a need for the regulator to allow importers to prove that the actions undertaken by them were “comparable in effectiveness” to what was required under US law.\textsuperscript{316}

The practice of adopting “single, rigid and unbending requirement(s)” is common to many regulations for services providers across the world. It is a peculiar ingredient, in particular, in the main recipes adopted by large regulatory arenas (namely the EU and the US) in the domain of financial services in the reform packages adopted and implemented in the aftermath of the 2007-2008 financial crisis.\textsuperscript{317}

A pervasive scrutiny of domestic policy choices with regard to financial services, along the lines of that provided for by the *chapeau* of the General Exceptions (at least in the way in which the Appellate Body has understood they do), may not be considered a welcome development by many of the actors of the international trade system. In particular, it may alter a balance that has lasted until now and has allowed for greater flexibility and for the possibilities for governments to address loopholes and shortcomings in their legislation on financial services markets. Moreover, the Appellate Body has gone even further, putting into question the defensive strategy adopted by Brazil before the MERCOSUR tribunal in the dispute whose decision led to Brasília lifting the embargo on retreated tyres from other Parties to the South American FTA.

\textsuperscript{314}This is not the correct place to raise the argument on the basis of which it is, at least, debatable whether the Appellate Body was right in finding that turtles can be considered as being “natural exhaustible resources”, a category that was introduced in the text of Article XX with regard to fossils and minerals, as emerges from the negotiating history. For a thorough analysis on the issue, see Mavroidis, *Trade in Goods* (pp. 345-351).


\textsuperscript{317}See the discussion in 2.6.2 and 2.6.3.
iii. Conclusions on the differences with the chapeau

From the above discussion it emerges that there are substantial differences in wording between the chapeau of Article XX of the GATT 1994 and Article XIV of the GATS and the final clause of the PCO. This difference is not insignificant and it represents the outcome of a different drafting process and a different function performed by the two provisions. The PCO serves the function of excluding the domain of prudential regulation from the coverage of trade obligations.

The final clause of the PCO represents a reaffirmation of the requirement to perform treaty obligations in good faith, and does not go beyond it. The chapeau, because of its stricter wording and because of the interpretations rendered by the Appellate Body, has acquired a quasi-autonomous and different standing in the domain of international trade law. It serves the function of marking out a line of equilibrium between the rights of the regulating Member and those of other Members who seek access to the former’s market. In other words, it represents the ultimate test that domestic measures have to pass in order to benefit from the exception and not to be found in violation of one or more provisions of the GATT 1994 or the GATS.

It is at least debatable whether the final clause of the PCO can be understood along these lines. The absence of case law does not help us in this regard, hence leaving wide space for speculation. It can certainly be read as reaffirming the principle according to which Parties to a Treaty shall not abuse their rights (abus de droit), which is a general principle of international law and is common to most legal orders, either domestic or international. It does not, however, ask judges to evaluate whether regulating Members have afforded their trading partners the opportunity to prove that they are in a comparable situation, that their prudential measures are equivalent in effectiveness and does not warn against discrimination.

Pushing the parallel between the PCO and Article XX of the GATT 1994 or Article XIV of the GATS too far would severely impede the possibility of a correct understanding of the state of the art of liberalisation of trade in financial services and the regulatory space left for national governments with regard to prudential measures and, in particular, crisis prevention and crisis management tools.
The last sentence of the PCO cannot be interpreted as being similar to the *chapeau* of Article XIV of the GATS. It only reaffirms the general principle of international law according to which parties to a treaty should not abuse of the rights deriving from the latter (*abus de droit*). It does not require parties to refrain from implementing measures in a discriminatory or arbitrary fashion. Moreover, contrary to the policy objectives in Article XIV of the GATS, the prudential reasons covered by the PCO are non-exhaustive and no necessity test is required for a successful invocation of the provision.

Admittedly, the last sentence of the PCO could be read in parallel with the requirement that measures do not constitute a disguised restriction to trade. The concept of “disguised restriction” provided by the *chapeau* of Article XX of the GATT (and identical to that included in Article XIV of the GATS) has been interpreted in WTO case law in a way which is reminiscent of the French doctrine of *abus de droit*. The two concepts are similar in the sense that they point to situations in which a Member, while affirming that it pursues a lawful objective, aims in reality at an illegal one. However, the parallel between the final sentence of the PCO and the *chapeau* of Article XIV cannot be pushed any further. First of all, the requirement provided by the *chapeau* of Article XIV of the GATS must be read together with the other requirements included therein, which do not apply to the PCO. Second, the final sentence of the PCO, rather than just reaffirming a general principle of law that would have applied regardless, points to the fact that each provision has a definite scope. It cannot be read as if it requires a chapeau-like test to be respected. Third, given the difference in wording and context, it has to be expected that in the case of the PCO the line of equilibrium between the conflicting interests of the regulating Members and those who seek access to the markets of the latter shall definitely lean much more on the side of the importing trading nation.

As stated at the beginning of this Chapter, the *chapeau* of Article XX of the GATT 1994 provides a hierarchy of policy objectives. In this regard, case law has consistently repeated that the first indication of this function performed by the *chapeau* can be found in the title of the provision ("General Exceptions"). Moreover, this case law has linked the shifting of the burden of proof to

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318 See Article 26 of the VCLT (*Pacta sunt servanda*).
the linguistic choice of the drafters. The differences in wording and title of the PCO suggest that we are in presence of something different. Rather than establishing a hierarchy of values, the aim of the PCO is that of excluding the application of trade obligations or commitments to areas of regulation that pertain to the domain of the pursuance of prudential policy objectives. Given the differences in wording and structure, the PCO deserves an autonomous evaluation, separate from the jurisprudential evolution of the general exceptions provision of the GATT 1994 and the GATS.

4.2.2 A non-exhaustive list of prudential objectives

The differences between the PCO and other exception-type provisions are not exhausted by the difference in wording and function performed by the chapeau, on the one hand, and the final clause on the other. Another source of distinction lies in the structures of the provisions. Exceptions-type provisions are typically drafted with a fixed and exhaustive list of policy objectives in pursuance of which Members may deviate from their international trade obligations. The PCO, on the contrary, only provides an indicative list of what can be considered “prudential”, in the domain of financial regulation.

The rationales between the different structures of the provisions ought to be different, otherwise it would have made little sense not to recreate to what was already used in other contexts within the realm of the same Organization. In this case, Article XX of the GATT 1994 (and its twin Article XIV of the GATS) on the one side and the PCO on the other pursue different aims.

Exceptions are typically in place to avoid situations that, in decision-theory, are defined as Type II – false negatives, that is, situations in which a Member is not found to have violated one or more WTO obligations even if it has done so. In simpler terms, this issue can be broken down as follows: when a violation of a trade obligation occurs, the WTO system is designed in a way in which the balance of rights and obligations has to be, in principle, restored, bringing back into compliance domestic regulations that are found to be in violation of one or more provisions of one or more agreements. The system itself makes some instruments available for those Members who have indeed committed a violation of trade obligations, but that have done so in pursuance of one of the listed policy objectives, subject to the conditions provided for by the relevant
exception-provision. This is why the drafters of the GATT 1994 and the GATS have individuated an exhaustive list of policy objectives that can be pursued.

It is true that concepts such as “public morals” or “human health” may vary over time. It is also true, however, that the policy objectives cannot be stretched so as to encompass things that differ substantially from the original catalogue of exceptions. In this regard, the PCO again substantially differs from the typical exception-type provisions in other WTO Agreements. The former only provides for a non-exhaustive list of reasons according to which Members are entitled to adopt prudential measures. This expands much more the scope of manoeuvre for Members in need to deviate from trade obligations and commitments. This is yet another warning against the comparison between exception-type provisions and the PCO.

4.2.3 Absence of requirements for prudential justifications to kick in

Finally, there is another level of difference between exception-type provisions and the PCO. The latter does not require that any condition be satisfied for prudential measures to be put in place, with the exclusion of the restatement of the obligation to perform international obligations in good faith, on which this work has already elaborated in detail above.

This amounts to another difference that cannot be ignored when one compares the structure of the PCO and that of Article XIV of the GATS, for instance. Letters (a) to (e) of the latter all provide for requirements that Members have to fulfil in order to legitimately deviate from their trade obligations and commitments. Letters (a), (b) and (c) require Members to adopt measures that are “necessary” in order to achieve the stated aim, that is that the measures enacted by the Members have to be the least trade restrictive. Letters (d) and (e), instead, provide for less stringent requirements, but they nonetheless do not allow Members to deviate from their obligations easily. Members will still have to prove that they were entitled to depart from trade obligations according to the requirements and conditions set forth in Article XIV.

Returning to the PCO it is self-evident that none of the previous requirements are present in the text of the provision. This may lead to a question pertaining to the hierarchy of values protected
under WTO law. Members may find it harder to deviate from their obligations when they want to step in and modify their regulation in order to protect, for instance, human health, than when they want to modify their legislation with the aim to protect consumers of financial services.

How can it be that measures for the protection of financial stability or any other prudential concern do not have to meet stringent tests whereas measures adopted in pursuance of public health objectives have to be necessary to achieve their aims? Trade agreements are not the result of rigorous mathematical equations and they do not necessarily follow a rigorous logic. Sometimes, given that they are the outcome of negotiations between governments, it may be that the latter are willing to make concessions on some issues whereas they probably wanted to protect their domestic industry, especially in some strategic sectors or subsectors. Further, it should be borne in mind that the Annex on Financial Services of the GATS was negotiated at a time when information was circulating on floppy disks and not all the possibilities for cross-border trade in financial services were available or, perhaps, even conceivable. The instrument, hence, was mainly used to open the door for access to foreign markets for firms in order to allow the latter to establish branches and subsidiaries in the territory of other trading partners. Consequently it is not surprising that the participants in the Uruguay Round did not push for substantial liberalisation in the domain of financial services, unlike what had happened in the decades ago in the domain of goods. In addition, the South East Asian financial crisis was in progress at the time of the negotiations, with SEACEN countries being vocal with regard to the necessity of protecting the prerogatives of financial regulators. Therefore, governments kept a higher degree of sovereignty on financial markets that in other fields, and no ex post evaluation can undo this balance and substitute it with a more refined and balanced hierarchy of values of the WTO system.

