

Financial Regulation and its Effects on Trade and Investment Architecture

Considerations for the Future

DEEPALI FERNANDES



Deepali Fernandes

**Financial Regulation and its Effects
on Trade and Investment Architecture**

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Zürich, September 2024

Deepali Fernandes

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List of Abbreviations

AFTA	ASEAN Free Trade Agreement
ASEAN	Association of Southeast Asian Nations
BIT	Bilateral investment treaty
BCBS	Basel Committee on Banking and Supervision
BIS	Bank of International Settlements
BOP	Balance of payments
CETA	EU-Canada Comprehensive Economic and Trade Agreement
DS	Dispute settlement
DSM	Dispute settlement mechanism
EEA	European Economic Area
EFTA	European Free Trade Association
EU	European Union
EC	European Commission
FATF	Financial Action Task Force
FDI	Foreign direct investment
FET	Fair and equitable treatment
FSB	Financial Stability Board
FTA	Free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
ICSID	International Centre for the Settlement of Investment Disputes
ILC	International Law Commission
ICJ	International Court of justice
IMF	International Monetary Fund
ISDS	Investor-state dispute settlement
IOSCO	International Organization of Securities Commissions
MA	Market Access
MFN	Most favoured nation
NAFTA	North American Free Trade Agreement
NT	National treatment
OECD	Organisation for Economic Co-operation and Development
PTA	Preferential trade agreement

List of Abbreviations

RTA	Regional trade agreement
TPP	Trans-Pacific Partnership
UN	United Nations
UNCITRAL United Nations	Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
US	United States
VCLT	Vienna Convention on the Law of Treaties
WB	World Bank Group
WTO	World Trade Organization

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- KAUFMANN KOHLER GABRIELLE, International Arbitrator at Levy, Kohler and Kaufmann, Professor of Law, University of Geneva, Honorary President, International Council for Commercial Arbitration
- JOUBIN BRETT ANNA, Secretary, United Nations Commission on International Trade Law, Director, International Trade Law Division, Office of Legal Affairs, UN
- MANKE MARINA, Head Labour Mobility and Human Development Division, International Organization for Migration
- OESCH MATTHIAS, Chair Institute for International Law and Foreign Constitutional Law and Professor, University of Zurich
- PANIZZA UGO, Professor of Finance, and Pictet Chair, Graduate Institute Geneva
- PAUWELYN JOOST, Professor of International Trade Law, Graduate Institute Geneva
- REDDY, YV, Former Governor, Central Bank of India and Chairman, Fourteenth Finance Commission of India
- RIKARDUR B. RIKARDSSON, Head, Balance of Payments Department, Central Bank of Iceland
- SOOKHLAL SUDHIR, Counsellor, South African Mission to the WTO and former Chair of the WTOs Committee on Trade in Financial Services
- SUNDARESAN SOMASEKHAR, Member of Working Group on Foreign Investment in India Consultant to the Financial Sector Legislative Reform Commission

Note: Individuals were selected according to their expertise and experience in trade, investment, and finance, as well as the role they play in academia, international organisations, and/or the private sector. Discussions/interviews spanned the period 2014–2021 with the exception of the discussion with Mr. Reddy, which took place prior to 2014.

Trade and Investment Agreements

WTO AGREEMENTS

GENERAL AGREEMENT ON TRADE IN SERVICE

ANNEX ON FINANCIAL SERVICES

UNDERSTANDING ON FINANCIAL SERVICES

TRANSPACIFIC PARTNERSHIP AGREEMENT 2016

ASEAN AGREEMENTS

ASEAN INVESTMENT AGREEMENTS (1987, 1998, 2009)

ASEAN FRAMEWORK AGREEMENT ON TRADE IN SERVICES (1995)

EFTA-SINGAPORE FTA 2002

EFTA-SINGAPORE FTA

EU-SINGAPORE FTA 2015

INDIA-SINGAPORE CECA 2005

INDIA MODEL BILATERAL INVESTMENT TREATY

US-KOREA FTA 2007

US-SINGAPORE FTA 2003

BILATERAL INVESTMENT TREATIES as relevant

FTAs examined for the purposes of specific issues include Canada-Chile FTA, the EU-Korea FTA, the Japan-Peru BIT, and the Japan-Korea BIT EU-Canada Comprehensive Economic and Trade Agreement, 2016, US-Chile, US-Peru, US-Columbia, and US-Singapore

Note: While several FTAs and RTAs have been considered, those that I focused on for in-depth study are highlighted above. The criteria used for the evaluation of trade and investment agreements was based on chapters/provisions on trade in services, investment, financial services, cross-border services, dispute settlement, prudential regulation, and capital transfers. Several BITs were also considered on an issue-focused basis.

Broad Overview of Dispute Settlement Cases

WTO DSB ARGENTINA, Measures relating to Trade in Goods and Services, Panel Report, 30 September 2015, WT/DS453/R, Appellate Body Report, 14th April 2016, WT/DS453/AB/R, Issue: Prudential carve-out

WTO DSB, 'European Communities – Regime for the Importation, Sale and Distribution of Bananas', Panel Report, 22 May 1997, WT/DS27/R/ECU, Appellate Body Report, 9 September 1997, WT/DS27/AB/R, Issue: Definitions relating to trade in services

WTO DSB, China-Electronic Payment System, Panel Report, 16 July 2012, WT/DS413/10, Issue: Financial services, market access obligations

WTO DSB, Brazil – Export Financing Programme for Aircraft, Panel Report, 28 August 2001, WT/DS46/29, Issue: Reference to soft law in dispute settlement

PL HOLDINGS S.Ā.R.L./ . REPUBLIC OF POLAND, Partial Award, 28 June 2017, Arbitration No.: V 2014/163, Issue: Seat of Arbitration, Stockholm, BITs, financial services

RAIFFEISEN BANK INTERNATIONAL AG & RAIFFEISENBANK AUSTRIA D.D. v CROATIA, ICSID Case No. ARB/17/34, 17 May, 2018, Issue: Macroprudential regulation impact on investor

ADDIKO BANK AG v MONTENEGRO, (ICSID Case No. ARB/17/35), Sept. 2017, Issue: Macroprudential regulation impact on investor

POŠTOVÁ BANKA, A.S. AND ISTROKAPITAL SE v. HELLENIC REPUBLIC, ICSID Case ARB/13/8, 9 April, 2015, Issue: Macroprudential regulation impact on investor

SALINI COSTRUTTORI S.P.A. AND ITALSTRADE S.P.A. v. THE KINGDOM OF MOROCCO, ICSID Case No. ARB/00/4, Decision on Jurisdiction, 23 July 2001, Issue: Investment obligation: coverage of investment and qualification of activity for jurisdictional purposes

Invesmart v. Check Republic, UNCITRAL rules, 26 June 2009, Issue: Elements of fair and equitable treatment test

- TECNICAS MEDIOAMBIENTALES TECMED SA v. MEXICO, ICSID Case No. ARB (AF)/00/2, 29 May 2003, Issue: FET, legitimate expectation, transparency, Financial instruments qualifying as an investment
- RUMELI TELEKOM A.S. AND TELSİM MOBİL TELEKOMİKASYON HİZMETLERİ A.S. v. KAZAKHSTAN, ICSID Case No. ARB/05/16), 29 July, 2008, Issue: FET, transparency, investors legitimate expectations, FET to be interpreted on specifics of the dispute
- MTD EQUITY SDN. BHD. AND MTD CHILE S.A. v. REPUBLIC OF CHILE, ICSID Case No. ARB/01/7, 25 May, 2004, Issue: FET, good faith and consistency of government action
- METALCLAD CORP v. MEXICO, ICSID Case No. ARB(AF)/97/1), 30 August, 2000, Issue: FET, transparency
- TECMED v. MEXICO, ICSID Case No. ARB (AF)/00/2, 29 May, 2003, Issue: FET, transparency
- OCCIDENTAL EXPLORATION AND PRODUCTION COMPANY v. THE REPUBLIC OF ECUADOR, LCIA Case No. UN3467, 1 July, 2004, Issue: FET, maintenance of a stable business and legal environment
- CMS GAS TRANSMISSION CO v. THE REPUBLIC OF ARGENTINA, ICSID Case No. ARB/01/82005, 12 May, 2005, Issue: FET, maintenance of a stable business and legal environment
- L. F. H. NEER AND PAULINE NEER (U.S.A.) v. UNITED MEXICAN STATES, Claims Commission under the Convention between the United States of America and the United Mexican States of 1923, 15th October, 1926, Issue: FET: Test to determine bad action by regulator
- ADF GROUP, INC. v. UNITED STATES OF AMERICA, ICSID Case No. ARB (AF)/00/1, 9 January 2003, Issue: FET: Test to determine bad action on part of regulator, international standard element
- POPE v. TALBOT, UNCITRAL/NAFTA, Award in Respect of Damages, 31 May, 2002, Issue: FET: Evolving Neer criteria for CIL and bad regulation, FET: Proportionality of the impact on the foreign investor
- GLAMIS GOLD LTD.v UNITED STATES OF AMERICA, ICSID in accordance with the UNCITRAL Arbitration Rules, 14 May 2009, Issue: FET: Standard for violation and direction of CIL movement
- ALEX GENIN AND OTHERS v. REPUBLIC OF ESTONIA, ICSID Case No. ARB/99/2, June 25, 2001, Issue: FET: Objectivity of regulator
- DEUTSCHE BANK AG v DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA, ICSID Case No. ARB/09/2, Award, 31 October 2012, Issue: Financial instruments that qualify as an investment
- FEDEX N.V. v THE REPUBLIC OF VENEZUELA, ICSID Case No. ARB/96/3, Decision of the Tribunal on Objections to Jurisdiction, 11 July 1997, Issue: Financial instruments that qualify as an investment
- OKO PANKKI OYJ v. REPUBLIC OF ESTONIA, ICSID Case ARB/04/6), 19 November 2007, Issue: Financial instruments that qualify as an investment
- INT'L THUNDERBIRD GAMING CORP. v. MEXICO, UNCITRAL/NAFTA, 26 January, 2006, Issue: FET: Investor due diligence and conduct

Secondary Sources

- SALUKA INVESTMENTS V. CZECH REPUBLIC, UNCITRAL 1976, Partial Award 17 March 2006, Issue: Protection of regulatory flexibility within reasonable limits
- EISER INFRASTRUCTURE LIMITED AND ENERGÍA SOLAR LUXEMBOURG S.À R.L. V. KINGDOM OF SPAIN, ICSID Case No. ARB/13/36, 4 May, 2017, Issue: Tribunal analysis: (i) FET does not give rise to a right to regulatory stability per se
- CONTINENTAL CASUALTY; LEVY DE LEVI V. REPUBLIC OF PERU, ICSID Case ARB/10/17, 26 February 2014, Issue: Recognition of public interest role served by financial regulation
- ANTOINE GOETZ ET CONSORTS V. RÉPUBLIQUE DU BURUNDI, (ICSID Case ARB/95/3), 10 February 1999, Issue: State can be held liable for improper/discriminatory regulation
- VALERI BELOKON V. KYRGYZ REPUBLIC, UNCITRAL Arbitration Rules, 24 October, 2014, Issue: State can be held liable for improper/discriminatory regulation
- RENEE ROSE LEVY DE LEVI V. REPUBLIC OF PERU, ICSID Case ARB/10/17, 26 February 2014, Issue: Regulatory discretion and investment arbitration
- SLOVAK REPUBLIC V. ACHMEA, BV, ECJ Case No. C284/16, 2018, Issue: Non-recognition by EU law of intra-EU BITS
- BANK MELLI IRAN AND BANK SADERAT IRAN V BAHRAIN, PCA Case No. 2017-25, 2017, Issue: State bailouts and compulsory administration of banks, which led to investment protection cases
- ABACLAT AND OTHERS V ARGENTINE REPUBLIC, ICSID Case ARB/07/5, Issue: Decision on Jurisdiction and Admissibility August 4, 2011, Issue: State debt default
- AMBIENTE UFFICIO S.P.A AND OTHERS V ARGENTINE REPUBLIC, ICSID Case ARB/08/9, 8 February, 2013, Issue: State debt default

I. Overview, Literature Review and PHD Methodology

Since the 2008 financial crisis, financial regulation – both macro and microprudential – has increased, thus substantially changing the financial landscape. From the perspective of an investor or financial service provider, the change in the financial regulatory landscape has resulted in substantial economic costs arising from regulatory compliance, changes in banks' business models and opportunity costs, and cross-jurisdictional regulatory differences. Meanwhile, from the regulator's perspective, the post-2008 financial crisis regulation raised issues relating to regulatory approach, i.e. home or host country, macroprudential versus microprudential regulation, and, most importantly, the preservation of regulatory flexibility to maintain systemic stability and avoid the costs of another financial crisis.

Even though the development of the trade/investment and finance architecture at the global level have occurred separately from each other, in practice the two spheres of trade/investment and finance work in conjunction. Certain kinds of post-2008 financial crisis regulation clearly illustrate this interlinkage between the trade and investment sphere and the financial sphere. Macroprudential regulation relating to capital controls and microprudential regulation relating to legal form, ringfencing and proprietary trading are examples of how new regulation or reregulation has impacted investors/financial services suppliers by acting either directly or indirectly as trade barriers. Yet, at the same time, the enactment of these regulations is important for preserving systemic stability.

There are several points of interlinkages and potential inconsistencies and incongruities between the evolving post-2008 financial crisis regulation and the international trade and investment architecture as contained in the WTO's General Agreement on Trade in Services ('GATS'), bilateral and regional trade agreements ('FTAs') and bilateral investment treaties ('BITs'). The international trade and investment architecture is comparatively developed, with binding obligations and its own dispute settlement mechanisms. In contrast, financial regulation is largely nationally driven with loose non-binding mechanisms of cooperation at the international level within the Basel Committee, Financial Stability Board, IOSCO and at the regional level, as is the case for the EU, for whom there is no dedicated international avenue for dispute settlement.

Thus, there has always been an inherent tension between the trade and finance spheres at the global level in relation to the question of regulatory flexibility versus preservation of investor and financial services provider rights, and this tension has once more emerged center stage post the 2008 financial crisis.

The incongruities between financial regulation since the 2008 crisis and international trade and investment architecture is further complicated by several recent external factors. First, technology and the rising trend towards fintech has resulted in more complex financial products and transactions (Petràlia, Philippon, Rice, and Véron, 2019). Second, political, and institutional developments such as Brexit¹, the EU proposal for a multilateral investment court² and the freezing of the WTO's Appellate Body followed by the alternative multi-party interim arrangement, are likely to highlight these incongruities³.

Third, the impact of the COVID-19 pandemic will influence financial markets in the decades to come in several ways, starting with stimulus packages that will need to be implemented by commercial banks and other entities, larger amounts of debt aligned to corresponding instruments and indications of increased protectionism, to name a few. While COVID-19-related measures do not in themselves amount to prudential regulation, they are likely to create structural and operational changes in the financial markets, as well as potentially exacerbate existing trends of digitisation, more regulation etc. The implications of these COVID-19 dynamics are currently too early to predict, though (see Carletti, Claessens, Fatas, and Vives, 2020).

Fourth is the rise of dispute settlement cases in the financial sector. There are currently an estimated 3,400 BITS and FTAs in existence (UNCTAD 2018), nearly all of which have dispute settlement provisions, while the more recent FTAs/BITS also have separate financial services and investment provisions or chapters. The

¹ As we move towards Brexit, given the UK's position as a preeminent financial centre as well as its role as a gateway for financial services into the EU, there are likely to be points of tension, leading some commentators to view the filing of successful investor disputes within a narrow band of facts as a real possibility. See Ioannis Glinavos, 'Brexit, the City and Options for ISDS', Spring 2018, ICSID Review – Foreign Investment Law Journal, Volume 33, Issue 2, pp. 380–405.

² European Parliament Briefing, 'Multilateral Investment Court Overview of the reform proposals and prospect', 2020, Last Accessed 29/08/2020 at: [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/646147/EPRS_BRI\(2020\)646147_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/646147/EPRS_BRI(2020)646147_EN.pdf).

³ The multi-party interim arrangement will be based on Article 25 of the WTO Dispute Settlement Understanding. It will secure the participating 16 WTO members (Australia, Brazil, Canada, China, Chile, Colombia, Costa Rica, the European Union, Guatemala, Republic of Korea, Mexico, New Zealand, Norway, Panama, Singapore, Switzerland, and Uruguay) an effective and binding dispute settlement process for potential trade disputes among them. For further information, see EC press release https://ec.europa.eu/commission/presscorner/detail/en/IP_20_113.

global financial crisis of 2008 brought an unprecedented wave of financial market litigation, based on the trade and investment architecture (Golden, 2012)⁴.

A. Thesis Value and Methodology

1. Objective and Questions to be Answered

The objective of this thesis is (i) to provide a better understanding of the interlinkages and contradictions/incongruities between financial regulation and the trade and investment architecture that emerged in the wake of the 2008 financial crisis. These incongruities and contradictions are relevant as the trade and investment architecture is often the framework on which investors/financial services suppliers base their business operations. The thesis also aims to (ii) highlight the potential challenges that arising incongruities can pose for financial services providers, investors as well as regulators. And (iii) it also examines regulatory flexibility in the financial sector vis-à-vis investor and market access protection in light of the post-2008 financial regulation.

It seeks to achieve the above objectives by answering three questions:

1. To what extent do certain aspects of post-crisis financial regulation conform to existing trade/investment commitments? → Financial services provider and policy perspective
2. Does the conformity/lack thereof lead to possible trade/investment (including fair and equitable treatment) violations? → Investor perspective
3. How does it impact the flexibility of financial regulators? → Regulator perspective

Based on these findings this PhD thesis seeks to develop recommendations/suggestions in the concluding chapter on issues and modalities for further consideration.

⁴ Jeffrey Golden, 'Judges and Systemic Risk in the Financial Markets', *Fordham Journal of Corporate and Financial Law*, 2012 Volume 18, p. 330. Golden claims that a 'tsunami' of financial market litigation from the financial crisis has been predicted, and that the cases are pouring in, citing the Lehmann securities litigation as a starting point <http://www.lehmansecuritieslitigation.com>. The 2012 Eurozone crisis is also regarded in the financial services sector as likely to have an impact on litigation activity. In the survey 'Corporate Choices in International Arbitration' (2013), the plurality of the financial services industry respondents (46%) indicated that they foresaw a rise in disputes because of the 2012 crisis.

2. Methodology

In terms of methodology, the paper seeks to answer these questions by using select macroprudential (capital controls) and microprudential regulation (regulation relating to legal form, ringfencing and proprietary trading) as ‘probes’ for investigation. Macroprudential tools seek to address externalities with the financial system and from the financial to the real sector, thereby preventing systemic crises (FSB, BIS, IMF 2011)⁵. Microprudential regulation, meanwhile, focuses on the prevention of individual bank failures (Bhattacharya and Thakor, 1993; Freixas and Rochet, 2008) by focusing on individual institutions, ignoring the impact of financial institutions’ risk-taking on the broader financial system (Alexander, 2010).

The examples of macroprudential and microprudential regulation explored for the purposes of this PhD thesis have been selected based on their relevance and discernible impact on the trade and investment sphere. Macroprudential regulation related to capital controls is a key feature of the trade and investment architecture as well as the financial sector. Two key areas of microprudential regulation relevant to the 2008 financial crisis relate to ‘legal form’, i.e. the requirement to incorporate as a subsidiary as opposed to a branch and ‘restrictions on riskier activities’ by way of segregation of risky banking activities i.e. proprietary trading and ringfencing⁶. Both these forms of prudential regulation have implications for systemic stability, economic costs, and trade, testing the interface between regulatory interests and those of investors/financial service suppliers (*See Table 1: Methodology using examples of Macro and Microprudential Regulation (Post-2008 Financial Crisis) with Trade/Investment Impacts and Dispute Settlement Coverage*).

⁵ Examples of macroprudential regulation include regulation relating to countercyclical capital requirements, cap on leverage, levy on non-core liabilities, time varying reserve requirements and higher capital charge applied to global systemically important banks.

⁶ Please note that for the rest of the paper the reference to proprietary trading and ringfencing may be collectively referred to as ‘microprudential regulations’, regulation linked to ‘segregation or separation of financial activities’ and/or ‘restrictions on riskier activities’. Reference to capital controls, unless otherwise specified, may be interchangeably used with macroprudential regulation, but in the context of this paper it is to be understood as referring solely to capital controls as opposed to other macroprudential regulation such as capital reserve ratio requirements, and others.

Table 1: Methodology using examples of Macro and Microprudential Regulation (Post-2008 Financial Crisis) with Trade/Investment Impacts and Dispute Settlement Coverage

Measure	Post-2008 Crisis Regulation	Trade/ Investment Impact	Dispute Settlement Coverage
MACROPRUDENTIAL REGULATION			
Capital controls such as restrictions, taxes, quotas adopted to prevent unpredictable and sudden inflows or outflows of capital that can affect the economy	Yes	Yes	Yes
MICROPRUDENTIAL REGULATION			
Separation of financial activities through proprietary trading and ringfencing, e.g. UK ringfencing: US Volcker Rule	Yes	Yes	Yes
Regulators preference for certain kinds of legal forms or regulatory structures, e.g. subsidiary as opposed to a branch, e.g. preference of Spanish regulators	Yes	Yes	Yes

Source: Author Construction

Second, a select sample of FTAs have been evaluated to analyse their financial services and investment provisions. The FTA selection is based on geographical relevance – Europe, US, Asia – reflecting economies with sizeable financial sector interests and focuses on recent FTAs which have more detailed financial services and investment provisions⁷(*See Trade and Investment Agreements Evaluated for PhD Thesis*).

Third, the thesis will also draw on relevant case law established in ICSID and the WTO as it relates to the conceptual understanding of trade and financial terminology, scope of applicable treaties, the FET standard and the WTO's prudential carve-out clause (*See Overview of some of these cases and the issues they touch upon*).

⁷ While several FTAs and RTAs have been considered, the ones focused on for in-depth study are the Transpacific Partnership Agreement ('TPP'), EU-Singapore FTA, EFTA-Singapore FTA, US-Korea FTA, US-Singapore FTA, India-Singapore FTA, and ASEAN Agreements on Investment and Services.

Fourth, while the focus of the thesis is primarily legal and institutional, an economic approach will be utilised to highlight developments on the market front, establish a regulatory rationale and convey the impact of regulation in terms of economic/business costs. For instance, economic costs accrue to investors and financial services providers in conforming to the emerging financial regulation. They also accrue to regulators and taxpayers, potentially in the form of financial crisis or systemic damage, in case there is inadequate regulation or non-conformity to existing regulation.

Fifth, since the entire area of emerging financial regulation in terms of its congruence with the international trade and investment architecture and potential dispute settlement considerations is still emerging, the thesis has relied on the interview approach with certain regulators, trade and investment practitioners, bankers, lawyers and academics to provide a pragmatic understanding of the issues⁸(*See List of individuals interviewed*).

3. Relevance of the Thesis

The novelty of this thesis is that it brings together two distinct streams – finance and trade in the new context created by the 2008 financial crisis – by adopting an interdisciplinary approach that attempts to match economic trends with regulatory developments and their impact where possible and relevant. It also combines several methodological approaches, i.e. research, interviews, case law analysis, and uses sample regulation – both macro and microprudential – to test different aspects of the thesis.

The relevance of the thesis is primarily that it (i) raises the relatively new issue of regulatory flexibility vis-à-vis investment/trade protection in the financial sector.

⁸ These have included Asariotis Regina, UNCTAD, Beyert Vincent, Graduate Institute, Geneva, De Mello Rajiv, Chief Investment Officer, Bank of Singapore, Andrew Cornford, Observatoire de la Finance, Sudhir Sookhlal, Counsellor, South African Mission to the WTO and former Chair of the WTOs Committee on Trade in Financial Services, YV Reddy, former Governor, Central Bank of India, Ugo Panizza, Professor of Finance, HEI, Joost Pauwelyn, Professor of International Trade Law, Regina Asariotis, Chief, Policy Legislation Section, UNCTAD, Marina Manke, Head Labour Mobility and Human Development Division, International Organisation for Migration. Rodd Izadnia, Counsellor World Trade Organization, Gabrielle Kohler Kaufmann, Levy, Kohler, Kaufmann, Rikardur Ricardsson, Bank of Iceland. Valuable feedback was also received at two seminars attended at the University of Zurich, conducted by Professor Kern Alexander, Chair of Law and Finance, and Professor Mathias Oesch, Chair of Public Law, European Law and International Business Law at the University of Zurich.

This is an important issue as the failure of the financial system has incurred significant costs for the economy, whilst at the same time investor/financial services suppliers have had to operate within a predictable environment which enables competition and security of investments/interests. (ii) It enhances our understanding of the interlinkages/contradictions between financial regulation and the trade and investment sphere post the 2008 financial crisis. These findings have relevance for policy making and dispute settlement, especially in light of Brexit, new developments in fintech and the post-COVID-19 world, coupled with the rising trend in financial-sector-related dispute settlement. And (iii) the thesis also brings together two distinct streams of finance and trade using an interdisciplinary approach that attempts to match economic trends and analysis with regulatory developments and impacts.

Within the wide ambit of the thesis, the overarching purpose is to identify the cross-stakeholder and cross-disciplinary linkages. However, there is leeway for in-depth consideration of several areas, which would involve far more time and resources and in some cases is still evolving.

4. Definitions and Concepts

Next, we turn to this paper's specific usage of terminology. By 'investor/financial service supplier', this thesis refers to a broad definition of investor, i.e. both foreign direct investment and portfolio investment⁹. Financial services suppliers would follow the GATS definition¹⁰. The terms 'regulator' and 'financial regulator' are referred to interchangeably in the course of this thesis and pertain to financial regulator bodies with a regulatory or supervisory function including banking and securities regulators. Moreover, the term 'trade and investment architecture' refers to the network of approximately 3,400 trade and investment agreements, i.e. WTO, FTAs, RTAs and BITs, while the term 'financial architecture', by contrast, refers to the non-binding cooperative efforts made primarily by the G7 within fora such as the BCBS, FSB, IOSCO and others.

⁹ Broadly, the definition of investment covers not only physical assets located in the host country, but also other intangible assets such as mortgages, liens, pledges as well as portfolio investment in the form of shares, stocks, debts, or interests in the property of local companies.

¹⁰ GATS Annex on Financial Services, Paragraph 1.5 (b), 'A financial service supplier means any natural or juridical person of a Member wishing to supply or supplying financial services but the term "financial service supplier" does not include a public entity.'

B. Background on emerging post-2008 crisis financial regulation

The global financial crisis of 2008, which began in the US subprime mortgage market, developed into a full-blown international banking crisis when Lehman Brothers collapsed in September 2008. It was the worst financial crisis since the Great Depression of the 1930s¹¹, costing the world economy and impacting Asian¹² and European markets. IMF estimates indicate that American and European banks shed some \$10 trillion of assets or an equivalent of 13.5% of their stock of bank credit (IMF Global Financial Stability Report, 2008).

The post-2008 financial crisis era is marked by regulatory changes macroprudential, e.g. the use of capital controls, capital and liquidity requirements, and changes microprudential, e.g. the segregation of activities, ring fencing, legal form requirements occurring at differing levels and speeds of regulatory reform (Oliver Wyman, State of Financial Services Report, 2014, McKinseys Financial Globalization, 2017, IMF Financial Outlook 2010, Fernandes, Mashayekhi 2013).

The prime objective of changes in both macro and microprudential regulation post the 2008 crisis was to ensure systemically important financial activities were subject to appropriate oversight and regulation (WTO Secretariat, 2012). The proposed regulatory reform was implemented after detailed discussion and analysis (*See Volker, 2009; Turner, 2009; LaRosiere, 2009; and Kern Alexander's testimony before the UK Parliamentary Affairs committee*), (*See Table 2: A Brief Taxonomy of Post-2008 Financial Crisis Regulation*).

The results of an IMF survey of banks' international operations shows that many countries tightened regulations on banks' international operations between 2006 and 2014. Marked increases were seen in the areas of supervisory discretion (particularly in host countries), presence, information, and resolution¹³.

¹¹ Barry Eichengreen and Kevin H O'Rourke, 'A tale of two depressions: What do the new data tell us?' VoxEU.org, March 8, 2010, Last visited 13/11/2019, <https://voxeu.org/article/tale-two-depressions-what-do-new-data-tell-us-february-2010-update>. Although the COVID 19 pandemic is likely to have worse economic and potentially financial impacts.

¹² Monica Singhanian and Jugal Anchalia, 'Volatility in Asian stock markets and global financial crisis', October 28, 2013, Journal of Advances in Management Research.

¹³ Hibiki Ichiue and Frederic Lambert, 'Post-Crisis International Banking: An Analysis of New Regulatory Survey Data', April 2016, IMF Working Paper WP/16/88, p. 9.

Table 2: A Brief Taxonomy of Post-2008 Financial Crisis Regulation

Attempts to eliminate implicit and explicit guarantees	– Alternative resolution regime to create non-bankruptcy non-bailout solutions for failing banks – Expansion of scope of regulatory authority to govern non-banks – Contingent capital solutions for systematically important institutions
Increased safety and soundness	– Migration of derivatives to exchanges – Basel III capital and liquidity standards – Introduction/expansion of maximum leverage ratios – Compensation reform – Restrictions on riskier activity (e.g. proprietary trading, private equity investing) – Requirement to incorporate as a subsidiary – Usage of capital controls
Consumer protection	– Creation of consumer protection bodies – Conduct regulation in Europe – US CaRD act limitations on re-pricing for risk – Limits on debit interchange fees – Provision to impose a fiduciary duty on advisors to consumers/ retail

Source: Drawn from Oliver Wyman, State of Financial Services Report, 2014, as modified by the Author

A key observation of the changing financial regulation landscape post 2008 is the transition of the regulatory approach from financial deregulation, which marked the two decades prior to the 2008 financial crisis, to a financial reregulation approach (see Bolton, Cecchetti, Danthine, Vives, 2019). This deregulation approach in the financial sector was also reflected in the trade and investment architecture. By contrast, post-2008 governments of countries hardest hit by the 2008 financial crisis created new regulation, regulating so far unregulated areas (e.g. hedge funds and hedge fund managers, and credit rating agencies), deepening existing regulation (e.g. enhanced capital reserve requirements) or rolling back on existing regulation e.g. by repealing parts of the US Glass Steagall Act.