The WTO is one set of international agreements, in the negotiations of which sovereign States have agreed to make concessions and cede parts their sovereignty for the purpose of tackling barriers to trade. They have in all likelihood considered that, in the absence of stringent limitations for the invocation of certain public policy objectives, those trade agreements would have been dried up. The choice of policy objectives was made according to the preferences of the negotiators as well as the feasibility of a compromise. There are also more objective criteria to
determine what causes harm to human health than what can be defined as prudential regulation and what cannot. As the discussion in Chapter 2 revealed there is lack of unanimity in economic literature and among policy makers with regard to an exact classification of measures that can genuinely be considered as being put in place for the protection of micro or macro-prudential objectives.

The case of the PCO, therefore, seems to differ substantially from exception-type provisions. Rather than simply providing for a defensive instrument, that is an exception capable of justifying measures that would otherwise be considered inconsistent with the provisions of an agreement, the PCO marks the line between what is covered and what is not under the Annex on Financial Services of the GATS. Therefore, the PCO points out, although probably not in the most elegant and clear possible fashion, that measures adopted in pursuance of prudential objectives are not covered by the discipline of the GATS, even in case the Member has adopted commitments and the new regulations may have a detrimental impact on them. The PCO restates the right for WTO Members to step in and amend their legislation on financial markets according to prudential concerns. In so doing, it performs a function that is radically different from that assigned to exceptions in international trade agreements, and therefore the interpreter has to pay extra care in assigning a function to it that does not have, otherwise the balance of rights and obligations of WTO Members may risk to be severely harmed.

In sum, the idea behind the PCO, and the reading of it that is being advocated in the present contribution is the following. Trade liberalisation in the field of financial services, as in any other sector, was engineered in light of the normal conditions of doing business. In this light, regulators are expected to behave in a particular way and to respect the obligations and commitments they agreed upon at the multilateral level. Regulators are also expected to work in good times to consolidate the stability of the financial system and to intervene when a crisis hits their domestic market. In order to be able to do so, the Annex on Financial Services of the GATS provides all WTO Member with the PCO. In this sense, the way in which the PCO is drafted makes it clear that there is nothing exceptional or unforeseeable in the behaviour of a government that pursues micro or macro-prudential policy objectives. Moreover, especially in times of crisis, one cannot reasonably expect national governments to adopt a “business-as-usual” attitude and avoid
addressing the situations by using all the powers they have in order to avoid the proliferation of the negative consequences of financial turbulences.

4.2.4 The availability of general exceptions for WTO plus commitments

There is another source of potential problems connected with the hypothetical decision by the Appellate Body to import the case law on general exceptions in the analysis of the compliance of a Member’s domestic legislation with the PCO. Recently, the Appellate Body had the chance to clarify its position with regard to the availability of Article XX of the GATT 1994 for WTO-plus obligations listed in the protocols of accession of Members that have joined the organisation at a later stage, years after the conclusion of the Uruguay Round.

By WTO-plus obligations, the international trade epistemic community commonly refers to provisions of protocols of accession (or preferential trade agreements) which are usually under the mandate of one of the WTO agreements, where the party (or the parties) decide to go beyond what commonly applies to all other WTO Members.319

The discussion on the availability of general exceptions for the violation of WTO-plus obligations first came out in the context of the WTO in the China — Publications and Audiovisual Products case.320 In that first case, the Appellate Body analysed paragraph 5.1 of the Chinese Protocol of Accession, which allows Beijing to regulate in a manner consistent with WTO Agreements, to avail itself of the general exceptions set forth in Article XX of the GATT 1994.

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319 Horn et al. define WTO-plus obligations, with regard to PTAs, as follows: “The (...) [WTO-plus] category corresponds to those provisions of PTAs which come under the current mandate of the WTO, where the parties undertake bilateral commitments going beyond those they have accepted at the multilateral level. An example would be a reduction in tariffs.” See Henrik Horn, Petros C. Mavroidis, and André Sapir, ‘EU and US Preferential Trade Agreements: Deepening or Widening of WTO Commitments?’, in Kyle W. Bagwell and Petros C. Mavroidis (eds.), Preferential Trade Agreements: A Law and Economics Analysis (Cambridge: Cambridge University Press, 2014), 150 - 72 (p. 151). The 2011 World Trade Report on Preferential Trade Agreements issued by the WTO Secretariat endorses this definition. See World Trade Organization, World Trade Report 2011 - the WTO and Preferential Trade Agreements: From Co-Existence to Coherence (p. 131).

In 2012, the Appellate Body Report in the *China – Raw Materials* took a different stance, stating that, in the absence of an express reference to the conditions set forth in Article XX of the GATT 1994, the latter cannot be invoked as a justification for the violation of the obligations undersigned by China not to impose export restrictions on a particular list of goods that are instrumental for the production of technological equipment or other more complex products.\textsuperscript{321}

In the summer of 2014, the Appellate Body had the chance to solve this apparently incoherent case law with its report in the *China – Rare Earths* dispute. At the panel stage, judges took different approaches with regard to the issue, with a dissenting panellist opposing the view of the majority according to which in the absence of a direct *renvoi* to Article XX of the GATT 1994 in the provisions listing WTO plus obligations in the protocol of accession. One dissenting panellist warned against the systemic implications of such an approach, insisting on the importance exception-type provisions have in the context of trade agreements. According to the view of the dissenting panellist an exception should not be made available to new WTO Members only to the extent that they have expressly renounced to it.\textsuperscript{322} The Appellate Body upheld the view of the majority of the panellists.\textsuperscript{323}

Express reference to Article XX of the GATT 1994 may not imply, ipso facto, the availability of the exception as a defence for domestic measures that may contradict WTO-plus obligations. The WTO judges will have to carefully scrutinise the nature of the WTO-plus obligation against the background of the Working Party Report and the Accession Protocol, and taking into account the whole architecture of the WTO system.

The last decision in the series makes it clear that it is highly unlike that a WTO Member that has acceded after the conclusion of the Uruguay Round may avail itself of the general exceptions provisions in order to justify a departure from WTO-plus obligations, unless the Protocol contains language to this effect. At this stage of the analysis, it would not serve the interests of the


economy of the present work to undertake a long detour on whether the decisions of the Appellate Body are correct from a systemic point of view.

The discussion conducted in this subparagraph, instead, may have an impact on the interpretation of the PCO. Should the WTO judiciary adopt the approach proposed by some scholars according to which the PCO must be classified as an exception, this may lead them to adopt, *mutatis mutandis*, the same approach with regard to its applicability to WTO plus commitments in the protocols of accession of new WTO Members, compared to what has happened with Article XX of the GATT 1994.324

A transposition of this approach to the domain of the PCO may have a remarkable systemic impact and substantially alter the equilibrium of parity between all WTO Members. A classification of the PCO as an exception would probably limit (or cast doubt on) its availability for new WTO Members that have listed GATS-plus commitments. The situation is even more dramatic since specific commitments in the context of the GATS have particular relevance, given that disciplines on National Treatment and Market Access provisions only kick in upon the condition that Members have not listed limitations in their schedules. In a context like that of the GATS, in which Membership is already asymmetric, the concept of WTO-plus obligations and commitments may expand and shrink the ambit of application of the PCO. Such a solution is suboptimal and may unduly constrain the right to regulate of WTO Members that have joined the club after 1995. Given the degree of interconnectedness of financial systems, it is probably not even in the interest of the original WTO Members to limit the regulatory autonomy on prudential legislation for latecomers, as this may lead to the spreading of market failures from the country of origin to other markets as well. This is yet another warning sign against the classification of the PCO as an exception-type provision.

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324 It is clear that AB reports have effects only on the parties to the dispute. It is also true that the AB is not bound by its previous case law and can issue decisions in contrast with its established jurisprudence in presence of “cogent reasons”, as per Article 3.2 of the DSU.
4.3 The PCO as a tool to address contingencies

The PCO is very broad in scope, to the extent that it is essentially able to cover any deviation from the obligations determined by the Annex on Financial Services and the commitments made by Members in their schedule under the relevant sectors and sub-sectors. One may wonder, at this stage, whether the presence of a provision structured with this formulation renders inutile or of negligible value the rest of the discipline provided for by the Agreement itself.

From the discussion conducted above it emerges that the terms for the invocation of the PCO by a regulating Member are almost entirely up to the considerations that the latter may make, in accordance with the political agenda pursued. In other terms, the PCO may lead a Member to intervene in the regulatory landscape and to modify it (but also to maintain regulations in place irrespective of their compatibility with internationally agreed trade obligations) according to self-judged prudential concerns. Reference to other self-judging provisions in the WTO legal system may help understand the uniqueness of the PCO and its particular role.

In a recent piece Sykes analyses the concept of "economic necessity" in the WTO system. Among the provisions he takes into account in his work, he makes interesting points on Article XXI of the GATT 1994 and, more generally, on the discipline on Safeguards under WTO law. Article XXI of the GATT 1994 reads as follows:

Article XXI – Security Exceptions

Nothing in this Agreement shall be construed

(a) to require any contracting party to furnish any information the disclosure of which it considers contrary to its essential security interests; or

(b) to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests

325 Sykes, 'Economic "Necessity" in International Law'.
(i) relating to fissionable materials or the materials from which they are derived;

(ii) relating to the traffic in arms, ammunition and implements of war and to such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment;

(iii) taken in time of war or other emergency in international relations; or

(c) to prevent any contracting party from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security.