As far as macroprudential regulation, such as capital controls, is concerned, the conventional thinking prior to the financial crisis was generally geared towards capital account liberalisation and away from the use of capital controls (IMF), despite arguments to the contrary (Stiglitz 2000). Since the 2008 financial crisis,

however, capital controls have been endorsed as an effective macroprudential regulatory tool (IMF 2010, IMF 2012). Furthermore, in the case of microprudential regulation, here too conventional wisdom changed for legal forms of incorporation, e.g. there was a move from advocating for branch-based supervision (BCBS 1997, BCBS 2006) to subsidiary-based operations. There have also been areas of new regulation/reregulation, e.g. ringfencing and proprietary trading.

Changes in financial regulation post the 2008 financial crisis have on the one hand directly impacted financial service providers and/or investors¹⁴ and on the other hand financial regulators. From an investor's perspective, regulatory changes post the 2008 financial crisis macroprudential (e.g. capital and liquidity requirements) and microprudential requirement (e.g. segregation of activities, ring fencing, legal form requirements) occurring at differing levels and speeds have posed challenges in terms of the cost and scope of financial and investor operations (Alvarez, Garcia, Gouvela, 2016).

As regulation in the aftermath of the global financial system becomes more complex, regulatory regimes may be designed to act or inadvertently end up acting as trade and investment barriers by altering the existing regulatory landscape and incurring significant economic and business costs such as business restructuring, regulatory ambiguity, differing regulations and arising economic costs. The new regulatory regime may also contradict international trade and investment commitments that investors/financial service suppliers relied on at the time of commencing their operations.

The objective of financial regulators for the new regulation has been clear, namely the continued stability of the financial system, given its economy-wide impact in cases of failure. However, financial regulators must also face challenges related to the following:

- a) Implementation and blurring of lines between macro and microprudential regulation, raising questions of economic and human resources costs for the regulator.
- b) Fallout effects of regulation on other sectors of the financial industry: regulation in one financial sector, e.g. capital reserve requirements can impact other areas, necessitating a bank to incorporate a subsidiary as opposed to a branch so that the regulator has better oversight and control.
- c) Choice of home versus host country oversight, especially in times of crisis when host country authorities may demand a degree of regulatory control¹⁵.
- d) Regulatory arbitrage as regulators (US, UK, European) may pursue different paths.

¹⁴ Hereafter interchangeably referred to as financial services providers or investors.

¹⁵ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The globalization of banking: How is regulation affecting global banks?' 8 August 2016, BBVA Research Papers on Financial System and Regulation, Global Economic Watch, p. 8.

From the regulator's perspective, the interface between macro and microprudential regulation on the one hand and the trade/investment architecture could potentially raise investment and trade challenges to its ability to regulate in the financial sector. At the same time, it can be argued that changes in international banking regulations since the start of the financial crisis are more aligned with underlying systemic risk.

Table 3: Differing Objectives and Impact of Post-2008 Financial Crisis Regulation for Regulators and Investors

	Regulator	Investor/Financial service supplier
Objective	Stability of financial system	Maximisation of shareholder and profit value
Impact of post-crisis regulation	implementing new regulation, focus on host as opposed to home country regulation, greater emphasis on macroprudential regulation	Size of operations, structure of firms, cross-border operations, business models
Costs	Costs to regulator of implementing regulation Costs of not maintaining systemic stability – bail-out measures, quantitative easing, reregulation and implementation	Economic costs of implementing new measures and altering firm structure
Regulatory framework	National regulation, BCBS in certain areas, IMF for capital control measures. WTO, FTA, BITs, provisions for protection of regulatory activity.	WTO, FTAs, BITs, market access and national treatment clauses for trade and investment protection, national regulation relating to the financial sector.
Key protection of international trade and investment architecture	Yes, for regulatory flexibility but extent and terms of protection unclear	Yes, for market access, national treatment, fair and equitable treatment provisions in trade and investment architecture

Source: Author Construction

As one can observe from *Table 3: Differing Objectives and Impact of Post-2008 Financial Crisis Regulation for Regulators and Investors*, the objectives, impacts, costs and applicable regulatory frameworks differ for investors/financial services suppliers and financial regulators.

C. Overview of the Interface between the Trade and Investment Architecture and the Evolving Financial Regulatory Architecture Post-2008

The static trade and investment architecture vis-à-vis an evolving financial regulatory regime:

A key starting point relating to the incongruity between the trade and investment architecture and the evolving financial architecture lies in their respective structure and evolution. The financial architecture is largely nationally driven; at the international level it has followed a best principle/endeavours-based approach, broadly contained in the Basel concords, G-20 decisions and outcomes of the Financial Stability Board and at the regional level more binding arrangements as for instance ASEAN, MERCOSUR, European common market¹⁶.

The trade and investment architecture on the other hand is well developed and binding at the global level through a network of nearly 3,400 international trade and investment agreements including the WTO, and a range of bilateral and regional trade and investment treaties (UNCTAD 2018).

The international trade and investment architecture, whether by way of the WTO, FTAs or BITs, tends to be structured in a similar manner with provisions for investor/financial service supplier protection as well as regulatory flexibility. Most FTAs, specifically the more recent ones, tend to reflect the GATS provisions to varying degrees.

¹⁶ The EU is perhaps the only regional block with binding financial regulation measures applied within the common market relating to market access, operations and prudential measures. These measures have also been revised in a range of areas since the financial crisis of 2008.

Table 4: Overview of Provisions in the GATS and select FTAS Relating to Macro (Capital Transfer) and Micro (Market Access) Prudential Regulation, Prudential Flexibility, Fair and Equitable Treatment Provisions and Dispute Settlement

FTA/BIT	Investment, financial services chapters	Freedom of capital transfer	Regulatory Flexibility measures	Kind of FET provision	Provision for investor-state dispute settlement
GATS	Provisions for investment, financial services and cross-border services	Yes, related to commitments undertaken	Prudential carve-out in financial sector, BoP safeguards Potential disciplines on domestic regulation	None	Yes. State-to-state, WTO's dispute settlement body
TPP	Investment, financial, cross-border services	Yes	Prudential carve-out in financial sector, BoP safeguards	Minimum standard	Yes
EU-Singapore	Investment	Yes	Prudential exception, BoP safeguards	Autonomous	No, but provision for ICSID arbitration
EFTA-Singapore	Investment, trade in services chapters	Yes	Prudential exception, BoP safeguards	Autonomous	No, but provision for ICSID arbitration
US-Korea	Investment, financial, cross-border services	Yes	Prudential carve-out in financial sector	Minimum standard	Yes
US-Singapore	Investment, financial, cross-border services	Yes	Prudential carve-out in financial and investment chapter	Minimum standard	Yes
India-Singapore	Investment, trade in services chapters	Yes	Prudential exception and BoP safeguard	No obvious FET clause	Provides for ICSID arbitration
ASEAN	Several agreements, the main one being ASEAN Investment Agreement	Yes	Prudential exception and BoP safeguard	Yes	Investor state dispute settlement and ICSID arbitration

Source: Author Compilation

The provisions of the WTO's GATS and related agreements such as the Annex on Financial Services ('Annex on FS') and the Understanding on Financial Services ('Understanding on FS') contain provisions relating to market access, national treatment, specific sectoral commitments for financial services, capital transfers, regulatory flexibility, and dispute settlement¹⁷. FTAs contain specific provisions/chapters relating to investment, trade in services, cross-border services or financial services. In the case of BITS, there are varying forms of the FET standard. Regulatory flexibility in general is protected under provisions related to domestic regulation¹⁸. Regulatory flexibility in the financial sector is protected under the GATS well known 'Prudential Carve-Out' as well as related to the BoP safeguards. Almost all agreements contain provisions for dispute settlement either state-to-state or investor-state (*See Table 4: Overview of Provisions in the GATS and select FTAs Relating to Macro (Capital Transfer) and Micro (Market Access) Prudential Regulation, Prudential Flexibility, Fair and Equitable Treatment Provisions and Dispute Settlement*).

BITs contain the terms on which a foreign investor makes investments, including provisions relating to capital transfers, dispute settlement and investor protection through the fair and equitable treatment ('FET') standard. The FET standard is reflected in varying forms in most investments and to a lesser extent in trade agreements. It is also the most frequently relied-upon claim in investor-state dispute settlement ('ISDS') cases after expropriation claims (Schreuer 2005, UNCTAD, 2012).

The key element of the FET standard relevant to the emerging micro and macroprudential regulation is transparency. Tribunals have interpreted elements of the FET standard to include 'meeting investors' legitimate expectations' (*Tecmed v. Mexico*, 2003; *Rumeli Telekom A.S and Telsim Mobil Telekomikasyon Hizmetleri A.S v. Kazhakstan*, 2008) and 'maintaining a stable business and legal environment' (*Occidental v Ecuador*, 2004; *CMS Gas Transmission Co v. Argentina*, 2005). However, a key problem in the application of the FET formulation is the varying, and at times vague, treaty formulation of the FET standard, granting

¹⁷ For capital transfer provisions there is the Balance of Payments Safeguards GATS Article XII. For Market Access and National treatment, XVI (2) XVII respectively. For regulatory flexibility in taking financial measures for prudential reasons, Paragraph 2 A of the Annex on Financial Services. And for dispute settlement GATS Article XXII (consultations) and Article XXIII (dispute settlement).

¹⁸ GATS Article VI, varying forms of this article are found in FTAs and RTAs.

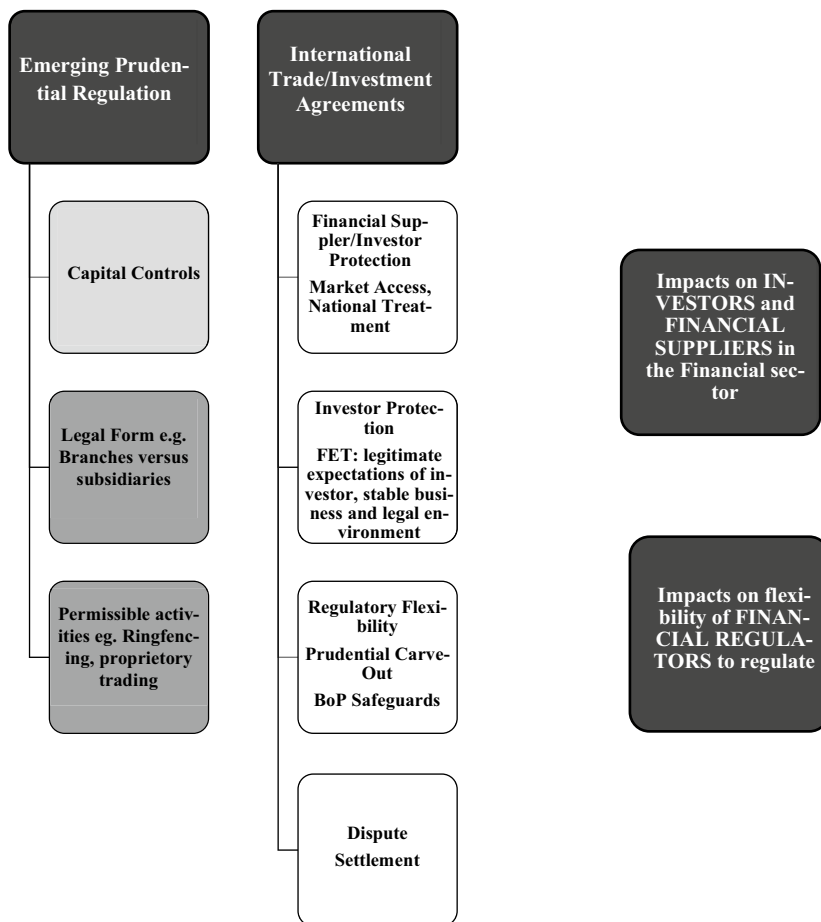
tribunals considerable discretion in determining the principles that breach the obligations (Malik, 2009).

However, even though the continued evolution of the international trade/investment and finance architecture are different, in practice the two spheres work in conjunction. Incongruities and contradictions, particularly those caused by the cyclical nature of regulation in the financial sector as compared to the binding obligations of the trade and investment architecture, have implications for investors/financial services suppliers and regulators. Trade and investment commitments take a while to negotiate but once negotiated they are binding, whereas over roughly the same period financial regulation has undergone a process of deregulation pre financial crisis and then reregulation post the 2008 financial crisis.

The emergence of post-2008 financial crisis regulation has further highlighted the interlinkages between the trade and investment sphere and the financial sector, exacerbating areas of potential non-conformity. From *Figure 1: An overview of the interlinkage between select emerging macro and microprudential regulation relating and provisions contained in the WTO, FTA/BITs* we can observe that on the one hand most trade and investment agreements cover financial services and therefore measure the effects on the financial sector by way of trade in services, investment, and sectoral obligations through market access, national treatment, capital transfer, FET and dispute settlement provisions. The same agreements simultaneously provide for regulatory flexibility in the financial sector through prudential carve-out-like clauses. The emerging post-2008 prudential regulations under consideration directly correspond to these provisions, creating potential areas of inconsistency/contradiction. Such issues of inconsistency between and within treaties have already been raised within the UN and in academia¹⁹.

¹⁹ See discussions of UNCITRAL Working Group 3 on Investor-State Dispute Settlement Reform, accessible at https://uncitral.un.org/en/working_groups/3/investor-state; see also Julian Arato, Chester Brown, and Federico Ortino, 'Parsing and Managing Inconsistency in Investor-State Dispute Settlement', 22nd June, 2020, *The Journal of World Investment and Trade*, 21(2–3), pp. 336–373.

Figure 1: An overview of the interlinkage between select emerging macro and microprudential regulation and provisions contained in the WTO, FTA/BITs



(Source: Author Construction)

D. Inconsistencies and Contradictions arising out of the Interlinkage between the Trade and Investment Architecture and evolving Post-2008 Crisis

Several possible inconsistencies/contradictions arise out of the interlinkages between the trade and investment architecture and the financial architecture in light of the post-crisis financial regulation.

First, contradictions and/or incongruities may arise between emerging prudential regulations in the cross-jurisdictional context, which can pose a problem for trade. Cross-jurisdictional differences in post-2008 macro and microprudential regulations can act as a trade and investment barrier for cross-border financial operations. If we were to take the example of microprudential regulation related to the separation of risky banking activities, in the US regulation on proprietary trading extends to depository institutions, their parent companies, and subsidiaries²⁰. However, in the case of the UKs ringfencing regulation²¹, the reverse is true whereby the parent company of the ringfenced entity can also own a bank that undertakes prohibited or excluded activities. Thus, both kinds of entities can sit within the same banking group as a ringfenced bank. For a bank with cross-border operations in the US and UK, this can pose problems in terms of business structuring, permissible activities, and potential liabilities.

The second is contradictions that could arise from within the same international agreement, e.g. the GATS or a given FTA. For instance, in order to impose capital controls, the GATS BoP safeguard measure requires a necessity test; however, at the same time, the prudential carve-out grants regulatory flexibility to financial regulators in the interest of preserving financial stability.

The third is contradictions arising between trade/investment agreements. In inter-trade agreements, there can be differences of approach that impact the implementation of post-2008 financial crisis regulation and raise questions around hierarchy in investor/financial service supplier rights and applicable law, i.e. FTA, BITs, or WTO. An example of this is the GATS, which provides for regulatory flexibility; however, BITs through the FET clause protect investors' interests, leading to a potential area of conflict. Another example is the disparity of FTA approaches on the use of capital controls. US FTAs have narrow and strict provisions on capital controls versus EU/Japanese/Canadian FTAs (Pasini, 2012). Korea, for instance, as a member of the OECD with FTAs with both the US and EU, would be permitted to adopt capital controls under certain circumstances under the OECD Code of

²⁰ See US Code, Title 12, Chapter 17, Section 1851 (h)(1), Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds.

²¹ Section 6 and Schedule 1 to the Banking Reform Act 2013 (FS(BR)A 2013) require certain UK financial institutions with significant retail and small and medium-sized enterprise banking operations, to ringfence certain activities for retail and SME depositors with effect from 1 January 2019 into a legal entity that will not be permitted to carry on certain specified wholesale and investment banking activities.

Liberalisation of Capital Movement, and by the EU-Korea FTA, but not necessarily under the US-Korea FTA²².

The fourth and perhaps most direct is contradictions between post-2008 crisis financial regulation and the existing trade and investment architecture, which is the crux of this thesis and answers the three questions that this thesis aims to address.

Example of how the interlinkage between post-2008-crisis financial regulation and the trade and investment architecture could lead to disputes, testing the interface between investor/financial service supplier protection and regulatory flexibility:

A bank with cross-border is required to comply with post-crisis macro and micro-prudential regulation incurring economic costs and also economic loss from closure of existing operations. The bank relied on trade and investment obligations (WTO, bilateral FTAs, BITS) at the start of its operations, which it now deems to be contravened. Depending on the FTA and the jurisdiction, the investor/financial service supplier could file for ISDS. The financial regulator may be protected under the GATS prudential carve-out but the extent of regulatory protection will be tested. Furthermore, the outcome may vary depending on the forum in which the dispute settlement is sought, i.e. WTO, ICSID, etc. and potentially the political climate.

1. Investor and Financial Service Supplier Considerations → To what Extent do Aspects of the Post-2008 Financial Crisis Regulation conform with the existing Trade and Investment Architecture?

The conformity of emerging financial regulation with the trade and investment architecture brings together three areas: (i) evolving macro, e.g. capital controls and microprudential regulation, e.g. legal form and segregation of activities; (ii) provisions contained in international trade and investment agreements, relating to market access and national treatment commitments, prudential and regulatory carve-outs; and (iii) FET provisions contained in BITs.

By bringing together these three areas, one is faced with a myriad of interlinkages and potential incongruities.

²² Federico Lupo-Pasini, 'International Regulatory Regime on Capital Flows and Trade in Services', January 2012, ADBI Working Paper No. 338.

Table 5: Possible Contraventions of Trade Agreements by select Post-Crisis Microprudential and Macroprudential Regulation Relating to Capital Controls, Legal Form, Ringfencing and Proprietary Trading

Measure	Potential contravention	Trade/Investment agreement impacted
Capital controls	Provisions relating to balance of payments, provisions protecting financial regulators regulatory flexibility, e.g. GATS prudential carve-out	WTO GATS, FTAs, BITs, potentially FET clause
Legal form	– MA: Requirement to incorporate as a subsidiary, with own capital – MA: Branch required to provide guarantee by parent company – MA: Permission for supply of cross-border services (Mode 1), may be changed to require a commercial presence, i.e. either branch or subsidiary – MA: Changes higher capital reserve ratio for foreign branches or existing subsidiaries – National treatment provisions	FS commitments in Mode 3 and 1, understanding on FS standstill provision, FTAs, BITs commitments
Ringfencing	MA: Separation of existing investment activity from retail banking incurring business restructuring and economic costs	FS commitments in Mode 3, understanding on FS commitments standstill provision, FTAs, BITs commitments
Proprietary trading	MA: Proprietary trading from jurisdiction in which permitted to one where it is not impacted, particularly for group holding companies	Mode 1 understanding on FS commitments standstill provision, FTAs, BITs commitments
All four areas of regulation	– Business restructuring and economic costs for regulatory compliance, regulatory arbitrage impacts – NT: discrimination against foreign banks, e.g. lighter CRR requirements for domestic suppliers, proprietary trading for foreign banks' cross-jurisdictional operations – Potential FET clause	

Source: Author Construction

Note: For the column on trade agreement impacted, actual contraventions will depend on individual countries' trade in services and investment commitments to the overarching agreement provisions. The GATS Article 1.2 defines trade in services as the supply of a service through four modes of supply: cross-border (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3), and the presence of natural persons (Mode 4). MA: Market Access, NT: National Treatment

In the case of macroprudential regulation such as capital control there are several areas of potential contradiction. To begin with, the prevalent view prior to the 2008 financial crisis that capital controls should be liberalised has been reversed. In fact, several governments implemented capital control measures such as taxes on certain forms of capital flows, ceilings on different types of capital flows and derivative operations, and minimum stay periods.

The use of capital controls is closely linked to the transfer of capital provisions found in international trade agreements and BITS, which, following the conventional wisdom of the time, require the free transfer of funds linked to covered trade and investment commitments, potentially preventing the use of capital controls²³. *Table 4: Overview of Provisions in the GATS and select FTAs Relating to Macro (Capital Transfer) and Micro (Market Access) Prudential Regulation, Prudential Flexibility, Fair and Equitable Treatment Provisions and Dispute Settlement*

At the same time, trade and investment agreements contain provisions relating to prudential exceptions ('prudential carve-out' or 'prudential exception') and balance of payment safeguard measures, which protect regulators' flexibility to regulate in the financial sector²⁴, thereby providing justification for the usage of capital controls. Thus, depending on the kind and duration of capital controls implemented, the trade commitments a member state has undertaken, interpreted by the extent of permissible regulatory flexibility, a specific kind of capital control measure may or may not conform to its trade and investment obligation. In theory, this would disallow the usage of capital control measures for covered investments or trade commitments.

This highlights the potential conflict between investor/trade protection measures in trade and investment agreements which provide for capital transfers and simultaneous provisions for regulatory flexibility.

In the case of post-2008 microprudential regulation and the trade and investment architecture there are also several areas of potential incompatibility. Microprudential regulation – ring fencing, proprietary trading, requirement to incorporate

²³ The GATS contain a clear obligation (Article XI) that transfers the capital essential to trade in services commitments undertaken (investment or cross-border financial services) should be permitted. This provision is reflected to varying degrees in the OECD capital code and most BITS and FTAs.

²⁴ The GATS provides regulatory flexibility through the prudential carve-out contained in the Annex on Financial Services, section 2(a) as well as a balance of payment safeguard clause (GATS Article XII).

as subsidiaries – can act as trade barriers²⁵ by going back on commitments made in trade agreements or requiring investors/financial services suppliers to meet additional conditions before they can operate. *Table 5: Possible Contraventions of Trade Agreements by select Post-Crisis Microprudential and Macprudential Regulation Relating to Capital Controls, Legal Form, Ringfencing and Proprietary Trading*

Once trade liberalisation commitments are undertaken, the GATS does not permit limitations on the supply of services, such as the size of the service providers, number of branches, types of products offered, legal character, foreign capital participation, and preference for domestic service suppliers, amongst others²⁶. The financial services commitments in FTAs and BITs tend to be more far-reaching than the GATS, making the likelihood of incompatibility higher. Contraventions would depend on the exact nature of trade and investment commitments undertaken by WTO member states or FTA parties in their schedule of commitments.

An example of how microprudential regulation can contravene trade commitments is the regulatory requirement for a financial operator to incorporate locally – with its own capital – rather than as a branch of a foreign institution. The regulatory rationale for the requirement to incorporate as a subsidiary is that cross-border credit (Mode 1) provided through a branch tends to be less stable than the supply of credit by local subsidiaries (Mode 3), particularly in times of crisis (De Haas and van Lelyveld, 2002). Furthermore, foreign bank branches may become systemically important in the host country²⁷. From an investor/financial service perspective, however, the post-2008-crisis requirement to establish as a subsidiary could act as a trade/investment barrier.

In addition, the post-2008 financial crisis regulation has changed the trade and investment landscape for financial services suppliers and investors, requiring substantial business restructuring and economic costs – such as compliance, changed business models and incentives, structural reform – and in that sense may be considered to have an indirect trade-barrier-like effect (Ernst and Young, 2012). For instance, existing operations of subsidiaries or branches involved in proprietary trading will need to be restructured, e.g. universal banks may need to set up two

²⁵ Specifically, market access and national treatment barriers (GATS Article XVI (2) XVII), in Modes 3 (commercial presence) and 1 (cross-border trade).

²⁶ GATS Article XVI (2) and Article XVII.

²⁷ See also WTO Secretariat, ‘Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services’, 3 February 2010, S/C/W/312 S/FIN/W/73.

different entities or be ringfenced as in the case of the UK. The required changes to any single entity could apply to the whole group as in the case of the US and Germany. In case of legal form, there may be changes in the condition of existing operations, e.g. higher CRR requirements for foreign branch operators or subsidiaries, requirement to report to and be supervised by the host country regulator, and parent companies to provide guarantees for their branches, amongst others.

National regulatory divergences in the implementation of post-2008 financial regulation have driven changes in business models and activity. Regulations directly and/or indirectly make it less attractive for banks to maintain large foreign operations (Forbes, Reinhard, and Wieladek, 2016). Regulators' preference for a certain kind of legal form and the extent of regulatory compliance influence a bank's entry or continued operation in a market, owing to rising costs. In fact, a post-2008 financial crisis impact analysis of banks from the US, Canada, the UK, Sweden, Germany, Austria, Netherlands, France, Italy, Spain and China found that half of the banks surveyed pulled out of certain countries for regulatory reasons (Alvarez, Garcia, and Gouvela, 2016).

Other issues related to the interlinkage between the trade and investment architecture and post-crisis regulation are conceptual ambiguity and differences between trade agreements and macro and microprudential regulatory provisions. For instance, the GATS views branches and representative offices on a par with domestic service suppliers, even though a branch is not a juridical person²⁸. This in essence means that, in trade terms, a branch is viewed on a par with a subsidiary, which is problematic for post-crisis financial regulation relating to proprietary trading and legal form requirements where a branch and subsidiary are treated as separate legal entities with different privileges and obligations²⁹.

²⁸ Article XXVIII(g) was introduced in order to clarify the status of branches in the GATS. Footnote 12 states the following: 'Where the service is not supplied directly by a juridical person but through other forms of commercial presence such as a branch or a representative office, the service supplier (i.e. the juridical person) shall, nonetheless, through such presence be accorded the treatment provided for service suppliers under the Agreement. Such treatment shall be extended to the presence through which the service is supplied and need not be extended to any other parts of the supplier located outside the territory where the service is supplied.'

²⁹ However, the branch can be subject to differential requirements in areas such as taxation and deposit taking, given that it is not a legal entity in itself. See WTO Secretariat Note on Status of Branches as Services Suppliers, document MTN.GNS/W/176, 23 October 1993.

Direct contradictions between macro and microprudential regulation post the 2008 crisis and the trade and investment architecture as it stands therefore do exist, depending also on national commitments undertaken. The post-2008 financial crisis regulation can create market access barriers or rollbacks on existing standstill provisions, which could have direct or indirect trade-barrier-like effects. *Table 5: Possible Contraventions of Trade Agreements by select Post-Crisis Microprudential and Macroprudential Regulation Relating to Capital Controls, Legal Form, Ringfencing and Proprietary Trading*

2. Investor Considerations → Does the Conformity/Lack thereof Lead to possible FET Violations?

The FET clause is a central standard for investor protection contained in most BITs and some FTAs. Invocation of the FET standard requires (a) qualification as an ‘investment’ under the BIT/FTA under consideration and (b) sufficient cause for invocation by investors. A key element of the FET standard is the transparency element, which includes the onus on the host state to meet investors’ legitimate expectations³⁰, and act in a consistent and non-arbitrary manner so as to maintain a stable business and legal environment³¹.

The elements of what constitutes legitimate expectations of investors can be drawn from ICSID case law (*Investmart v Czech Republic*, 2009)³²:

1. Legitimate expectations arise from either specific or general assurances given to an investor, based on which an investment is made.
2. The expectations must be reasonable and flow from the business environment at the time of the investment.

However, ICSID case law has also upheld regulatory flexibility, highlighting that the investor should not expect absolute legal stability as, generally, a state’s right to regulate will not be unreasonably impaired (*Saluka v Czech Republic*, 2006, *Levy de Levi v. Republic of Peru*, 2014).³³

³⁰ *Tecmed v. Mexico*, 2003, *Rumeli Telekom A.S and Telsim Mobil Telekomikasyon Hizmetleri A.S v. Kazakhstan*, 2008.

³¹ *Occidental v Ecuador*, 2004, *CMS Gas Transmission Co v. Argentina*, 2005.

³² *Invesmart, v. Czech Republic Award* (26 June 2009) para. 254.

³³ *Saluka, Partial Award* (17 March 2006) para. 305. See also *Continental Casualty; Levy de Levi v. Republic of Peru* (ICSID Case ARB/10/17), Award (26 February 2014).

In a generic sense it can be argued that the new macro and microprudential regulation have substantially changed the financial services landscape in several ways, thereby failing to meet the legitimate expectations of investors or maintaining a stable business and legal environment.

First, as discussed earlier, the regulatory landscape and the underlying economic rationale of regulation itself have changed drastically, moving from a laissez-faire approach followed for over two decades to a reregulation, new regulation approach. This is at several points in contravention of binding trade and investment commitments – WTO, FTAs, BITs – and non-binding financial initiatives, e.g. BCBS, G20, OECD, which investors and financial services suppliers relied on while expanding their operations. The laissez-faire approach led to substantial financial sector liberalisation and expansion. For example, in terms of loans, deposits and profits, current market shares of foreign banks average 20% in OECD countries and close to 50% in emerging markets/ developing countries.³⁴

Second, legitimate expectations arise from either specific or general assurances given to an investor, based on which an investment is made. The binding trade and investment architecture can be considered general commitments made to investors and financial services suppliers, since they are directly linked to ‘covered investments’ and ‘financial services commitments’ undertaken in the WTO, FTAs or BITs (*Table 4: Overview of Provisions in the GATS and select FTAs Relating to Macro (Capital Transfer) and Micro (Market Access) Prudential Regulation, Prudential Flexibility, Fair and Equitable Treatment Provisions and Dispute Settlement*). For instance, trade provisions relating to freedom of capital transfer provisions, as well as specific provisions permitting market access under agreed legal forms or structure and activities, may be contravened by post-crisis macroprudential regulation relating to capital controls and microprudential regulation relating to the segregation of legally permissible activities or propriety trading, respectively.

³⁴ Stijn Claessens and Neeltje van Horen, ‘Foreign Banks: Trends, Impact and Financial Stability’, January 2012, International Monetary Fund Working Paper WP/12/10, Pg. 5. The paper bases its findings on a comprehensive database on bank ownership, including the home country of foreign banks, covering 137 countries from 1995 to 2009. It provides salient facts on trends in foreign ownership, compares foreign and domestic bank characteristics, and analyses the relationship between foreign bank presence and financial development and the impact of foreign banks on lending stability during the recent crisis.