Sykes acknowledges that the provision was never an archetypical benchmark for lawfulness of domestic measures in the context of a GATT/WTO dispute. He finds that the explanation for this is two-fold: on the one hand, the provision allows Members to take measures that they themselves “consider” to be necessary to achieve the stated objectives. Such wording should suggest deference from the adjudicators in the scrutiny of the ratio behind measures adopted in pursuance of the objectives indicated in Article XXI of the GATT 1994. On the other hand, however, the author maintains that the provision under analysis is limited to specific concerns that, however broad, seem to leave the possibility to address industrial policy or economic problems outside of its ambit. From all of the above, Sykes draws the lesson that narrowly tailored exceptions can function well, even in cases where they are left to the discretion and the self-judgment of the regulator. Moreover, it goes even further clarifying that, noteworthy in his opinion, “Article XXI does not encompass exigencies such as financial distress of a member government or domestic economic crises unrelated to war and international emergencies”.

Clearly, Article XXI of the GATT 1994, considering its reliance on circumstances that are observable and objective, cannot serve as a useful comparator for the PCO which seems to go even further in carving out policy space for governments when addressing policy concerns that may change over time and could not be foreseen at the time in which the Annex on Financial Services was negotiated.

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326 Ibid. (p. 10).
Sykes also takes into account Article XX of the GATT 1994. Given that the argument has been extensively dealt with earlier in this Chapter we shall not linger on any further on it. Finally, he makes reference to Article XIX of the GATT 1994 (Emergency Action on Imports of Particular Products). The latter is more useful in our analysis because it specifically addresses issues of economic contingencies, namely that of a dramatic increase in imports of a particular product so as to cause harm to the domestic producers of like or directly competitive goods, on the condition that the situation be the outcome of an unforeseen development and the effect of the trade obligations of the importing Member.

On the one hand, the rationale behind a measure drafted in this way may not seem to serve the interests of the efficiency of the world’s market. A broad and vague escape clause may contribute to diminishing the credibility of the concessions made during the negotiations, given the possibility for Members to withdraw them according to situations that are not specified with a great amount of detail. On the other hand, however, such a legal construction may contribute towards enhancing the flexibility of the system. In other words, since not all the developments in the market can be foreseen at the time of the signing of the agreement, Members may feel safer at the time of agreeing on concessions because they will keep the autonomy to address dramatic market failures.\footnote{It must be borne in mind that, as a result of the negotiations of the Uruguay Round, an Agreement on Safeguards clarifies the scope of application of Article XIX of the GATT 1994 and the conditions that Member have to respect in order to put in place Safeguard-schemes.} Safeguards do not provide flexibility for the sake of flexibility \textit{ex ante}. Rather, they incite commitments \textit{ex post}, in the sense that they ease adjustment.

In order to benefit from Article XIX of the GATT 1994 (to be read together with the clarifications ensued from the provisions of the Agreement on Safeguards), four requirements have to be met\footnote{See Petros C. Mavroidis and Mark Wu, \textit{The Law of the World Trade Organization: Documents, Cases & Analysis} (2nd edn.; St. Paul (MN): WEST, 2013) 1072 (pp. 503 and ff.) for an overview of the relevant provisions along with the main clarifications provided for by the case law. For a detailed analysis of the law and the economic rationale for the Agreement on Safeguards, see Alan O. Sykes, \textit{The WTO Agreement on Safeguards - A Commentary} (Oxford: OUP, 2006) 357.}: a dramatic increase in quantity of imports of a particular good must occur; such an increase should not be the result of the ordinary course of trade or a mere effect of greater trade liberalisation, but it should rather be the result of an “unforeseen development”; such a situation must have caused (or, at least, threatened to cause) injury to the domestic producers of like or
similar goods; a casual link between the increase in imports and the injury suffered by the domestic industry must be proved. Moreover, the safeguards schemes must be progressively phased out after maximum eight years and the Member that imposes them shall enter into negotiations with the exporting Member in order to provide the latter with compensation.

Escape clauses have been extensively debated in the literature and political economists have also tried to formalise models for the optimal design of escape clauses in international trade agreements. Rosendorff and Milner argue that escape clauses represent an efficient equilibrium under conditions of domestic uncertainty. Uncertainty about the developments in the world economy and the potential situations of distress that the domestic industry may face is likely to lead to the creation of mechanisms for institutional flexibility. However, some costs on their use have to be imposed, otherwise these escape clauses will end up not performing their function efficiently. This argument is key to the explanation because a “low cost” solution for a Member wishing to deviate from its commitments may lead the latter to make frequent use of the escape clauses. The third element of the explanation advanced by Rosendorff and Milner is that the introduction of an escape clause allowing Members to intervene in a situation of distress makes trade agreements easier to be concluded.

How is this discussion relevant for the current work? Essentially, the PCO is a provision that gives Members the freedom to address contingencies, even if their actions would dry up their trade commitments. However, it cannot be usefully compared to the discipline on safeguards because it is not detailed enough, among other things. It is true that the PCO may be used as a tool to address contingencies, but it is also something more than that and deserves a more coherent interpretation and explanation.

4.4 Conclusions on why it is better not to classify the PCO as an exception

In addition to what has been reported so far systemic concerns must also be assessed. If we were to assume, for the sake of argument, that the PCO is an exception (or a tool to address contingencies), the question arises as to why it was included in the Annex on Financial Services as an annotation to Article VI of the GATS (Domestic Regulation) and not as an annotation to Article XIV of the GATS? The answer to this question lies in the structure of the GATS as well as in the negotiating history of the provision.

The GATS is the outcome of a delicate compromise. Given the initial positions of the parties involved, the conclusion of a framework agreement was considered a big achievement. Contrary to the GATT, which is still going strong after more than 60 years in force, the GATS is a complex and convoluted agreement which nonetheless resembles the GATT in its negative integration approach. Within that approach the GATS seeks to strike a balance between “progressive liberalisation” and the “right to regulate”.

Progressive liberalisation and the right of Members to regulate are not in a hierarchical relation to each other. Article VI of the GATS (Domestic Regulation) is supplementary to the obligations on non-discrimination and market access of the same Agreement. In its current form it provides for some obligations regarding the domestic regulatory process and lays the foundations for future disciplines on licensing, qualification and technical standards. Against this background, the negotiating history and the rationale for the provision may help us come up with a more coherent explanation of the PCO.

330 Quoting from the preamble of the GATS: “Members, (…) Wishing to establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization”.

331 In the US - Gambling case, the AB refrained from pronouncing on the relationship between Articles VI and XVI GATS. Instead, the AB considered that “it is neither necessary nor appropriate for us to draw, in the abstract, the line between quantitative and qualitative measures”. See WTO Appellate Body Report, US – Gambling, above n 10, para. 250.
4.5 Negotiating history meets the economic rationale

4.5.1 Negotiating history

At this stage of the analysis, it is worth taking a step back and putting the analysis of the provision against the background of the negotiating history and the main sources of concern during the talks in the Uruguay Round. Chapter 2 dealt with the negotiating history of the provision. Here we shall reassess some of the main issues in order to make the analysis provided by this chapter as comprehensive as possible.

During the Uruguay Round it became clear that most of the world's financial regulators would have preferred that financial services not be included in a multilateral trade agreement whilst pressure was mounting from the private sector, mainly in the United States, in the opposite direction. By the year 1990 it became even clearer, however, that the future GATS would cover financial services but with a caveat; that it should contain a provision preserving the right of governments to adopt measures for prudential reasons. This indication appears in all the contributions that have dealt with the issue of how the specific disciplines on financial services were negotiated during the Uruguay Round and in its immediate aftermath.

In June 1990, a Working Group on Financial Services including Insurance was set up, with the mandate to consider the need and the possible contents of an annex on financial services. The Group met until October that year. Interestingly, the submissions made to the Working Group by

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332 Despite the Annex on Financial Services was only agreed on in 1997, well after the conclusion of the Uruguay Round, the PCO, in its current formulation, it was negotiated in the early nineties.
333 Some of the ideas expressed in Sections 4.5 and 4.6 were anticipated in Carlo M. Cantore, 'Shelter from the Storm': Exploring the Scope of Application and Legal Function of the GATS Prudential Carve-Out', Journal of World Trade, 48/6 (2014), 1223-46. This Section and the following one build upon that contribution and expands the main findings.
the European Communities, the SEACEN countries and the US, despite making reference to or containing provisions on prudential regulation, never referred to it as an exception.\footnote{See Uruguay Round Docs. MTN. GNS/fin/W/1, 2 and 3.}

By the Brussels Ministerial Conference in December 1990, no agreement could be reached on the content of a financial services annex. However, during the Conference, a proposal for a financial services Annex was submitted by Canada, Japan, Sweden and Switzerland.\footnote{Uruguay Round Doc. MTN.TNC/W/50.} The proposal, the wording of which was much similar to the current PCO, was drafted as an \textit{addendum} to Article XIV of the GATS (General Exceptions) of the draft agreement.\footnote{Uruguay Round Doc. MTN.TNC/W/50/Add.2: “In addition to Article XIV of the Framework, the following shall apply: 1. Nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Party of reasonable measures taken for prudential reasons, including for the protection of investors, depositors, policy-holders or persons to whom a fiduciary duty is owned by a financial service provider, or to ensure the integrity and stability of a Party’s financial system. Such measures shall not be applied in a manner which would constitute a means of arbitrary or unjustifiable (a) restriction on the provision of financial services by financial service providers of another Party or (b) discrimination between domestic and foreign financial service providers or between countries. (...)”} At the same time Malaysia, on behalf of the SEACEN group, filed another proposal for an annex on financial services.\footnote{Uruguay Round Doc. MTN.TNC/W/51.} The formulation of the provision dealing with prudential measures was again similar to the one in force. However, the SEACEN countries imagined the PCO as being an addendum to Article VI of the GATS (Domestic Regulation). Notwithstanding the overall consent on the need for a PCO, there were still different positions regarding the legal function of such a provision. Moreover the SEACEN countries insisted on the non-justiciability of prudential measures.\footnote{Interestingly, in discussing the US objectives in TTIP negotiations with the EU, Johnson and Schott strongly argue against the opening of decisions on prudential measures to dispute resolution, so as to avoid “too great a risk of tactical litigation aimed at constraining or slowing new regulation, which could be dangerous at a time of continuing vulnerability in financial markets.” To that end –they argue– the TTIP could add a clarification to provisions taken from prior FTAs that measures taken for prudential reasons—i.e., to safeguard the financial system—would not be brought before dispute panels and not considered to result in expropriation of a firm’s assets”. See Johnson and Schott, ‘Financial Services in the Transatlantic Trade and Investment Partnership’ (p. 4).}