Third, the implementation of large-scale micro and macroprudential regulation compliance involved major structural changes to business operations both nationally and in terms of financial firms' cross-border operations (Ernst and Young, 2012). For instance, the application of proprietary trading rules and ringfencing regulation to a banking company with cross-border operations in the US and UK requires changes in its business model and operations. In the case of capital controls, their impact on the legal/business environment and the legitimate expectations of financial investors can be more easily observed and quantified, making it relatively easy to compare a firm's balance sheet and economy-wide data prior and post the use of capital controls.³⁵

It may therefore be argued that the change in traditional regulatory approaches, business restructuring arising from compliance with the new financial regulation, coupled with national regulatory differences and uncertainty in global financial markets has substantially changed the business and legal landscape for an investor, resulting in a potential breach of the FET standards 'to meet legitimate expectations of investors' and 'maintain a stable legal and business environment'.

3. Regulator's Perspective → How is the Regulator's Flexibility impacted by the Interface between post 2008 Financial Crisis Regulation and the Trade and Investment Architecture?

The goal of prudential regulation is to safeguard the financial system by creating a more disciplined, less pro-cyclical financial system, which better supports balanced growth (WTO Secretariat, 2012). Macroprudential regulation seeks to smooth excessive financial and credit cycles, limiting system-wide financial risk and the incidence of disruption in the provision of key financial services that can have serious consequences for the real economy (FSB, BIS, IMF 2011). Microprudential regulation protects small depositors by limiting the frequency and cost of individual bank failures (Bhattacharya and Thakor, 1993; Freixas and Rochet, 2008).

Both micro and macroprudential regulation have regulatory flexibility and cost implications for the regulator. Regulatory costs arise not just from enacting and supervising regulation, but also from system-wide costs arising from the non-implementation of effective prudential regulation due to the build-up of systemic

³⁵ For instance, in the case of capital controls in Chile and Malaysia, it is possible to see how capital controls can alter the business and legal environment in which an investor operates.

risk. A compilation of banking crises around the world (147 countries) from 1970–2011 found that the average fiscal costs of resolving a banking crisis is approximately 7% of GDP and the cumulative output loss averages 23% of GDP (Laeven and Valencia, 2013).

The interlinkages between financial regulation and the trade and investment architecture poses a challenge for the regulator specifically in terms of the scope of regulatory flexibility vis-à-vis trade and investment commitments (Dobson and Jacquet, 1998, Alexander, 2003). The interlinkage between emerging 2008 financial crisis regulation and the trade and investment architecture has created three key areas of potential regulatory incongruity, namely a change in regulatory approaches, a change in regulatory responsibilities (i.e. home versus host country), and the extent of regulatory flexibility vis-a-vis trade and investment commitments.

a. Changes in Regulatory Rationale and Regulatory Approaches

Post financial crisis, the economic rationale for financial sector regulation has shifted from the pre-crisis ‘laissez faire’ deregulation approach to the post-crisis new regulation or reregulation approach. From the microprudential perspective, the pre-2008-crisis trend towards deregulation of the financial sector led to the encouragement of branch operations as opposed to the incorporation of subsidiaries. Proprietary trading and the merging of banking activities were also permitted or tolerated. After the financial crisis, however, there has been a move towards the incorporation of subsidiaries and ringfencing, which has effectively rolled back or reregulated these areas.

Similarly, from the macroprudential perspective, the prevalent wisdom prior to the financial crisis was that capital movement as it relates to trade/investment in financial services should be unfettered by the usage of capital controls. Post the 2008 financial crisis, however, the use of capital controls has reemerged as a macroprudential tool that may be necessary to maintain the stability of the financial sector and the economy at large. Several countries since the 2008 crisis have used capital controls to stem large short-term inflows of speculative investment, which causes volatility in exchange rates and asset markets³⁶. This has in turn led to a reversal of regulatory views on the usage of capital controls in international fora such as the IMF, G20.

³⁶ See Chapter 3 on Macroprudential regulation, post-2008 financial crisis for a list of countries and measures undertaken.

Iceland Financial Crisis – Illustration of Regulatory Change Impacts

Perhaps one of the best elaborations of several areas of this thesis can be illustrated by the Iceland Financial Crisis 2008–2011 ('Iceland financial crisis'), which encapsulated issues of financial liberalisation, regulatory change/reversal and dispute settlement. In the years leading up to 2008, Iceland was swept up in a wave of financial liberalisation – all its banks were privatised between 1998 and 2002, which led to the emergence of three systemically important banks: Kaupthing, Landsbanki and Glitnir. Moreover, capital controls that had been in place since the 1970s were lifted. As a result of financial liberalisation, Icelandic banks were permitted to borrow internationally and thus they expanded their operations, most notably in the UK and in the Nordic and Baltic countries. Furthermore, in 2006, in order to withstand a potential liquidity crunch with loans/bonds maturing, Icelandic banks accepted foreign deposits from the Netherlands, the UK and other countries, paying out high interest rates. By the end of the second quarter of 2008, Iceland's external debt was more than seven times its GDP in 2007.

By 2008, there was a reversal of financial liberalisation as the three systemically important banks started to fail and ultimately filed for bankruptcy. Capital controls were thus applied once again. Domestic deposits were guaranteed, but outside Iceland, more than half a million depositors lost access to their accounts in foreign branches of Icelandic banks. On top of that, there was a rise in dispute settlement as foreign deposit holders filed for compensation. This led to the 2008–2013 diplomatic dispute between the Netherlands, the UK and Iceland referred to as the 'Icesave dispute', which was settled in 2015 when an EFTA Court ruled that Iceland was not obliged to repay Dutch and British depositors the minimum deposit guarantees.

This case raises a number of issues regarding finance and trade, including the switch from the pre-2008-crisis focus on financial liberalisation with free capital flows and operations to the reintroduction of capital controls and limited financial firm operations after the 2008 crisis. On the regulatory front, the question of home (Icelandic banks) versus host (customers/deposit and loan holders in the UK and the Netherlands) country regulation and finally the issue of dispute settlement.

Another change in regulatory approaches has been the change in focus from micro to macroprudential regulation. The focus of financial regulation in the decade leading up to the financial crisis was on the operations of financial firms, i.e. microprudential regulation premised on the notion that if bank supervisors could manage individual financial entity risk they would be profitable and stable, and systemic risks across the financial system would be negligible (Alexander, 2010). As a result, in the run-up to the 2008 financial crisis, microprudential regulation focused on individual institutions, ignoring the impact of financial institutions' risk-taking on the broader financial system³⁷. However, after the 2008 crisis, the

³⁷ Kern Alexander, 'Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges', p. 6, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

focus shifted to macroprudential regulation with the objective of preserving systemic stability at all costs.

Some scholars have emphasised that micro and macroprudential regulation are complementary to each other, both being intermediate targets on the road to achieving the overall stability of the financial system (Freixas, Laeven, Peydro, 2015). Macroprudential supervision provides valuable information for the supervision of financial institutions and the regulation of financial markets, while information gathered through microprudential supervision can facilitate macroprudential supervision³⁸. However, the complementary approach can have unintended spillover effects in the trade context³⁹, such as an increase in domestic activation of macroprudential instruments, which in turn increases the scope for international spillovers (Buch, Goldberg, 2017). For example, national regulators demand that international banks satisfy local capital/liquidity requirements, resulting in several US and European firms tasking their subscale foreign operations with concentrating on domestic markets.

b. Regulatory Burden: Home versus Host Country Regulation

The second consideration is the change of focus from home to host country regulation. Both macro and microprudential regulation impact the home and host country regulator in terms of who can and should bear the regulatory and supervisory burden. Prior to the financial crisis, the general view in the BCBS and many developed countries was that home country regulation was sufficient (BCBS 1997, BCBS 2006)⁴⁰. In the case of microprudential regulation, the pre-crisis model for

³⁸ WTO Committee on Trade in Financial Services, Report of the Meeting held on 20th March 2013, S/FIN/M/70, 19 April, 2013. Norway and Australia both pointed out the close complementary role between macro and microprudential regulation and supervision.

³⁹ WTO Committee on Trade in Financial Services, Report of the Meeting held on 20th March 2013, S/FIN/M/70, 19 April 2013. Norway and Australia both pointed out the close complementary role between macro and microprudential regulation and supervision.

⁴⁰ The Basel Committee's position on home and host authorities' responsibilities relating to the supervision of branches of cross-border banks is described in the Basel Concordat and summarised in the Basel Core Principles for Effective Banking Supervision. Section VI of the Basel Core Principles describes the obligations of home and host supervisors as follows: 'Home supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted

foreign banks relied on home country jurisdiction, allowing banks to operate freely across borders, providing for and encouraging incorporation as a branch, which entailed fewer regulatory requirements and generally a single point of supervision for the home country. The WTO's Understanding on FS commitments also encourages branches and subsidiaries of foreign banks to defer to home country supervision.

In the case of macroprudential regulation, while several arguments were made for the removal of capital controls, in fact capital controls may be necessary not only in the classical balance of payments crises but also for handling difficulties caused by excessive upwards pressures on exchange rates due to capital inflows (Cornford, 2016). The power and flexibility of a host country's central bank to regulate in times of boom and bust has therefore been highlighted as essential for the stability of a financial system, particularly in developing countries (YV Reddy, 2004)⁴¹.

Since the financial crisis, the renewed focus on host-country supervision has manifested in the actions of financial authorities in several ways, all of which have trade implications:

- a) Supervisors seeking greater assurances about the financial soundness of branches' and subsidiaries' parent institutions.
- b) Evaluation of adequacy of liquidity being held locally by the branch or subsidiary.

by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries' (Core principle 23). With regard to host country responsibilities, there is an expectation that host supervisors will ensure that the business conduct of local affiliates of foreign banks is of the same high standard expected and enforced for domestic institutions, and that they can share information with relevant home authorities in order for the latter to carry out satisfactory consolidated supervision (Core principle 25).

⁴¹ Former Reserve Bank of India Governor, YV Reddy Reddy argues for a distinction not only between residents and non-residents or between inflows and outflows but also between individuals, corporates and financial intermediaries. He points out that financial intermediaries are typically a greater source of volatility, especially when owned or controlled by foreign entities/investors operating in developing countries. As they are often influenced by considerations other than domestic economy apart from the issues relating to cross-border supervision of financial intermediaries by the host country supervisor. Y V Reddy, 'Capital account liberalization and capital controls' Remarks by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Central Bank Governors' Symposium convened by the Bank of England in London, 25 June 2004. Last visited 5 August 2021 at: <https://www.bis.org/review/r040713d.pdf>.

- c) Evaluation of standards of regulation and supervision in the home country.
- d) Local regulatory requirements in the case of US proprietary trading and UK ringfencing regulation.

Within the EU, the issue of home and host country regulation has been minimised because of the common market, in which financial providers have a ‘passporting privilege’ that enables them to operate throughout the European Banking Union while relying on host country supervision, regulation and reporting requirements⁴². In the Brexit context, the issue of home and host country regulation is an acute consideration for existing or future British banks operating in the EU and vice versa, as they may lose their passporting privileges.

Meanwhile, from the perspective of investors and financial services suppliers, the home and host country regulation is important as it would determine the point of regulatory compliance and, in the case of disputes, determine the point of cause of action and jurisdiction.

c. The importance of regulatory Flexibility for Minimising Systemic Risk versus Regulatory Burden on Investors and Financial Service Suppliers

Regulatory flexibility in the design, implementation, and enforcement of macro and microprudential regulation is important for protecting against the build-up of systemic risk. Systemic risk is ‘the risk of threats to financial stability that impair the functioning of a large part of the financial system with significant adverse effect on the broader economy’ (IMF-BIS-FSB, 2009 and ECB, 2009). It can originate in any part of the financial system and typically builds up over time. Channels of transmission of systemic risk can be shocks caused by excessive risk taking, wholesale depositors’/investors’ expectations (which cause rational revisions) and/or pure panic unrelated to fundamentals (Freixas, Laeven, Peydró, 2015). A good example of systemic risk build-up during the 2008 financial crisis was when bank branches became a source of instability, causing them to act as transmitters of the crisis (Claessens, Van Horen, 2012).

⁴² Under the EU’s passporting regime, a firm authorised and/or regulated in an EU/EEA member state may (i) establish a branch in another EU member state with reliance on the home country authorisation and/or (ii) provide services on a cross-border basis without the need for further authorisation in the state in which they have established a branch or provide services. See European Passport Rights for Financial Institutions Regulations, 2011 which was replaced by the European Passport Rights for Financial Institutions Regulation 2020.

Systemic risk is an elusive and volatile concept, making regulatory flexibility – including through the continuous review of regulatory choices – indispensable for consumer protection and financial integrity (Delimatsis, 2007). This is especially true in times of crisis when a regulator must act swiftly. For instance, during the 2008 financial crisis, the quick action of the Vienna Initiative enabled⁴³ European banks with subsidiaries and branches in Eastern Europe to continue their support in terms of capital/liquidity and the extension of government assistance to subsidiaries/branches in Eastern Europe. This served as a sharp brake on the withdrawal of European banks, thus mitigating problems of financial stability in the region⁴⁴.

Recognising the importance of regulatory flexibility in the financial sector, most trade and investment agreements contain provisions protecting regulator flexibility to act in a prudential manner. However, the post-2008 crisis prudential regulation tests the interface between regulatory flexibility and the protection of investors and financial services providers.

In the case of microprudential regulation, regulatory flexibility can help identify, prevent and address small issues before there is a buildup of systemic risk. For instance, in the case of proprietary trading, whether banks are trading for proprietary reasons or to facilitate client business, they will be exposed to certain market and counterparty risks. Ultimately, as with any risk, if losses are sufficiently large, they can lead to a bank's insolvency and, depending on the size and interconnections of the bank in question, may have wider systemic risk implications. However, from the investor's perspective, the new and evolving prudential regulation can act as a barrier to trade and investment and potentially mean going back on trade and investment commitments that countries may have undertaken.

A dichotomy therefore exists on the one hand between micro and macroprudential regulation that is emerging in different countries and the trade and investment architecture as it stands. An essential element of the trade and investment architecture is the protection of investor/trade rights, which can be contravened by emerging financial regulation. For instance, in the case of legal form, and as

⁴³ The successful Vienna Initiative led by the EBRD was a plan undertaken in January 2009 by European banks and governments during the height of the financial crisis to control the situation and work towards a joint solution specifically in developing regions of Europe. More information is available at: <http://www.ebrd.com/downloads/research/factsheets/viennainitiative.pdf>.

⁴⁴ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The globalisation of banking: How is regulation affecting global banks?' p. 12, BBVA Research Papers on Financial System and Regulation, Global Economic Watch, 8th August 2016.

can be observed from *Table 6: Examples of Macroprudential and Microprudential Regulation that could fall within the Scope of the Prudential Carve-Out in the GATS and select FTAS* a requirement to incorporate as a subsidiary means higher costs and a business model change for investors. Moreover, it could mean a roll back of existing trade and investment commitments that may allow operations as a branch. For the host country regulator, however, it entails better oversight of and more control over the subsidiary's asset.

Regulatory flexibility, therefore while important, must be balanced against loss in efficiency of financial services provision as it could curtail credit availability, resulting in regulatory arbitrage or risk shifting to unregulated parts of the financial system, which in turn negates the prudential objective of the regulatory action (Freixas, Laeven, Peydro, 2015). Arguments have therefore been made for a reconceptualisation of international economic law to bring it in line with developments on financial regulation⁴⁵.

**d. Regulatory Flexibility under Trade and Investment Agreements:
The Prudential Carve-Out and Select Post Financial Crisis Prudential
Regulation**

Provisions for regulatory flexibility for undertaking prudential regulations are contained in trade and investment agreements. The usage of capital controls has some degree of protection under the BoP safeguard like provisions contained in most trade and investment agreements and based on the GATS BoP safeguard⁴⁶.

⁴⁵ Kern Alexander, 'Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges', Page 14, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

⁴⁶ Article XI of the GATS prohibits WTO members from applying restrictions on payments and transfers for current international transactions relating to their specific commitments, except in exceptional circumstances in conformity with GATS Article XII and the IMF Articles of Agreement. Article XII in turn sets out that a member may impose temporary restrictions that suspend its commitments (on all sectors included in its schedule, not only financial services) in the event of serious balance-of-payments and external financial difficulties or threat thereof as long as the restrictions (i) do not discriminate among WTO members; (ii) are consistent with the IMF Articles; (iii) avoid unnecessary damage to the commercial, economic, and financial interests of other WTO members; (iv) are necessary to deal with balance-of payments and external financial difficulties/threats faced by the member; and (v) are phased out progressively as the member's situation improves.

Similarly, regulatory flexibility in the financial sector is protected by the GATS prudential carve-out and similar provisions in FTAs. *Table 4: Overview of Provisions in the GATS and select FTAs Relating to Macro (Capital Transfer) and Micro (Market Access) Prudential Regulation, Prudential Flexibility, Fair and Equitable Treatment Provisions and Dispute Settlement*

Three key questions surround the use of the prudential carve-out contained in the GATS and other trade agreements as it relates to the post-2008 financial crisis regulation. The first is whether the prudential carve-out covers regulatory flexibility in the post-2008 financial crisis context?

The GATS Annex on Financial Services, which contains the prudential carve-out, allows members to take prudential measures in the financial sector in order to protect the safety and soundness of the financial system, provided they are not used to circumvent GATS obligations or nullify commitments undertaken by a WTO member⁴⁷. Post-2008 financial crisis regulation has been undertaken for clear prudential reasons, i.e. protecting systemic stability. (See *Table 6: Examples of Macprudential and Microprudential Regulation that could fall within the Scope of the Prudential Carve-Out in the GATS and select FTAs*)

Thus, a measure falling within the prudential carve-out, even if it is inconsistent with provisions of the GATS (e.g. MFN obligations or specific commitments), is legally permissible, affording post-2008 crisis regulatory measures and financial regulators' broad discretion to adopt measures. However, at the same time, the prudential carve-out is not an unqualified exception that protects against the misuse of the provision.

⁴⁷ Paragraph 2 (a) of the GATS Annex on Financial Services states, '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.'

Table 6: Examples of Macroprudential and Microprudential Regulation that could fall within the Scope of the prudential Carve out in the GATS and select FTAS

Regulators' preference for certain kinds of legal forms or regulatory structures, e.g., subsidiary as opposed to a branch	Microprudential measure for the prevention of branch-based contagion from branches to parents and vice versa from parents to branches.	Preference of Spanish regulators vis-à-vis Latin American operations.
Separation of financial activities through proprietary trading and ringfencing	Microprudential measure ringfence or separate deposit taking activity from more risky investment like activities, with greater control on supervision and deposits.	UK ringfencing US Volcker Rule
Capital controls: taxes, quotas, etc.	Macroprudential measure to prevent unpredictable and sudden inflows or outflows of capital that can affect the economy.	National examples

Source: Author Construction

The coverage offered by the prudential carve-out appears to be wider in scope when compared to other general exceptions under the WTO Agreements. GATS Article XIV, for instance, allows measures inconsistent with a member's obligation provided they are 'necessary' to protect public morals and public order as well as human, animal, and plant life⁴⁸. Thus, GATS Article XIV presupposes a kind of necessity test, which is not the case for the prudential carve-out. A prudential measure therefore may not be challenged on the grounds of whether it is 'necessary' or 'least trade restrictive' (Key 2003, Sorsa 1997). Hence, while the prudential carve-out is an exception to the GATS rules, it is wider in scope when compared to other GATS exceptions, although the issue of whether a prudential measure is being used to avoid GATS obligations is still to be considered⁴⁹.

A second question relates to whether micro and macroprudential regulation are covered under the prudential carve-out. The GATS prudential carve-out appears to afford WTO members a high level of discretion regarding prudential measures they may adopt. The GATS Annex on FS applies to 'measures affecting the supply

⁴⁸ GATS Article XIV on General Exceptions.

⁴⁹ Piritta Sorsa, 'The GATS Agreement on financial services – A modest start to multilateral liberalization', IMF Working Paper, Page 11, WP/97/55, May 1997.

of financial services'⁵⁰. The term 'affecting' has been interpreted broadly in WTO jurisprudence to encompass any measure of a member that affects the supply of a service directly or even if it regulates other matters but nevertheless affects trade in services⁵¹. According to this interpretation of the term, it appears that both macroprudential regulation such as capital controls and microprudential regulation as it applies to legal form and segregation of financial activities would technically be covered under the GATS definition of measures affecting financial services.

At the same time, measures that are purely protectionist in effect, are not likely to be permitted (WTO Secretariat, 2010)⁵². It is clear that, at a minimum, the prudential carve-out imposes an obligation of good faith with respect to the adoption and application of prudential measures (Von Bogdandy and Windsor 2008).

A third question relates to the extent and circumstance of coverage of post-2008 financial crisis regulation under the GATS prudential carve-out. While the general academic view is that the prudential carve-out offers Members a high level of regulatory flexibility, the prudential carve-out is yet to be fully interpreted by a WTO dispute settlement body.

The first case to attempt to address the issue of the prudential carve-out is the WTO dispute 'Argentina – Measures relating to Trade in Goods and Services'⁵³. One of the key outcomes of the Panel's findings in its report of 2015, as modified by the Appellate Body Report, was to signal to WTO Members that they would be accorded wide – though not unrestrained – latitude in adopting and implementing measures taken for prudential reasons and affecting the financial services sector⁵⁴.

⁵⁰ GATS Annex on Financial Services, Paragraph 1 (a).

⁵¹ WTO Panel Report EC-Bananas III, paragraph 7.285, WTO Appellate Body Report EC-Bananas III paragraph 220.

⁵² WTO Secretariat, Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services, 3 February 2010, S/C/W/312 S/ FIN/W/73.

⁵³ See WTO Panel Report, WT/DS453/R and WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, WT/DS453/AB/R, 14th April 2016.

⁵⁴ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, Paragraph 7.849, Page 202, WT/DS453/R, 30th September 2015, WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, Paragraph 6.260, Page 84, 14th April, 2016.

Box 1: Key Points from the Argentina Case and its Implications
CONCEPTS

‘Prudential reasons’ refers to ‘causes’ or ‘reasons’ that motivate financial sector regulators to act to prevent a risk, injury or danger.

CRITERIA

Rational relation linking CAUSE (prudential reason) and EFFECT (measure).

Risk, injury to danger does not have to be IMMINENT.

To be decided on a CASE-BY-CASE basis in terms of design, structure and architecture of measure.

SOME OBSERVATIONS

- Signals wide – though not unrestrained – latitude in prudential regulation adoption and implementation.
- Can be used to justify derogation from MA, NT and MFN.
- Potential prudential reasons accepted by the Panel include solvency of insurers/reinsurers, avoidance of possible systemic risk of insolvency and failure of direct insurance companies, investor protection, reduction of systemic risk.

The Panel considered the notion of ‘prudential reasons’, finding that the expression refers to those ‘causes’ or ‘reasons’ that motivate financial sector regulators to act to prevent a risk, injury or danger, which do not have to be imminent⁵⁵.

The Panel also found that a measure taken ‘for’ prudential reasons denotes a rational relationship of cause and effect between the measure and the prudential reason and would be determined from a case-by-case analysis of the design, structure, and architecture of the measure.

In this case, the Panel accepted as ‘prudential’ the reasons given by Argentina with respect to measure 5 (the protection of the insured, the solvency of insurers and reinsurers, and the avoidance of the possible systemic risk of the insolvency and failure of direct insurance companies) and with respect to measure 6 (investor protection, the reduction of systemic risk, and the prevention of money laundering and terrorist financing offenses). Many financial sector measures can be argued to have similar prudential objectives. However, despite the Panel’s deference to financial regulators to determine the prudential motivations that they choose to pursue, the Panel found that measures 5 and 6 were not designed rationally to serve the stated prudential reasons⁵⁶. The Panel decision therefore accepts the avoidance or mini-

⁵⁵ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, See discussions of the Panel at pages 205–212, WT/DS453/R, 30th September 2015.

⁵⁶ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, See discussions of the Panel at pages 205–212, WT/DS453/R, 30th September 2015.

minging of systemic risk as a prudential reason, whilst at the same time recognising the protection of investor rights.

The Appellate Body viewed the prudential carve-out as being relatively wide in its coverage. It disagreed with Panama's argument that the prudential carve-out covers only measures constituting 'domestic regulation', finding instead that the provision covers all types of measures affecting the supply of financial services within the meaning of paragraph 1(a) of the GATS Annex on Financial Services⁵⁷. Furthermore, the Appellate Body reasoned that the provisions of paragraph 2(a) mean that it could be invoked to justify inconsistencies with all of a Member's obligations under the GATS, including a Member's MFN, market access and national treatment obligations⁵⁸.

While the Argentina financial services dispute does not delve in great depth into several aspects of the prudential carve-out, it does for the first time consider aspects of the prudential carve-out and may inform future panel interpretations on the prudential carve-out coverage of regulators' flexibility vis-à-vis trade and investment commitments. As set out in Box 1, the flexibility of the regulator is clearly protected and a kind of criteria consisting of establishing a rational reason between the measure and the prudential reason and considering each case on an individual basis is set out.

This in effect would mean most post-2008 financial crisis regulation could potentially be exempted under the GATS prudential carve-out, although ambiguity remains in terms of conceptual understanding, procedure and coverage.

In general, then, both WTO and investment arbitration tribunals have shown deference to legitimate regulatory activity in the financial sector. The question remains as to the weightage given to what is perceived as legitimate regulatory interests as opposed to investor/financial service suppliers protection.

⁵⁷ WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, Paragraphs 6.256–6.258, Page 83, WT/DS453/AB/R, 14th April 2016.

⁵⁸ WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, Paragraphs 6.262– 6.270, Pages 84–86, WT/DS453/AB/R, 14th April 2016.

E. Outcome of Contradictions between Trade/Investment and Financial Architecture: Dispute settlement and Economic Costs

1. Increasing Trend in Financial Sector linked Disputes in International Fora

The contradictions of post-2008 financial crisis regulation vis-à-vis the trade and investment architecture raise the possibility of a dispute settlement challenge arising out of two factors: (a) structure and fora for the dispute settlement challenge; and (b) the willingness of investors and financial services suppliers to challenge post-2008 financial crisis regulation.

The structure and fora for dispute settlement is provided for by the network of nearly 3,400 trade and investment treaties which provide the minimum standards of protection (market access, national treatment, fair and equitable treatment, free transfer of funds amongst others) to investors and financial service suppliers, based on which many financial institutions make investment and trade decisions.

The trade and investment architecture also provides for dispute settlement on a state-state basis (e.g. WTO) or investor-state basis (e.g. ICSID). (*Table 4: Overview of Provisions in the GATS and select FTAs Relating to Macro (Capital Transfer) and Micro (Market Access) Prudential Regulation, Prudential Flexibility, Fair and Equitable Treatment Provisions and Dispute Settlement*)

Given the areas of potential contradiction between emerging post-2008 financial crisis regulation and the trade and investment architecture, the likelihood of disputes is high. Indeed, a rising trend in ISDS in general and financial-sector-linked disputes has been noted, indicating the willingness of investors and financial services suppliers to initiate dispute settlement proceedings. As of the end of 2019, there were a total of 1,023 ISDS cases, of which 343 were pending and 674 concluded. Of the concluded ISDS arbitration proceedings, nearly 29% were decided in favour of the investor, 37% in favour of the state and 21% were settled (UNCTADs ISDS Navigator).

Financial institutions, which have traditionally resolved disputes by litigation in jurisdictions hosting recognised financial centres, are increasingly turning their attention to ISDS (ICC, 2016)⁵⁹. The distribution of new cases by economic sec-

⁵⁹ ICC Commission report, 'Investment Arbitration and Financial Institutions', 2016, Last accessed on 24/02/2020 at: <https://iccwbo.org/content/uploads/sites/3/2016/11/icc-financial-institutions-and-international-arbitration-icc-arbitration-adr-commission-report.pdf>.

tor as of the end of 2017 indicates that 15% of cases relate to the finance sector (ICSID, 2018).

The rising possibility of disputes in the financial sector is the result of a combination of several factors. The importance of the financial services sector to the national economy means that it is subject to substantial domestic regulation in virtually all countries. Financial transactions and markets are increasingly becoming more complex, often dealing with multi-party and multi-contract transactions, as well as cross-border transactions that implicate a number of legal relationships (Golden, 2012).

Recent technological (e.g. Fintech), political (e.g. Brexit) and economic developments such as the impact of the COVID-19 pandemic will make complexities more pronounced. While the global financial crisis of 2008 brought an unprecedented wave of financial market litigation⁶⁰, UNCTAD points out that the usage of BITS/FTA dispute settlement by foreign investors is very likely because governments have responded to the COVID-19 pandemic by protecting ‘critical’ domestic industries (UNCTAD 2020)⁶¹.

Finally, despite its global and de-centralised operations, the financial marketplace does not have access to a global dispute settlement mechanism⁶². State-to-state dispute settlement is generally settled through dispute settlement processes under FTAs, BITS or the WTOs dispute settlement body⁶³. The WTOs Appellate Body

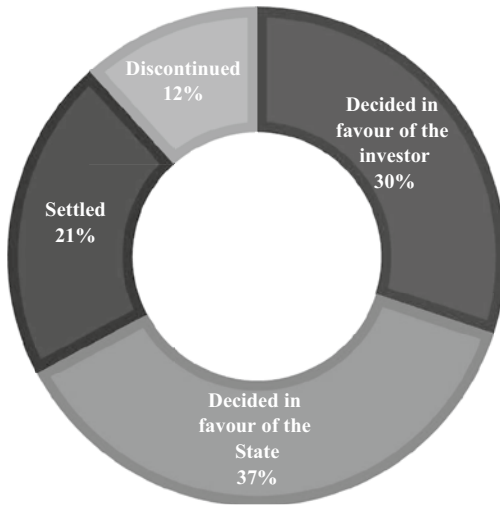
⁶⁰ Jeffrey Golden, ‘Judges and Systemic Risk in the Financial Markets’, 2012, *Fordham Journal of Corporate & Financial Law*, XVIII, Page 330, highlights ‘a “tsunami” of financial markets litigation from the financial crisis are pouring in.’ The 2012 Euro-zone crisis is also regarded in the financial services sector as likely to have an impact on litigation activity. In the survey ‘Corporate Choices in International Arbitration’ (2013), the plurality of financial services industry respondents (46%) indicated that they foresaw a rise in disputes as a result of the 2012 crisis (page 11).

⁶¹ UNCTAD Investment Policy Monitor, ‘Investment Policy Responses to the COVID-19 Pandemic’, 4th May 2020
https://unctad.org/en/PublicationsLibrary/diaepcbinf2020d3_en.pdf, Last accessed 12th July 2020.