In the end the negotiators reached an agreement on a broad PCO, structured with an indicative list of policy objectives that could be considered prudential and hence not covered by the discipline of the Annex on financial services. The core of the talks moved to the issue of whether or not to hold measures adopted in pursuance of prudential objectives still justiciable under the dispute settlement system of the WTO. Canada, the EU, Japan and the US were in favour of the application of the dispute settlement provisions to measures taken for prudential concerns. The
SEACEN countries were opposed to this possibility. In the end, Members decided that prudential measures can be scrutinised by the WTO judges only to the extent that they amount to backhanded avoidance of trade obligations and commitments and with the caveat that, according to Paragraph 4 of the Annex on financial services, such disputes should be adjudicated at the panel stage by experts in the domain of financial services.

The available documentation from the Uruguay Round shows that some participants proposed to draft the provision on prudential measures following the structure and wording of typical exception-type provisions. However consensus could not be reached on this, mostly due to the opposition of the SEACEN countries. Furthermore, it should not be forgotten that negotiations on the specific disciplines on financial services were among the most complicated ones in the history of the GATT or WTO. The compromise on financial services risked foundering many times, mainly because not all the Parties were keen on making substantial concessions. The PCO, with its broad scope of application and the wide margin for manoeuvre left to national governments, serves as cornerstone for a difficult compromise. It is fair to conclude that there would not be any Annex on financial services of the GATS without a PCO drafted in these terms.

Prudential regulation was one of the main issues of concern for Uruguay Round negotiators. Neither the governments of developed countries nor those of developing and least developed countries were eager to concede ground on this issue. Negotiations could only proceed on the basis that a provision excluding prudential measures from the coverage of the Annex on Financial Services of the GATS was included in it.

The negotiating history is further backed by the economic rationale behind the drafting of the provision at the time of the Uruguay Round talks as well as the evolution of the economic literature over the last twenty years.

4.5.2 Economic Rationale

The financial sector is at the heart of modern economies, especially in industrialised countries, and the integrity and soundness of financial institutions and the financial system considered as a
whole are a crucial factor for the stability of the entire economy of a country. As such the arguments in favour of sound regulation of financial markets are solid. Deregulation occurred in some domestic jurisdictions (especially in the 1980s and 1990s) but happened with the vocal opposition of different sectors of the public and came at a cost. Moreover, the unprecedented financial crisis of 2007 and 2008 signalled the start of a new wave of financial regulation, both coordinated in international forums as well as driven by the political priorities of governments in domestic jurisdictions. We live, in fact, in re-regulation times. Financial regulation is justified by market failures, generally: market power, information asymmetries and negative externalities.

Against the background of these market failures it is important to stress that the financial industry is one of the most innovative with new instruments being traded in the markets in the absence of pre-existing rules. One of the hardest tasks for financial regulators it that of keeping up with financial innovation, especially when unforeseen problems arise. This alone might be a solid basis for Members to keep freedom to regulate when negotiating an international agreement on trade in financial services. Sometimes actors in financial markets are not even exactly aware of the instruments they are using.

These market failures and their potential negative effects are so prevalent in the financial sector that national authorities are often in a condition of “ignorance”. Borrowing from Stirling, such a condition can be defined as “a state under which there exist neither grounds for the assignment of probabilities, nor even a basis for the definition of a comprehensive set of outcomes”.341

In other scientific fields the acknowledgment of ignorance has led to the establishment of the so-called “precautionary principle”.342 The rationale behind such a principle is that of allowing regulators, who are ignorant as to the probability of the occurrence of imminent harm, to adopt the necessary interventions in order to avoid negative outcomes until scientific evidence emerges. In other words the precautionary principle allows regulators to maintain a modest but nonetheless proactive approach towards unknown developments and to avoid the potential


342 Mavroidis, Trade in Goods (p. 731) assesses the status of the precautionary principle under customary international law.
negative outcomes which could derive from a permissive legislation adopted upon the bases of scarce scientific information. Given the importance of the protected interests, the WTO legal order in its SPS Agreement introduced the concept of “adequate level of protection” (ALOP) and allows Members to set their own, both on a definitive level under Article 5.1 of the SPS Agreement as well as on a temporary basis under Article 5.7 of the SPS Agreement. Members must be consistent with the chosen ALOP and their policies have to be based on scientific evidence. The case is even more dramatic when it comes to financial services. History reveals that it has proven difficult for governments and for institutions entrusted with the duty to supervise financial institutions to predict crises and to promptly react in order to avoid the spreading of dramatic consequences.

This is why, especially in the aftermath of the recent crisis, both international forums and national authorities stressed the need to revise the financial regulatory architecture and to provide supervisory authorities with the necessary tools in order to timely intervene and limit the negative consequences of financial distress. A collapse in the financial sector is likely to trigger domino effects in – potentially - all other sectors of the economy.

Moreover, the crisis and its aftermath have also shown that some governments may have the incentive to deregulate or not to regulate financial markets according to sound prudential principles because that would be costly and amount to economic losses. Therefore, they may have the incentive to free ride the prudential burdens imposed on larger jurisdictions and offer cheap and safe harbours to riskier and more lucrative speculative activities. Given that this latter problem, together with the very nature of international coordination in the domain of financial regulation and issues that belong to path dependency, impede the formation of international consensus for the establishment of common international rules on financial markets, we can expect to see more years of weak cooperation with regard to definition of the limits of domestic governments to intervene in financial markets. Those Members that have to face the challenge of a more sound financial regulation should not be prevented from taking bold steps for the
protection of the stability of financial systems because of strict and debatable interpretations of WTO provisions.\textsuperscript{343}

Therefore, against this background, it is not surprising that Uruguay Round participants have decided keep sovereignty over financial regulation and to exclude prudential legislation from the coverage of WTO law. Such elasticity probably serves the interests of the WTO system as a whole, given that a stricter interpretation of the PCO may lead to situations of regulatory chill under which Members may be afraid to modify their financial regulation in order not to be found in violation of WTO law by the judges in Geneva.\textsuperscript{344}

### 4.6 An alternative approach

#### 4.6.1 The heading “Domestic Regulation” - *Nomina sunt consequentia rerum*

An often quoted passage from Justinian’s Institutiones is “nomina sunt consequentia rerum”. The expression, meaning that “names correspond to the things they are attached to” is a reasonable starting point for the present discussion. The heading of the provision under analysis (“Domestic regulation”) should have warned those who attempt to interpret the PCO of the GATS about the peculiar nature of the provision, as opposed to the traditional exception-type provisions provided for by the various WTO Agreements.

The Annex on Financial Services of the GATS is complementary to the main framework agreement for trade in services and follows its structure. The idea behind the Annex is to clarify the function and scope of application of the various provisions of the GATS when disciplining Members’ obligations and commitments in the domain of trade in financial services, a delicate and still heavily regulated sector at the domestic level. It provides for a *lex specialis* on some

\textsuperscript{343} See Coffee, 'Extraterritorial Financial Regulation: Why E. T. Can't Come Home' (p. 1297 and ff.) for a detailed analysis of the issue.  
\textsuperscript{344} Negotiations of the Annex on Financial Services mainly took place informally. Anecdotal evidence, however, suggests that the text of the Annex was drafted by financial experts with little or no background in trade negotiations. Therefore, it is probably more appropriate to affirm that financial regulators “took latitude” as opposed to Uruguay Round participants giving them latitude.
aspects of the GATS, in order to better protect (at least this was the idea of the drafters) the Members’ interests in the field.

In a contribution that can be considered seminal in terms of providing a better understanding of the instrument, Jarreau wrote:

The Annex on Financial Services, like the Annex on Article II Exemptions, is an integral part of the GATS. The financial services annex is, however, applicable only to trade in financial services. It is a financial services supplement to the framework agreement designed to provide greater specificity with regard to trade in financial services. The Annex on Financial Services is divided into five numbered sections, each relating to a specific article or articles of the framework agreement. (...) The second section of the annex corresponds to Article VI of the framework agreement, Domestic Regulation. It authorizes each WTO Member to establish "prudential" regulatory measures to protect purchasers and beneficiaries of financial services, as well as its domestic financial system (Emphasis added).345

Later in the same piece the author clarifies that:

Section 2 of the Annex on Financial Services is referred to as the "prudential carve-out". Notwithstanding any other provision of the GATS, Section 2 of the Annex permits Members to enact measures for "prudential reasons". Measures that may be deemed prudential are not defined but may include measures taken for “the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier or to ensure the integrity and stability of the financial system”. This section of the Annex affords Members considerable autonomy to enact financial regulatory measures. The freedom afforded by Section 2 may be subject to protectionist abuse as prudential measures are not considered limitations on market access or national treatment and, therefore, need not be inscribed in a Member's Schedule.346

345 Jarreau, 'Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer’s Perspective' (p. 36).
346 Ibid. (p. 67).
Headings do not have the same power as the substantive wording of provisions. They are not sources of legal obligations but reflect the content of the provisions they are linked to. It may certainly be seen as an *ex-post* evaluation, and there is indeed an element of hindsight, but if one takes a closer look at the structure of the Annex on Financial Services and puts it in parallel with that of the GATS, one will find that there is a definite tendency to make the provisions of the former correspond to those of the latter, and that respect is paid to the order of appearance of the various Articles. Paragraph 1 of the Annex on Financial Services (Scope and Definition) corresponds to Article I of the GATS (Scope and Definition), Paragraph 3 of the Annex on Financial Services (Recognition) corresponds to Article VII of the GATS (Recognition), Paragraph 4 of the Annex on Financial Services (Dispute Settlement) corresponds to Article XXIII of the GATS (Dispute Settlement and Enforcement) and Paragraph 5 of the Annex on Financial Services (Definitions) corresponds to Article XXVIII of the GATS (Definitions). Following this pattern, then, the PCO – should it be drafted as an addendum to Article XIV of the GATS (General Exceptions) – would have followed (and not preceeded) Paragraph 3 on recognition and, moreover, it would have more probably had another heading.

Instead the order of appearance of the various provisions suggests that the PCO performs the function of an *addendum* to Article VI of the GATS, setting up a special discipline for domestic regulation adopted in pursuance of prudential aims in the domain of financial services. It pertains to the regulatory autonomy that Members enjoy when pursuing legitimate policy objectives in that field.

The PCO applies “notwithstanding any other provisions” of the Agreement, thus it covers obligations as well as specific commitments. It applies, therefore, to the general discipline set forth in Article VI of the GATS as well. An explanation for this lies in the text of the latter. The first paragraph of the provision reads:

> In sectors where specific commitments are undertaken, each Member shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.

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347 A famous Latin maxim reads: *rubrica non est lex.*
Paragraph 5 (a) of the same provision adds:

In sectors in which a Member has undertaken specific commitments, pending the entry into force of disciplines developed in these sectors pursuant to paragraph 4, the Member shall not apply licensing and qualification requirements and technical standards that nullify or impair such specific commitments in a manner which:

(i) does not comply with the criteria outlined in subparagraphs 4(a), (b) or (c); and

(ii) could not reasonably have been expected of that Member at the time the specific commitments in those sectors were made.

One explanation for the introduction of such a broad PCO could be found in between the lines of Article VI of the GATS. Members negotiated a text that could allow them to amend their existing legislation or to enact new laws even in contrast with the limitations enlisted in their schedules of specific commitments, on the basis that they had done so in pursuance of legitimate prudential policy goals.

The GATS is a negative integration agreement and does not aim for the harmonisation of domestic policies. Right from its preamble it reaffirms Members' right to regulate according to domestic policy objectives, acknowledging, on the one hand that any policy choice may affect trade but, on the other, that trade liberalisation is not "the only game in town", as governments have more complex agendas and interests to protect. The PCO expands the perimeter of regulatory autonomy, giving Members wider scope of manoeuvre in the domain of prudential regulation, a concept which is, by its nature, evolutionary and broad.

Members of the WTO enjoy a considerable regulatory autonomy, and have kept sovereignty over the possibility of making modifications to their prudential regulation arsenal in ordinary and extraordinary times. Moreover, paraphrasing Jarreau, this 'considerable autonomy' granted to Members allows them to take such measures in ordinary and extraordinary times. In other words, since nothing in the PCO indicates otherwise, 'measures for prudential reasons' may include day-to-day regulation, as well as preventive and crisis management instruments.
The Annex on Financial Services of the GATS has a specific structure. It provides for *lex specialis* to that of the GATS in the context of trade in banking services, insurance services and other types of financial services, according to the definitions and commitments contained in Members’ schedules. More specifically, the PCO is a *lex specialis* to the discipline of Article VI of the GATS (Domestic Regulation) and clarifies the rights and limits that Members keep with specific regard to a broad area of financial regulation that is constantly evolving and is commonly known as prudential regulation. Members are free to adopt or modify their prudential regulation in the way they prefer.

Rather than an exception, the PCO can be better understood if interpreted as the affirmation of the right that Members keep when they adopt measures for prudential purposes in the field of financial services. There are no stringent requirements that need to be met should a Member decide to avail itself of the right in the domain of financial services and change the rules. In other words the PCO corresponds to ordinary measures in ordinary and extraordinary circumstances.

As such the PCO is better understood if classified as a ‘provision that excludes the application of other provisions’ and not an ‘exception’. Consequently the PCO is a ‘scope’ provision, in WTO law terminology. The next subsection gives an account of other provisions in WTO law that perform the same function.

### 4.6.2 Provisions that exclude the application of other provisions in WTO law

The PCO is not the first nor the only provision in WTO law to pursue the purpose of excluding the application of other provisions. Article IV of the GATT 1994 (*Special Provision relating to Cinematograph Films*), for example, serves the same function with regard to film quotas that Members can adopt in order to protect their domestic cultural industry. It reads:

> Article IV – Special Provisions Relating to Cinematograph Films

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If any contracting party establishes or maintains internal quantitative regulations relating to exposed cinematograph films, such regulations shall take the form of screen quotas which shall conform to the following requirements:

(a) Screen quotas may require the exhibition of cinematograph films of national origin during a specified minimum proportion of the total screen time actually utilized, over a specified period of not less than one year, in the commercial exhibition of all films of whatever origin, and shall be computed on the basis of screen time per theatre per year or the equivalent thereof;
(b) With the exception of screen time reserved for films of national origin under a screen quota, screen time including that released by administrative action from screen time reserved for films of national origin, shall not be allocated formally or in effect among sources of supply;
(c) Notwithstanding the provisions of subparagraph (b) of this Article, any contracting party may maintain screen quotas conforming to the requirements of subparagraph (a) of this Article which reserve a minimum proportion of screen time for films of a specified origin other than that of the contracting party imposing such screen quotas; Provided that no such minimum proportion of screen time shall be increased above the level in effect on April 10, 1947;
(d) Screen quotas shall be subject to negotiation for their limitation, liberalization or elimination.

The provision is designed in a different way from the PCO. However, the rationale behind the former is more similar to that behind the PCO than what is the case with regard to exception-type provisions. The way in which Article IV of the GATT 1994 is drafted leads the interpreter to consider it more in terms of a *lex specialis* dealing with a particular type of goods. As Ehring has stated:

Article IV grants WTO members a limited right to restrict the showing of films of foreign origin. The effect of Article IV is similar to that of a qualified exception to the obligations contained in Article III (national treatment) and Article I:1 (most-favoured-nation treatment). Legally, however, Article IV is formulated not as an exception of the same type as Article XX or XXI, but as a *lex specialis* dealing specifically with films. It imposes obligations on members
that establish or maintain internal quantitative regulations. Article IV establishes a special legal regime for internal quantitative regulations relating to cinematograph films, which partly differs from general rules such as Articles I:1 and III. In contrast, Article III:10 is an exception in the technical sense, and it exempts measures that fall under, and comply with, Article IV from the disciplines of Article III, which may otherwise apply. Article IV is thus not an exception in the technical sense, which a respondent would have to invoke, in a WTO dispute in response to a complainant’s claim of a violation of other provisions of the GATT. Rather, the complainant would have to invoke Article IV as being violated and bear the burden of proof in that regard.349

Article IV of the GATT 1994 is not the only provision in WTO to serve this function. Other agreements also contain specific disciplines addressing particular situations and dealing with special rules applicable only to a subset of domestic regulations adopted by governments of trading nations.350

Another analogy could be drawn with the precautionary principle under paragraph 7 of Article 5 of the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) (Assessment of Risk and Determination of the Appropriate Level of Sanitary or Phytosanitary Protection), which reads:

In cases where relevant scientific evidence is insufficient, a Member may provisionally adopt sanitary or phytosanitary measures on the basis of available pertinent information, including that from the relevant international organizations as well as from sanitary or phytosanitary measures applied by other Members. In such circumstances, Members shall seek to obtain the additional information necessary for a more objective assessment of risk and review the sanitary or phytosanitary measure accordingly within a reasonable period of time.

350 Case law has not always followed a coherent path in this regard. In China-Raw Materials, the Appellate Body dealt with a similar issue with regard to the interpretation of Article XI.2 of the GATT 1994 and its interplay with Article XI.1. Despite on its face Article XI.2 of the GATT 1994 looks like a “scope provision”, the WTO judges have held that it should be up to the defendant in case of a dispute to demonstrate that it met the conditions in order to lawfully impose export prohibitions or restrictions on a particular set of goods. See Appellate Body Report, China Raw Materials, paras. 308 – 344.
Again, this provision differs substantially in content and structure from the PCO. However, the rationale behind it is relatively similar and allows Members to regulate in situations of uncertainty or ambiguity. It does so, however, on the condition that Members satisfy a number of conditions, namely: 1) the available relevant scientific information must be insufficient; 2) provisional measures should be adopted on the basis of available pertinent information; 3) obtaining additional information will be necessary for a more objective assessment; and 4) the measures adopted must be reviewed after the elapse of a reasonable period of time. None of these conditions appear in the PCO.

Although no extensive case law exists on the issue and some WTO Members understand the application of this principle as limited by the requirements of proportionality, necessity and consistency with past practice,\(^{351}\) the Panel in *European Communities – Approval and Marketing of Biotech Products* clarified that Article 5.7 of the SPS Agreement must be classified as a “qualified right” and, therefore, the burden of proof in the event of a dispute should follow the general “*actori incumbit probatio*” rule.\(^{352}\) In other words, it is up to the complainant that brings the case against the regulating Member to make the case that the domestic piece of legislation goes beyond the boundaries crafted under Article 5.7 of the SPS Agreement.