⁶² Jeffrey Golden and Peter Werner, ‘The Modern Role of Arbitration in Banking and Finance, in *International Financial Disputes: Arbitration and Mediation*’, March 2015, Edited by Jeffrey Golden, Carolyn Lamm, <https://olrl.oupilaw.com/view/10.1093/law/9780199687862.001.0001/law-9780199687862-chapter-1#law-9780199687862-chapter-1-note-5>.

⁶³ The WTO’s dispute settlement mechanism is governed by the Understanding on Rules and Procedures Governing the Settlement of Disputes.

Figure 2: Decisions on concluded arbitration proceedings



Source: Author Recreation originally from UNCTAD ISDS Navigator

has not been able to function since December 11, 2019 due to the US administrations blockage of new judges. As an interim measure, 19 countries agreed to an alternate system of appeals to deal with disputes. The multi-party interim appeal arbitration arrangement was formally notified to the WTO as a temporary measure⁶⁴. In addition, the EU has floated a proposal for a multilateral ISDS court.

The rise in ISDS in the financial sector, therefore, seems a real possibility. The lack of conformity between macro and microprudential regulation and trade and investment commitments provide grounds for challenge under trade and investment agreements.

a. Grounds for Investors and Financial Service Suppliers

Claims for breach of the trade and investment treaty consider three issues:

- Whether a breach of existing rules, i.e. GATS, WTO, FET, has occurred?

The unprecedented level of regulatory intervention in the financial sector since the 2008 financial crisis provides banks and financial institutions with grounds

⁶⁴ Arij Limam, 'New Trade Appeals Body gets around US Block of WTO', 2 May, 2020, Accessible at: <https://newseu.cgtn.com/news/2020-05-02/New-trade-appeals-body-gets-around-U-S-block-on-WTO-Q96My9VYQM/index.html>.

for claims. This has resulted in ‘an unprecedented wave of claims by and against financial institutions, as well as among them’ (ICC 2016). The grounds for post-2008 financial crisis claims have ranged from debt recovery, foreclosure actions over collateral, claims by borrowers and their shareholders against financial institutions on negligence grounds and claims alleging breach of the lenders and financial advisors’ duty of care (ICC, 2016).

Possible contraventions of the trade and investment architecture also provide grounds for both ISDS and state-to-state dispute settlement claims. The FET standard contained in BITs also provides grounds for claims as it relates to investors’ legitimate expectations.

- Whether the investment or financial services qualifies as such under the relevant treaty/agreement under consideration?

The determination of whether an investor or financial services provider can seek the protection of an investment or trade agreement depends on the scope of treaty definitions relating to the object/target of investment or financial service provision, e.g. ‘investment’, ‘financial service’ and the person making the investment or providing the financial service, e.g. the ‘investor’ or ‘financial service supplier’. The nature of such definitions determine the boundaries of a state’s liability and the validity of the claim⁶⁵. It should also be noted that definitions between trade and investment treaties can vary substantially. The approach taken to the choice of definition depends on the intention of the parties concerned and is often reflective of the structure of their investment or financial regime as well as the trade volumes and interests of the countries involved.

Moreover, definitions may be set in BITs or FTAs, but at the point of dispute settlement their interpretation lies with the dispute settlement tribunal. In the case of ICSID jurisprudence, definitions relating to investment have not only been relatively broad and varied but also at times contradictory. In *Salini v. Morocco* (2000) an ICSID tribunal set out the so-called ‘Salini test’, highlighting inherent properties of a protected investment including a substantial commitment of resources or capital, a sufficient duration, the assumption of risk and a contribution to the development of the host state. This helps determine the types of financial products that can qualify as an investment attracting protection under a treaty.

⁶⁵ UNCTAD/ITE/IIA/2006/5 – E.06.II.D.16, 01/02/07 Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking, accessible at http://www.unctad.org/en/docs/iteiia20065_en.pdf at 7–11.

Several investment arbitral awards found that varying financial instruments qualify as investments. Financial instruments considered to be qualifying investments include straightforward loans, negotiable instruments, sovereign bonds and oil price hedges⁶⁶. Loans have been found to be protected under treaties under ‘claim to money’ or ‘obligations’⁶⁷. Other instruments include shareholdings, bank guarantees⁶⁸, promissory notes⁶⁹, Depository receipts⁷⁰, convertible debentures⁷¹ and dematerialised government bonds⁷². ISDS arbitral interpretations can also be contradictory at times. Sovereign bonds were considered a qualifying investment in three ICSID cases but not in a fourth case⁷³.

⁶⁶ *Oko Pankki Oyj v. Republic of Estonia* (ICSID Case ARB/04/6), Award (19 November 2007); *Fedax N.V. v. Bolivarian Republic of Venezuela* (ICSID Case ARB/96/3), Award (9 March 1998); *Abaclat v. Argentine Republic* (ICSID Case ARB/07/5), Decision on Jurisdiction and Admissibility (4 August 2011) [Abaclat]; *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka*.

⁶⁷ As in *British Caribbean Bank v. Belize*, concerning a default under a loan. In *Standard Chartered Bank v. Tanzania*, however, a loan held by a subsidiary did not qualify as an investment by the parent bank because the parent had had no involvement or knowledge of the decision to purchase the loan.

⁶⁸ *Joy Mining Machinery Ltd. v. Arab Republic of Egypt* (ICSID Case ARB/03/11), Award on Jurisdiction (6 August 2004).

⁶⁹ *Fedax v. Venezuela*, as the treaty’s definition of investments included ‘titles to money’.

⁷⁰ These were held to fall within ‘all types of assets’ for purposes of the definition of investment in the Russia-Spain investment treaty at issue in *Renta4 v. Russia*. The tribunal considered that depository receipts represent a property interest covered by the treaty, despite the fact that the recorded owner is a third-party intermediary and not the beneficiary.

⁷¹ Convertible debentures were held to qualify as investments under the NAFTA in *Fireman’s Fund v. Mexico*. Although loans were excluded from protection under the treaty, Mexican law, which governed the debentures, treated them as capital, which was subject to regulation in Mexico by the financial authorities.

⁷² Dematerialised government bonds were found to qualify as investments in *Abaclat v. Argentina* and *Ambiente Ufficio v. Argentina*. In *Abaclat*, which was a mass claim on behalf of 60,000 bondholders, the tribunal held that the inclusion of ‘obligations’ within the Argentina-Italy treaty’s definition of investment implicitly included sovereign debt and that this extended to the economic value incorporated in a credit title representing a loan, including bonds. The tribunal further noted that the sovereign debt could also constitute ‘securities’ – another example listed within the definition of investments in the treaty – and that bonds are covered investments in any event.

⁷³ *Abaclat; Ambiente Ufficio S.p.A. v. Argentine Republic* (ICSID Case ARB/08/9), Decision on Jurisdiction and Admissibility (8 February 2013); *Giovanni Alemanni v. Argentine Republic* (ICSID Case ARB/07/8), Decision on Jurisdiction and Admissi-

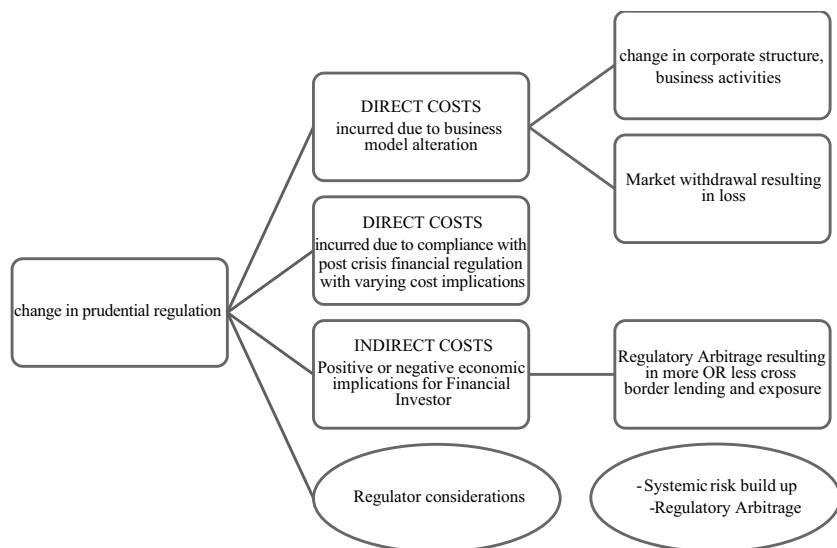
- Where the investment lies in terms of jurisdiction?

The key issue here is whether the investment was protected, and particularly whether the economic instrument or activity could be considered to have been an investment ‘in the territory’ of the host state for jurisdictional purposes.

2. Economic Costs accruing to Investors/Financial Services Suppliers and Government

The quantification of economic costs can be a tangible indicator of damage suffered by financial service providers and investors as a result of implementing post-2008 financial crisis regulation and depends on the restrictiveness of prudential regulation (*Figure 3: Economic Costs of Post-Crisis prudential Regulation*). Oliver Wyman in 2015 estimated that between 2.5% and 3.5% of North American, European and Australian financial institutions’ total costs came from meeting new regulatory guidelines⁷⁴.

Figure 3: Economic Costs of Post-Crisis prudential Regulation



Source: Author Construction

bility (17 November 2014); Poštová banka, a.s. and ISTROKAPITAL SE v. Hellenic Republic (ICSID Case ARB/13/8), Award (9 April 2015).

⁷⁴ Oliver Wyman, ‘18th State of Financial Services Industry Report’, 2015, Accessible at: <http://www.oliverwyman.com/our-expertise/insights/2015/jan/state-of-the-financial-services-2015-managing-complexity.html>.

The kind and extent of the economic costs accruing to an investor or financial services supplier depend on the restrictiveness of the prudential regulation. In the case of macroprudential regulation, capital controls may hamper both domestic and cross-border business operations. In the case of microprudential regulation, costs arise from separation of businesses, the establishment of different entities, compliance with varying regulations, and ensuring internal operational coherence, as is the case for the UK's ringfencing requirements, which result in direct economic costs (Alvarez, Garcia, and Gouvela, 2016).

Non-compliance is not an option as failure to comply with post-crisis financial regulation can result in substantial penalties. For instance, all European banks operating in the US must prove they have adequate systems and controls in place to ensure that market making meets the Volcker definitions guidelines. Deutsche Bank became the first institution to fall foul of this requirement, resulting in a \$157m penalty from the Federal Reserve⁷⁵.

Economic costs can also be indirect. There is the opportunity cost of pulling out of markets and inability to enter potentially newer markets, because of a lack of capital to do so. Ringfenced banks, for instance, are required to have higher levels of capital, while cross-border lending would fall outside the ring fence – and both of these make funding more difficult⁷⁶. Differing regulatory approaches also involve economic costs for cross-border financial service suppliers. A recent study by the OECD-IFAC found that regulatory divergence costs financial institutions between 5% and 10% of annual revenue turnover⁷⁷.

⁷⁵ Laura Noonan, 'UK-based banks still active in proprietary trading', Financial Times, October 8, 2017, Available at: <https://www.ft.com/content/c1704966-9f81-11e7-8cd4-932067fbf946?desktop=true&conceptId=71a5efa5-e6e0-3ce1-9190-a7eac8bef325&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft:notification:daily-email:content:headline:html>.

⁷⁶ McKinsey Global Institute, 'The New Dynamics of Financial Globalization', August 2017, p. 2.

⁷⁷ Report 'Regulatory Divergence: Costs, Risk, Impact: An International Financial Sector Study', International Federation of Accountants and Business at OECD (BIAC), February, 2018. The survey was conducted on 250 regulatory and compliance professionals from major global financial institutions. Smaller institutions were defined as institutions having an annual turnover of less than \$100m. Report accessible at: http://biac.org/wp-content/uploads/2018/04/IFAC-OECD_Regulatory-Divergence_V9_singles.pdf The factors behind this cost included increased number of staff to deal with cross-jurisdictional regulatory matters, training costs for personnel, systems costs required for multiple systems, restructuring of compliance departments and costs of external consultants.

In all the above situations, the direct and indirect economic costs incurred by the investor/financial services supplier enable the quantification of damage suffered as a result of contravened trade and investment commitments.

However, on the other hand, it should be pointed out that the economic costs accruing to investors/financial services suppliers should be weighed against the costs accruing to taxpayers from financial crises in terms of direct financial sector losses and larger economy-wide losses. A compilation of banking crises around the world (147 countries) from 1970–2011 found that the average fiscal costs of resolving a banking crisis is approximately 7% of GDP. Given the infrastructural role of the financial sector and the economy-wide impact in case of failure, the stability of the sector can be considered a ‘public good’⁷⁸, much like the case of environment externalities⁷⁹.

F. Conclusion and Suggestions going forward

Post-financial-crisis macro and microprudential regulation relating to capital controls, legal form, ringfencing and proprietary trading has changed, with some arguing that it has even reversed traditional thinking on the thrust of regulation in these areas. The regulatory rationale is the prevention of systemic risk build-up through establishing greater control and oversight over banks’ operations, thereby also changing the focus from home to host country regulation.

From an investor/trade perspective, the overarching regulatory landscape in the financial sector has changed drastically, changing the level playing field in the form of the trade and investment architecture, which investors/financial service suppliers have based their business models on and creating inconsistencies/contradictions between the nationally driven financial architecture and the global trade and investment architecture as well as between and within trade/investment treaties and treaty interpretations.

Issues of inconsistency between regulation and treaties and between and within treaties are not new; indeed, such issues have been raised before in academia and

⁷⁸ Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, September 21, 2009 – Stiglitz Report

⁷⁹ Environmental externalities refer to the economic concept of uncompensated environmental effects of production and consumption that affect consumer utility and enterprise cost outside the market mechanism. As a consequence of negative externalities, private costs of production tend to be lower than its ‘social’ cost. It is the aim of the ‘polluter/user-pays’ principle to prompt households and enterprises to internalise externalities in their plans and budgets. Source: OECD Glossary.

within the UN⁸⁰. It can be a natural outcome of the evolution of international law and not necessarily a point of concern. However, it is also important to uphold agreed trade/investment rules and standards to ensure the system coheres and that there is predictability for both financial regulations and financial service suppliers and investors⁸¹.

Ensuing economic costs arising from regulatory compliance, changes in banks' business models, opportunity costs, and cross-jurisdictional regulatory differences, amongst others, have resulted in substantial economic costs for investors, potentially contravening provisions of the trade and investment architecture and the investor protection offered under FET-like clauses.

At the interface where the trade and investment architecture and emerging financial architecture meet is the question of regulatory flexibility versus investor/trade, i.e. financial service supplier/investor protection. This is further complicated by the dispute settlement provisions that exist in all FTAs and BITs, providing either for state-to-state or investor-state dispute settlement. In the case of a regulatory challenge, the weighing of investor/trade rights versus regulatory flexibility will be a moot issue and it appears from current WTO and ICSID cases that regulatory flexibility will be upheld. However, this is not a certainty as WTO cases also emphasise that there is a need to show that no significant attempt to escape trade commitments has been made as well as the fact that each case will be decided based on a case-by-case evaluation. It is likely that the outcome of a dispute settlement decision could be different if it is undertaken in an investor-state format as well as depending on political discussions and the state of the economy at the point in time at which the dispute settlement decision occurs.