The latter confers on Members the right to set the level of protection they deem appropriate in a situation of insufficient scientific evidence. The Appellate Body has had the chance to clarify its understanding of the meaning of the expression “qualified right”:

> Where a Member exercises its right to adopt an SPS measure that results in a higher level of protection, that right is qualified in that the SPS measure must comply with the other requirements of the *SPS Agreement*, including the requirement to perform a risk assessment.\(^{353}\)

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\(^{351}\) See the communication by the EU: WTO Doc. G/SPS/GEN/168 of 14 March 2000.


This assessment of other WTO Agreements permits us to make two preliminary conclusions. The first is that there are other examples in WTO law of “provisions that exclude the application of other provisions” although the divide between “exceptions” and this latter category has not followed a linear path in the evolution of case law. This work argues that the PCO belongs to the group of measures including at least Article IV of the GATT 1994 and Article 5.7 of the SPS Agreement. The second point that is worth making here is that the PCO, contrary to the other examples that have been set out in the previous subsection, does not require that any conditions be met for it to become available to a respondent in a WTO dispute.

4.7 Conclusions

The wording of the PCO and the context in which it is placed give Members even wider scope for manoeuvre when regulating financial services for prudential reasons. The PCO is only limited by an obligation of good faith unlike other provisions such as, for instance, Article 5.7 of the SPS Agreement, described in the previous subsection. Similarly, however, the PCO is a guarantee for Members that they will not be deprived from the power to regulate in a situation of uncertainty as regards the stability of the financial system.

Moreover, it should be borne in mind that WTO judges hold the power to scrutinise whether domestic measures supposedly adopted by Members in pursuance of prudential objectives are in reality a means to surreptitiously avoid trade obligations or commitments. Since trade agreements are incomplete contracts by definition, and the PCO is a quintessential example of this given its non-exhaustive list of legitimate policy objectives and its circular wording, the interpreter has to take into account the possibility that judges may err.

Erroneous outcomes can be divided into two categories: Type I – false positives (where the court finds that the defendant has violated the rule, even though it has not) and Type II – false negatives (where the court finds that the defendant has not violated the rule even though it has). What is a more desirable outcome when an exception is invoked? And what is the case when it
comes to the PCO? The answers to these questions are essential to understanding the function assigned to the PCO in the WTO legal order.

Typically, exceptions perform the task of limiting *Type II - false negative* situations, and this is why they usually have a limited scope of application. This means that they are usually designed narrowly due to the fact that the gate should not be open too wide in order to permit to Members to easily deviate from their trade obligations. Consequently a closed list of legitimate objectives together with stringent requirements to be met and a final control over the *bona fide* application of the measures make a *Type I - false positive* error a more desirable outcome in the event of a dispute.

Therefore, where an exception is invoked in a dispute it is up to the defendant to demonstrate that its regulation, which in principle breaches one or more obligations of the agreement, satisfies the conditions set up in an exception and consequently is still lawful. A system that wants to avoid *Type II errors* allocates the persuasive burden in a dispute to the defendant in line with the general principle of law according to which ‘*quicumque exceptio invocat ejusdem probari debet*’.

In other cases, that is, when *Type II* errors are considered to be more desirable outcomes, the system is more deferential towards regulating Members. It accords them autonomy when regulating particularly sensitive issues, hence false negatives are considered the preferred outcome. In such cases, the burden of proof follows the general principle according to which it is up to the claimant to demonstrate that the defendant has violated the rules.

The rationale and the negotiating history of the PCO seem to suggest that the system wants to avoid *Type I - false positive* situations. Therefore, in the event of a dispute concerning prudential issues (to take up the language in paragraph 4 of the Annex on Financial Services), the complainant would have to persuade the judges not only that the defendant has violated one or more GATS provisions or commitments, but also that it has done so for reasons other than prudential purposes. Alternatively, even if it accepts that the purpose of a particular measure actually has a prudential goal, the complainant would have to show that the measure in question...
has been used as ‘a means of avoiding a member’s obligations or commitments’ (something which is particularly difficult since this would require proving that the other member had acted in bad faith).354

The rationale for the PCO differs substantially from that which is typical of exception-type provisions in WTO agreements. The only limit which applies to Members’ regulatory autonomy can be found in the final clause which, as explained above, only reaffirms an obligation of good faith. Since good faith is presumed, it would again be up to the complainant to demonstrate that the respondent has used measures in order to avoid its obligations or commitments.

The PCO is a fundamental provision in the WTO framework of rules governing trade in financial services. However its wording is self-cancelling and ambiguous, and it is left to speculation to answer the question of whether this situation came about by design or if it is an accident of the negotiations, given that it was the first time that the international community had tried to regulate international trade in financial services in the context of a multilateral forum.

At the time of the submission of the present contribution, not one single Panel has ever been called to interpret the provision, its scope of application or its legal function. Furthermore, academic debate on the issue has not provided much clarity (and, admittedly, very few scholars have analysed the provision, as we saw in the review of the literature provided in Chapter 1). Although the overwhelming majority of the contributions on the topic share the understanding of the PCO as a provision with a substantially wide scope of application, most adhere to the theory according to which it belongs to the realm of exception-type provisions. The repercussions of such a view can be of huge relevance, especially with regard to the standard of review and the allocation of the burden of proof.

354 Joachim Åhman, Trade, Health and the Burden of Proof in WTO Law (Global Trade Law Series; Alphen aan den Rijn: Wolters Kluwer, 2012) (p. 25): "If the persuasive burden is allocated to the claimant, the risk of Type II errors will generally be higher than the risk of Type I errors, and vice versa. This can be explained in the following way. Let us say that we have a larger number of two-party disputes, where one party claims that the other party has violated a certain rule. In the majority of the cases, the court will probably find that one party’s claim seem the more probable. However, in a number of cases (the uncertain cases), the court will find that the claims of both parties seem equally probable. If the court decides that the claimants should always carry the burden, the defendants will win all the uncertain cases”. Taking the same stance, see also Caroline Foster, Science and the Precautionary Principle in International Courts and Tribunals (Cambridge: Cambridge University Press, 2011) 375 (p. 214).
This work seeks to advance an alternative approach to the interpretation of the PCO which contradicts some of the assumptions of the mainstream contributions in the literature. This work confirms that the scope of the PCO is substantially broad and confers upon Members the right to react to financial crises or to work in order to prevent them.

This work has explained why there are good reasons to believe that the PCO is not an exception in the technical sense and that, if a parallel must be drawn between the PCO and other WTO provisions, it ought to be drawn between provisions other than Article XX of the GATT 1994 or Article XIV of the GATS.

The PCO is similar in function to Article 5.7 of the SPS Agreement (an 'autonomous right', in the words of the Appellate Body) or to Article IV of the GATT 1994 (lex specialis). Moreover, the PCO goes even further and it is clearly designed as a unique provision in the multilateral legal framework governing international trade. It has a uniquely broad scope of application due to the lack of confidence that Uruguay Round negotiators had with regard to the benefits of liberalisation of trade in financial services in terms of financial stability.

The main implications of this alternative approach relate to the allocation of burden of proof. Indeed, this is the area in which the practical consequences of the analysis conducted here seem most clear: in case of a dispute this work suggests the burden of proof should not fall on the defendant. The GATS and its special discipline on financial services are clear in the reaffirmation of the right of WTO Members to regulate the markets for services.

The legal function of the PCO is not that of providing an exception to the obligations of the GATS and its Annex on Financial Services. Rather, it preserves the regulatory autonomy of Members in the delicate domain of prudential regulation and supervision in the financial services sector. This can be better understood if put against the background of the preamble of the GATS which reads:

(...)

\textit{Recognizing} the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right (...)

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It is argued that it should be the complainant who should carry the burden of proving, in addition to the claimed inconsistency with regards to the general rule (namely GATS obligations or commitments), that the adopted measures amount to an attempt to avoid trade obligations and commitments without a concrete prudential objective being pursued. If we were to take the position of the majority of commentators then the burden of proof would be allocated similarly to other exception-type provisions (as set out by the Appellate Body in *US – Gambling*).\(^{355}\)

Recent developments in the aftermath of the 2007/2008 financial crisis reminded the world of the unpredictable nature of financial markets and of how bad regulation (or no regulation) may severely hit the global economy. An understanding of the PCO whereby its main function is considered to be to restate the right of domestic governments to step into financial markets and modify the regulations according to the needs of financial stability is more loyal to the Uruguay Round participants’ intentions.

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5. Suggestions for reform

The net divergence between the patterns used in other trade agreements for exception or escape clauses is illustrative of the peculiar and unique nature of the PCO in the context of international trade law.

As set out in the previous subparagraphs, there are potential shortcomings connected to the alternative interpretative approach advanced in the present work. Essentially, a measure that is so broadly drafted and unclear as to the boundaries of its application may lead to problems relating to lack of efficiency and, furthermore, may provide WTO Members with incentives to cheat or free-ride trade in relation to more open countries. This is particularly delicate in the current context of reform that all major financial systems are undergoing, considering that many commentators have rightly highlighted the current tendency of the pendulum of financial services market to swing towards host-country regulation as opposed to the previous tendency in the opposite direction in the previous twenty years.

Since case law has not yet clarified the terms of the PCO we only have the text of the provision to work on. Given that the PCO of the Annex on Financial Services of the GATS still represents the most influential example in the context of bilateral negotiations, efforts should concentrate on the multilateral context.

Four ideas will be advanced in the following subsections with regard to possible options for reform of the WTO system: enhancing transparency, encouraging Members to notify timely the adoption of new schemes; introducing time-requirements for the review of prudential measures which have an impact on the free flow of financial services and capitals; introducing reference to internationally agreed standards in order to have objective grounds on which to judge on the real aim behind the adoption of a particular regulatory scheme; following the example of the PTA between Canada and the European Union, introducing guidelines for the interpretation of the PCO, with a clarification of measures that are excluded from the application of trade obligations and commitments.
5.1 Transparency

Transparency obligations are common to the main WTO Agreements. The GATS is no exception to this and dedicates one of its first provisions to the discipline of transparency: Article III. In addition to asking Members to publish in a timely manner their domestic legislation that may have an impact on trade in services, paragraph 3 of the provision also requires Members to notify the Council for Trade in Services of the WTO about the enactment of new regulations or amendments to existing disciplines which affect trade in services under the sectors and modes that constitute part of the specific commitments of the given Member. Practice over the last twenty years has not been satisfactory in this area. According to Wolfe, Members seldom notify their legislation to the Council and practice is in general scarce on this issue. Moreover, transparency does not seem to be a main source of concern for most Members, and this claim seems to be valid for developed and developing Members alike.356 Paragraph 4 requires Members to establish enquiry points in order to provide adequate information to other Members that may seek it. Finally, Article III gives WTO Members the possibility to notify any other Member’s measures that it considers as affecting trade in services.

To name a paradigmatic example, the EU has not yet notified to the Council the introduction of the new “Services Directive”. This is revealing of the value that the WTO community has given to the issue so far. There is no case law dealing with transparency requirements at the WTO level. In all likelihood the lack of an effective sanction that could be imposed on Members who do not respect the transparency requirements makes the latter, if not inutile, at least redundant.357

The Annex on Financial Services of the GATS does not add to the discipline on transparency provided for by the main agreement. Practice in the domain of financial services (and prudential regulation) reveals a wide margin for improvement in this regard. Empirical evidence suggests that incentives (or disincentives) affect the operation of transparency requirements in the context of WTO Agreements.358 First of all, the more the subject matter of the transparency

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358 Ibid. (pp. 573 – 575).
requirement is identified in detail, the more WTO Members are expected to fulfil the task and to notify the changes in relevant regulation. Second, Members tend to avoid the notification of their regulatory schemes when they fear that it will lead to new negotiations or even to dispute settlement. “Self-incrimination”, as a result, is a powerful disincentive. Given the uneasiness of many WTO Members with regard to the coverage and application of the PCO, it is probably not to be expected that Members will autonomously proceed in notifying measures that could be considered to be in violation of their trade obligations or commitments.

One suggestion for reform in this domain may be that of providing Members with a list of measures that are clearly considered as being prudential (also referring to the existing practice at the level of international standard-setting forums, on which this work will elaborate further below) and asking them to notify to the Council for Trade in Services of the enactment of new pieces of legislation or the introduction of amendments to existing domestic disciplines. This will not impose an excessive burden on Members but will have the merit of increasing transparency and even making best practices circulate between Members, thus allowing those with a more fragile financial system to follow the example of those Members that perform better.

5.2 Periodical review

Prudential measures are often adopted in situations of uncertainty with regard to the conditions of the market for financial services, as clarified throughout this work. Since they have the capacity to override commitments and obligations at the multilateral level they may result in a permanent or semi-permanent derogation to the rules of the game on international trade that Members had agreed to abide by.

Prudential measures may be of two kinds. They may either address permanent and structural issues (such as capital requirements) or they may serve as a tool to address the market failures deriving from contingencies. Moreover, prudential measures are sometimes adopted in situations

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359 It suffices to recall the discussion that took place within the CTFS of the WTO, account of which has been given in Chapter 2, supra.
of uncertainty with regard to both the developments in the markets as well as the effectiveness of
the instruments adopted. As a result it is possible (at least in theory) that such measures unduly
restrict international trade in financial services or impose an unnecessary burden on financial
services providers from abroad in the market of the regulating government.

As such, the PCO does not impose any procedural requirement on WTO Members with regard to
the phasing out of prudential measures that override trade commitments or obligations, and it is
not even clear to what extent the reversion of turbulence in the financial market to the ordinary
course of business is capable of forcing the Member who benefitted from the PCO to lift the
prudential measures that are no longer necessary. The text of the PCO is silent on this and
consequently one can infer that WTO Members do not have any obligation to phase out
prudential measures once they are no longer needed.

Without constraining the right of Members to regulate financial markets and to intervene when
they deem it appropriate, examples from other WTO agreements may be taken into account for
the restructuring of the PCO in a way that could make the provision more loyal to the goals of
transparency and efficiency of the trading system.

The first example may be taken from the discipline on precautionary measures set forth in the
SPS Agreement. Article 5.7 of the SPS Agreement requires WTO Members to review the measure
adopted in circumstances of lack of sufficient scientific evidence with regard to the harmfulness
of a particular product within a (unspecified) reasonable period of time. The Agreement on
Safeguards also requires measures adopted in order to smooth the effects of contingencies in
which a surge in the imports causes a major harm to the domestic industry producing a
particular good to be phased out. Article 7.1 of the Agreement on Safeguards requires Members
to impose safeguard measures only for the period that is necessary to address the situation
causing the injury. This period cannot exceed four years unless it is extended under the
conditions provided for by Article 7.2 of the Agreement on Safeguards.

In the case of the PCO, a periodical review of the measures derogating from the obligations under
the GATS and its Annex on Financial Services may serve the goal of legal certainty, pushing
Members to enhance transparency and to strike a more efficient balance between trade commitments and prudential concerns.

5.3 Standards

As explained in Chapter 2, one of the main drivers for reform in financial services markets is the work conducted under the auspices on standard setting bodies, whose nature (public or private; formal or informal; binding or not binding) is not always clearly defined.

Contrary to practice in other WTO agreements (particularly the TBT and SPS), the GATS does not have a developed framework in this regard. The explanations for are many and an account of the situation has already been given in Section 2.5 supra. This section suggests that internationally agreed standards could potentially represent a benchmark in the attempt to separate prudential measures from purely protectionist measures. The following subsections clarify the current status of internationally agreed standards under the GATS, and what could possibly be done in order to provide more clarity and integrate the multilateral discipline on trade in financial services with the guidelines and requirements set up in international forums dealing with financial regulation.

5.3.1 The role of standards in the GATS and in the Annex on Financial Services

The Annex on financial services of the GATS does not make an explicit renvoi to internationally agreed standards and the WTO judiciary has not yet addressed the issue. It is interesting, therefore, to start the analysis by looking again at the negotiating history of the Annex on financial services, in order to understand whether the negotiators debated the issue during the Uruguay Round. At the time of the negotiations relevant standard-setting bodies in the field of financial services already existed, although their membership was limited and their role was arguably less prominent.
In the very first meeting of the working group on financial services negotiators debated the possibility of inviting experts from other institutions to participate in discussions. The Chairman proposed to invite experts from the OECD Secretariat and from the BCBS due to the fact their expertise could have been of help in order to set the agenda of negotiations. However, this proposal was rejected due to the opposition of some countries. In particular, the representative from India raised an explicit objection to the invitation of experts from the organisations mentioned above. He referred to the decision taken by the Trade Negotiation Committee that only relevant international organisations could be invited and argued that OECD and BCBS were "neither truly international in character, nor relevant to the work of the sectoral group".

From a systematic point of view it is now a passage obligé to look at the text of the GATS in order to understand whether it allows the interplay of its rules with those of other international bodies and under what circumstances. The GATS refers to international standards in Article VI (Domestic Regulation) and Article VII (Recognition). Article VI of the GATS concerns obligations related to domestic regulation. It applies only in cases where WTO members have already undertaken specific commitments in order to that “all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner”. The issue of the application of standards emerges in the analysis of Article VI:5 of the GATS, which contains an obligation not to apply licensing and qualification requirements and technical standards in a manner which “does not comply with the criteria outlined in subparagraphs 4(a), (b) or (c)” and “could not reasonably have been expected (…)”. According to subparagraph 5(b), in order to assess the compliance of a Member’s measures with the requirement set forth by Article VI:4 of the GATS, account shall be taken of whether such measures were adopted following standards of international organisations.

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361 Ibid., para. 9.
362 Article VI:4 of the GATS: “With a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, the Council for Trade in Services shall, through appropriate bodies it may establish, develop any necessary disciplines. Such disciplines shall aim to ensure that such requirements are, inter alia:
(a) based on objective and transparent criteria, such as competence and the ability to supply the service;
(b) not more burdensome than necessary to ensure the quality of the service;
(c) in the case of licensing procedures, not in themselves a restriction on the supply of the service.”
In addition, Footnote 3 to Article VI:5 of the GATS provides additional explanation of what bodies should be considered as “relevant international organizations”:

The term “relevant international organizations” refers to international bodies whose membership is open to the relevant bodies of at least all Members of the WTO.

The text of Article VI:5 of the GATS (together with footnote 3), therefore, seems to require that two conditions must be met in order for internationally agreed standards to be relevant in this context: i) the standards need to have been actually applied by the Member whose measures need to be scrutinised under Article VI of the GATS; ii) only standards issued by international bodies whose membership is open to – as a minimum - all WTO Members can be usefully be considered as a benchmark to assess the conformity of a Member’s measures to Article VI:5 of the GATS.

Article VII of the GATS (Recognition) is the other provision of the agreement where it is possible to find the word “standards”. It appears in the context of paragraph 5, which reads:

Wherever appropriate, recognition should be based on multilaterally agreed criteria. In appropriate cases, Members shall work in cooperation with relevant intergovernmental and non-governmental organizations towards the establishment and adoption of common international standards and criteria for recognition and common international standards for the practice of relevant services trades and professions.

In this case, it is difficult to consider this passage an obligation. Indeed, it seems to suggest a route to WTO members wishing to engage in unilateral recognition schemes or in Mutual Recognition Agreements (MRAs) – when they deem it appropriate - in order to work in cooperation with relevant international bodies (either intergovernmental or non-governmental) and to adopt common international standards.³⁶³

The “sibling provision” in the Annex on Financial Service is Paragraph 3 (Recognition):

³⁶³ Two WTO Agreements, namely the Agreement on Technical Barriers to Trade (TBT) and the Agreement on Sanitary and Phytosanitary Measures (SPS) have a more detailed discipline with regard to the interplay between trade rules and standards. In comparison with the latter the discipline of the GATS is rather minimalistic.
(a) A Member may recognize prudential measures of any other country in determining how the Member's measures relating to financial services shall be applied. Such recognition, which may be achieved through harmonization or otherwise, may be based upon an agreement or arrangement with the country concerned or may be accorded autonomously;

(b) A Member that is a party to such an agreement or arrangement referred to in subparagraph (a), whether future or existing, shall afford adequate opportunity for other interested Members to negotiate their accession to such agreements or arrangements, or to negotiate comparable ones with it, under circumstances in which there would be equivalent regulation, oversight, implementation of such regulation, and, if appropriate, procedures concerning the sharing of information between the parties to the agreement or arrangement. Where a Member accords recognition autonomously, it shall afford adequate opportunity for any other Member to demonstrate that such circumstances exist.

(c) Where a Member is contemplating according recognition to prudential measures of any other country, paragraph 4(b) of Article VII shall not apply.

It is important to recall that to date no mutual recognition agreements concerning prudential measures have been notified to the WTO Secretariat.  

States are still reluctant to agree on (binding) international law disciplines on financial markets. Financial services remain a sensitive issue in terms of States’ sovereignty and there is a lack of will to delegate the regulation on the topic to international organisations. Governments might not like third parties (mainly common agents like a secretariat or judges) intervening in this area. They are aware of the necessity of internationally agreed common practice, because financial markets are highly globalised and interdependent, but prefer to set the rules of the game informally, among themselves, outside the scope of international agreements. Moreover, the risks associated with bad regulation of financial services are high. Therefore, the gains for cooperation are not straightforward and this is a possible explanation of why Governments may prefer to

364 Marchetti and Mavroidis, 'I Now Recognize You (and Only You) as Equal: An Anatomy of (Mutual) Recognition Agreements in the GATS'. provide an overview of all the MRAs notified to the WTO Secretariat until 2009. Nothing new has emerged in recent years.
share their views informally and to give to flexible agencies the task of issuing general orientations of non-legally binding nature.

Do standard setting bodies of a hybrid nature such as, for instance, the BCBS fulfil the conditions set out in the GATS rules? From a formal point of view the FSB and the BCBS, for instance, do not meet the “opening-up” requirement of Article VI of the GATS as they are “spin-offs” from the G-20 architecture and consequently are not by definition open to the accession of all WTO Members.

Article VII of the GATS, instead, only encourages WTO members to base their recognition policies (both unilateral and bilateral) on relevant international standards. There is no reason to presume, in theory, that the BCBS might not be considered as an international body issuing relevant international standards. Nonetheless this cannot be enough to legitimise recourse to standards for two sets of reasons. First of all, Article VII of the GATS only suggests that WTO members cooperate with relevant international standards-setting bodies when granting unilateral or mutual recognition of measures dealing with trade in services. Nothing in the wording of the provision suggests that it could be interpreted as an obligation of any kind. Secondly the “sibling” provision in the GATS Annex on Financial Services deals specifically with the mutual recognition of prudential measures without making any reference to standards. Therefore, the renvoi to relevant international standards of Article VII GATS should not be overestimated, since it may even be overridden by the lex specialis contained in Paragraph 3 of the GATS Annex on Financial services. Moreover, the latter specifically excludes the application of Article VII:4(b) of the GATS, which requires Members which adopt or modify recognition measures to promptly inform the Council for Trade in Services about the negotiations of a MRA in order to give interested parties the opportunity to indicate their interest in the participation to such negotiations. Consequently it seems that the already shallow discipline for the accession of third parties to MRAs is even weaker with regard to financial services, leaving more leeway to the regulating jurisdictions.

Nonetheless, a formalistic approach might be somehow misleading. In the analysis of the potential interplay between the PCO and standards on prudential and sound financial regulation, some realpolitik arguments deserve to be taken into account. First of all, standards such as the
BCBS standards are generally implemented in a timely manner by its members (and interestingly not only by them)\(^\text{365}\).

Therefore, irrespective of their formal status as non-legally binding norms, they are undoubtedly part of the relevant rules that financial institutions have to respect, since the overwhelming majority of national regulators (whether BCBS members or not) apply Basel standards, turning them into hard law crystallised in national legislative acts.

Notwithstanding the fact that standards seem to not have access to the GATS system through the main door, there are cases where they are effectively taken into consideration. Reference to the effective application and implementation of standards via domestic legislative acts appears in various official records of WTO accession procedures after the conclusion of the Uruguay Round.\(^\text{366}\) Furthermore, many WTO members refer to standards in the policy statement reports they submit to the Secretariat for the Trade Policy Review Mechanism (TPRM). Unlike other WTO agreements (such as the TBT and SPS), the GATS Annex on Financial Services does not provide a reference to internationally agreed standards that might help the WTO judiciary in the interpretation of domestic legislation. However, although not formally recognised, BCBS standards already play an important role in the GATS as they are evoked in the accession procedures and in TPRM.

Since standards are almost universally applied and they already appear in many ways in the GATS context, their value should not be underestimated. Although there are no formal renvois in the text of the Agreement, nothing prevents the judges from using Basel standards as benchmarks in the interpretation of an unclear provision as they are guiding principles effectively implemented by the majority of WTO members, even by those who are not parties to the BCBS.


Although standards cannot be considered benchmarks for the lawfulness of domestic measures of financial services, they can certainly help the WTO judges confronted with the PCO. Evidence of compliance with international standards can certainly be a signal that the challenged measure was not adopted as a means of avoiding the Member’s obligations or commitments. Since it is not clear what the legal standard of the PCO is and the amount of evidence that the defendant is required to bring before the WTO judges, compliance with international standards is indeed a good arrow in the quiver of the defendant. Therefore a Member may easily prove that they have adopted a measure in pursuance of prudential goals, following standards set up by international bodies and in doing so shift the burden of proof back to the complainant who will have to then show why the challenged measure is protectionist.

5.3.2 Conclusions on standards

This work does not go as far as suggesting the adoption of internationally agreed standards as a benchmark for domestic measures in the domain of financial services. However, compliance with a standard may constitute a powerful argument for the responding Member in the event of a dispute in order to prove that the measure adopted actually pursues a legitimate objective and was not enacted with the aim of avoiding trade obligations. Members wishing to impose a level of protection of prudential objective which is higher than what is provided for by the standards may still be allowed to do so, but they will have to provide more evidence with regard to the clarification of the objective pursued and the insufficient of the existing standards to that extent. A suggestion for reform may include the introduction of an Annex making explicit reference to standard setting bodies and to the standards issued by the latter.

5.4 Guidelines

Chapter 3 provided an extensive overview of the evolution of carve-outs for prudential measures in PTAs. One recent development that can serve as a useful example in order to make the PCO in the Annex on Financial Services of the GATS more efficient and better designed is constituted by
the Understanding on the application of the PCO of CETA (the PTA between the EU and Canada), account of which was given in Section 3.4.3 supra.

The document contains the most advanced ideas with regard to the protection of prudential objectives in the context of agreements whose stated aim is that of lowering material and immaterial barriers to foreign trade in financial services. The document arguably contains a good compromise between the need for governments to keep sovereign control over financial regulation and issues of legal certainty, which, as we have seen, are sometimes sacrificed in the context of trade agreements in this particular domain.

Chapter 3 provided a detailed overview of this Understanding and as such it is not necessary to restate the details of the document. However, it is important, for the sake of the completeness of the argument put forward, to point out the main features of the Understanding that can be usefully replicated at the multilateral level, should there be consensus among the 161 Members of the WTO.

Among the other novelties introduced by the documents, a number deserve particular attention. For instance, adjudicators must give consideration to the information available as well as to the urgency of the situation; the document expressly acknowledges that regulators are in a better position to evaluate the risks that ensue from market failures in the domain of financial services and as such adjudicators have to be deferential to them “to the highest possible extent”; the document clearly lists the cases in which a measure is presumed to have been adopted in pursuance of legitimate prudential objectives and as a result a presumption of lawfulness of the measure must be recognised.

5.5 Possibility for other Members to comment and submit observations

Firms make huge investments in order to enter markets for financial services. A change in financial market legislation from a risk-averse government may lead to losses or to the reduction of opportunities for trade. The WTO is a multilateral treaty signed by States, and this work does
not go as far as proposing a revolution of the system by introducing any kind of right for private parties, whether they are natural or legal persons. However, other WTO agreements contain disciplines that can usefully be imported, *mutatis mutandis*, into the context of the Annex on Financial Services of the GATS.

In particular, Article 5.8 of the SPS Agreement represents an interesting example in terms of a possible evolution of the discipline on prudential measures in the GATS. The provision reads as follows:

> When a Member has reason to believe that a specific sanitary or phytosanitary measure introduced or maintained by another Member is constraining, or has the potential to constrain, its exports and the measure is not based on the relevant international standards, guidelines or recommendations, or such standards, guidelines or recommendations do not exist, an explanation of the reasons for such sanitary or phytosanitary measure may be requested and shall be provided by the Member maintaining the measure.

Considering the fact that Members do not have the incentives to challenge measures adopted in pursuance of prudential objectives before the WTO judiciary, as made clear earlier in this work, a tool designed along the lines of Article 5.8 of the SPS Agreement can enhance cooperative and transparent behaviours by governments. This could serve the cause of legal security and help bridge the gap between trade commitments and the current tendency to repatriate financial regulation.
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