Therefore, the interlinkages and inconsistencies in sum appear to be complex, as can be observed in Table 7. While some degree of consistency will occur in these developing legal regimes, there is a need for an understanding of issues, clarity of concepts, some degree of coherence on established rules and potentially global coordination in aspects of macro and microprudential regulation and how they interface with the trade and investment architecture. Emerging market trends and institutional developments make global understanding and approaches an important area for future consideration.

⁸⁰ See deliberations of UNCITRAL Working Group 3 on Investor-State Dispute Settlement Reform, last accessed 15th September 2021 at https://uncitral.un.org/en/working_groups/3/investor-state

⁸¹ Julian Arato, Chester Brown, and Federico Ortino, (2020), 'Parsing and Managing Inconsistency in Investor-State Dispute Settlement', 22nd June, 2020, *The Journal of World Investment and Trade*, 21(2–3), Pages 336–373.

Table 7: Direct/Indirect impact on Financial Investors and Financial Regulators of select Post-Crisis Macro and Microprudential Regulation relating to Capital Controls, Legal Form, Ringfencing and Proprietary Trading

Measure	Direct or indirect effect on whom	Conformity with trade and investment architecture	FET implications	Potential tension between regulatory prerogative and investor rights
Capital Controls	Investors, financial services suppliers, potentially wider business environment	Provisions on capital transfers, BoP and prudential carve-out	- Legitimate expectations - Economic costs	Potential challenge under WTO/BITS provisions balanced against prudential carve-out exception
Legal Forms	- Direct effect on investor from business restructuring, regulatory compliance, unclear regulatory landscape - Regulator as implementor and supervisor	Market access, national treatment provisions, Mode 3, new financial product, understanding on FS commitments, annex on FS and prudential carve-out	- Legitimate expectations - Economic costs - International standards: BASEL III: home and host country regulatory responsibilities	- Potential challenge under WTO/BITS provisions balanced against prudential carve-out exception and dispute settlement - Will depend on political will, implementation costs (as regulation comes into place), and regulators upholding systemic risk implications
Ring-fencing	Same as above	Same as above	- Legitimate expectations - Economic costs	Same as above

(Continued)

Table 7: (Continued)

Measure	Direct or indirect effect on whom	Conformity with trade and investment architecture	FET implications	Potential tension between regulatory prerogative and investor rights
Proprietary trading	Same as above	Same as above	Same as above	Same as above

Source: Author Construction

These interlinkages and inconsistencies raise several broad and specific issues for consideration.

1. Importance of Regulatory Flexibility for Minimising Systemic Risk versus Regulatory Burden on Investors and Financial Service Suppliers

The question of regulatory flexibility versus investor/trade protection is tested by post-2008 macro and microprudential regulation. The volatile nature of systemic risk makes regulatory flexibility in the design, implementation and enforcement of micro and macroprudential regulation crucial for consumer protection, financial integrity and prevention of systemic risk build-up. Microprudential regulation protects small depositors by limiting the frequency and cost of individual bank failures. Macroprudential regulation addresses broader systemic threats. The ‘exceptions’ provisions contained in trade and investment agreements provide for regulatory flexibility however ambiguity on their usage and a lack of conceptual clarity remains.

Furthermore, given the importance of the financial sector to the economy as an intermediary and infrastructural service⁸² coupled with the dangers of systemic risk build-up, regulatory flexibility can be considered a ‘public good’ that is necessary to support economic stability.⁸³

⁸² The financial sector plays an infrastructural role in the economy, facilitating domestic and international transactions, broadening the availability of credit for SMEs and households, channeling domestic savings, and facilitating firm entry and competition, amongst others.

⁸³ Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, September

2. International Law and Legal Regimes

The interface between the emerging post-2008 financial regulation and the international trade and investment architecture raises several questions in international law. The first is whether the finance and trade/investment legal regimes should continue to evolve independently in silos, or coherently through a common approach in policy, regulation and dispute settlement? Some scholars point out that the silo approach or fragmentation of international law is a natural phenomenon arising from increased international legal activity, which can be controlled using technical streamlining and coordination⁸⁴. In the context of ISDS, for instance, the divergent interpretations of treaty language are therefore inevitable⁸⁵ and not in themselves a concern.⁸⁶

By contrast, views critical of the silo approach argue that it leads to fragmentation/erosion of international law, conflicting jurisprudence, forum-shopping and a loss of legal security⁸⁷. Coherence, on the other hand, leads to legal certainty, efficiency in litigation and predictability of the investment framework for both the state and the investor⁸⁸. Moreover, the two regimes – finance and trade/investment – are operationally interlinked, necessitating a coherent approach, especially in light of new developments in fintech, dispute settlement and other areas. As a result,

21, 2009 – Stiglitz Report.

⁸⁴ International Law Commission Report of the Study Group, ‘Fragmentation of International Law: Difficulties arising from the Diversification and Expansion of International Law; Report of the fifty-eighth session Geneva’, 1 May–9 June and 3 July–11 August 2006, Paragraph 7, UN General Assembly, A/CN.4/L.702.

⁸⁵ Examples include application of the most-favoured nation (MFN) clause, contradictory interpretations of the notions of investment and expropriation were also mentioned. 32. See Paragraphs 31, 32 of UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, A/CN.9/935.

⁸⁶ UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, Paragraph 21, A/CN.9/935.

⁸⁷ The issue of fragmentation of international law is not a new one and has in fact been dealt with at length by the International Law Commission in 2006.

⁸⁸ UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, Paragraph 24, A/CN.9/935.

reconceptualisation of international economic law to bring it in line with developments on financial regulation has been suggested.⁸⁹

A second issue relates to the application of the doctrine of *lex specialis* to address the contravention between international trade/investment law and financial regulation⁹⁰. The doctrine of *lex specialis* can be used to (a) clarify/interpret general law, which enables financial sector regulation to interpret the prudential carve-out clause contained in international trade and investment law/agreements, and it can (b) be applied to conflicts, between provisions of the same treaty, two or more treaties, between a treaty and a non-treaty standard, as well as between two non-treaty standards⁹¹. It could in theory therefore be applied to resolve contraventions/contradictions between financial regulation and trade/investment architecture, such as those that arise between trade/investment agreements and within the same agreement, as well as where there are conflicts between soft law, e.g. financial standards and trade/investment agreements.

The alternative to the application of *lex specialis* is systemically integrating fragmented regimes of international law in a coherent order, without any hierarchy, under the Vienna Convention on the Law of Treaties⁹². Some academics have argued for a coherent approach that looks beyond investment treaty provisions

⁸⁹ A suggestion along these lines was made by the Swiss Government to the WTOs Committee on Trade in Financial Services in 2001. Communication by Switzerland to the CTFS, 2001, S/CSS/W/71. See also Kern Alexander, Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges, Page 14, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

⁹⁰ *Lex specialis derogat legi generali* translates into ‘special law derogates from general law’. Kindly note that the objective of this discussion is to highlight the interlinkage between the application of *lex specialis* to the interface of finance and trade/investment law. It will not be delving into the intricacies of the *lex specialis* and its application, as this would involve another body of work and would warrant another thesis in itself. The application of *lex specialis* in the context of ‘Fragmentation of international law’ was extensively discussed by the International Law Commission in 2006.

⁹¹ International Law Commission, ‘Conclusions of the work of the Study Group on the Fragmentation of International Law: Difficulties arising from the Diversification and Expansion of International Law’, 2006, Adopted by the International Law Commission at its fifty-eighth session, in 2006, and submitted to the General Assembly as a part of the Commission’s report covering International Law Commission, 2006, vol. II, Part Two.

⁹² Article 31 (3)(c) and Article 32 of the Vienna Convention on the Law of Treaties.

to monetary, fiscal, and banking regulation, thereby giving weight to the broader macroeconomic goals of financial stability⁹³.

A third issue is the identification and application of customary international law or ‘soft law’ in dispute settlement cases⁹⁴. Most BITS and some FTAs contain the equivalent to the FET standard, which makes some reference to CIL.

This in turn raises two questions: Can/will soft law be applied to dispute settlement cases? International financial bodies produce soft law instruments that are legally non-binding ‘but have legal consequences through their interpretation or exposition of what binding obligations mean or how they will be interpreted and implemented.’⁹⁵ ‘Soft law’ has indeed been used in the past by tribunals seeking guidance on the meaning and purpose of trade and investment agreements as in, for instance, the WTO’s Brazil aircraft case, where the OECD Guidelines for Officially Supported Export Credits were relied upon⁹⁶, and the Argentina-Panama case, where the G-20, OECD, and FATF guidelines/documents relating to tax information, harmful tax practices and money laundering were relied upon.⁹⁷ It is

⁹³ Matthias Goldmann, ‘International Investment Law and Financial Regulation: Towards a Deliberative Approach’, 2017, Pages 65, 69 and 84 in *International Investment Law and the Global Financial Architecture* (Editors: Tams C, Schill C and Hofmann R) Elgar Cheltenham.

⁹⁴ The term ‘soft law’ is used to denote agreements, principles and declarations that are not legally binding. It could include UNGA resolutions and declarations, codes of practices, guidelines, principles, financial action task force recommendations, G-20 and FSB recommendations, amongst others. Abbott and Snidal state that ‘[t]he realm of “soft law” begins once legal arrangements are weakened along one or more of the dimensions of obligation, precision, and delegation.’ See Kenneth Abbott and Duncan Snidal, ‘Hard and Soft Law in International Governance’, 2000. *International Organization*, 54(3), Pages 421–456. Customary international law shares several attributes in common with ‘soft law’.

⁹⁵ Timothy Meyer, ‘From Contract to Legislation: The Logic of Modern International Law Making’, 2014, 14(2) *Chicago Journal of International Law* 559 at 573.

⁹⁶ Brazil – Export Financing Programme for Aircraft, 28 August 2001, WTO Panel Report WT/DS46/29.

⁹⁷ Argentina – Measures Relating to Trade in Goods and Services, Panel Report, WT/DS453/R, 30th September 2015, paragraph 7.511 quotes Global Forum on Transparency and Exchange Information, *Tax Cooperation 2009: Towards a Level Playing Field* (OECD, 2009), paragraphs 7.512 and 7.515 (both quote OECD Report, *Addressing Base Erosion and Profit Shifting* (2013)). Reference is also made to the recognition of defensive measures by the OECD and G20 as a legitimate tool to protect tax systems and prevent harmful tax practices. (Paragraphs 7.713, 7.715–7.716). See also paragraphs 7.509–7.513 more generally.

therefore possible that provisions of the BASEL committee, IOSCO, FSB, IMF, OECD as a form of soft law and a potential source of CIL will be relied on in dispute settlement cases related to the financial sector.

A further question is Can the financial sector ‘soft law’ component generated by international financial bodies be considered a source of customary international law? Standards/guidelines/findings generated by international financial bodies can be considered ‘soft law’, even if some international financial bodies such as the BCBS clearly indicate that its decisions carry no legal force⁹⁸, as central banks tend to implement these standards into national regulation.

As per the UN, sources of customary international law include treaties, decisions of national/international courts, national legislation, opinions of legal advisors, diplomatic correspondence, and practice of international organisations. In the context of financial regulation, this in effect could mean national financial regulation, IMF Articles of Association, G20 Declarations, OECD guidelines, BCBS standards, policy papers issued by international organisations, and jurisprudence of national and international courts.

The International Court of Justice reference to sources of international law tends to be stricter⁹⁹, requiring the custom to be (a) evidence of general practice and (b) accepted as law or ‘opinion juris’. In terms of general state practice, the application of financial standards tends to be high across the financial sector. ‘Opinio Juris’ is a more difficult concept to ascertain¹⁰⁰ and arguments have been made for an updating of the ICJ listing of sources of CIL to include ‘soft law’¹⁰¹. Thus, the cross-influence between soft law relating to the financial sector and domestic financial regulation raises questions as to their potential status as sources of CIL.

Finally, the evolving nature of financial regulation and policy stances impact the stability of their usage as identified sources of CIL and soft law. In the case of

⁹⁸ See Basel Committee Charter, specifically Article 3 on ‘Legal Status’. The BCBS, for instance, sets out that it is the primary global standard setter for the prudential regulation of banks and does not possess any formal supranational authority as its decisions having no legal force.

⁹⁹ Statute of the International Court of Justice, Article 38(1)(a-d).

¹⁰⁰ *Opinio juris* is the subjective element used to judge whether the practice of a state is due to a belief that it is legally obliged to perform a particular act. See Bederman, David, *International Law Frameworks*, 2001, New York Foundation Press. Pages. 15–16.

¹⁰¹ See Zen Chang, ‘A Revision of Article 38(1) of the Statute of the International Court of Justice?’, University of Sydney, April 2017, Available at SSRN: <https://ssrn.com/abstract=2972437> or <http://dx.doi.org/10.2139/ssrn.2972437>

macro and microprudential regulation, the policy stance of international organisations and national governments has changed substantially since 2008 and has even been reversed in several areas. These shifts in regulatory approaches can create uncertainty around international bodies and national regulators as a source of CIL and soft law.

3. Increasing Dispute Settlement in the Financial Sector

Since 2008, there has been an increase in financial-sector-related disputes, arising from the highly regulated nature of the financial sector, increasingly complex multi-jurisdictional, multi-contract nature of financial transactions, market developments such as fintech, cryptocurrencies, political developments such as Brexit, and dispute settlement developments such as reform of the BITS and ISDS regime and within the WTOs DSB. These developments in turn raise several legal issues specific to financial services dispute settlement in terms of scope and coverage, preservation of regulatory flexibility, interlinkages between dispute settlement mechanisms and jurisprudence in various fora, award of damages, privacy and data considerations, the choice of arbitrators and arbitral approaches, amongst others.

The unprecedented level of post-2008 crisis regulation offers financial institutions the possibility of claims under investment and trade treaties, many of which were not contemplated by trade negotiators at the time of entering into said agreements. In addition, financial service suppliers/investors prefer international dispute settlement because of their reliance on trade and investment frameworks while commencing their operations.

At the same time, from a policy perspective, dispute settlement outcomes on a state can be disproportionate, impacting not just regulatory objectives and regimes but also leading to large financial payouts amounting to a portion of their GDP, as in the case of Ecuador¹⁰² and Pakistan¹⁰³. The stakes in ISDS and trade disputes therefore have economic and political ramifications that go beyond narrow treaty interpretation and requires to extent possible to uphold the state's legitimate ability to regulate in the financial sector, especially in light of post-2008 crisis developments.

¹⁰² In 2004, a U.S. investor won an arbitration against Ecuador, exceeding the Ecuadorian government's annual budget on health, which was around 7%.

¹⁰³ Tethyan Copper Company Private Limited v. Government of Pakistan, ICSID Case. No. ARB/12/1, Award, 12 July 2019. In 2019, Pakistan was ordered to pay USD 6 billion in compensation to a single foreign investor, equivalent to the total amount received in its IMF bailout package for the same year.

4. Differences in Provisions within and between Trade and Investments Agreements create a complicated Web of interlinked Commitments and wide and varied Definitions and Ambiguity in Conceptual Understandings

Structural anomalies and differences relating to definitions, provisions, scope and coverage within and between trade and investment agreements and between the trade and investment architecture and the financial architecture create a complex web of interlinked commitments, resulting in a degree of ambiguity for investors and financial services suppliers, specifically when applied to financial sector regulation.

The application, scope and interpretation of trade and investment architecture to micro and macroprudential regulation is determined by definitions contained in GATS Annex on Financial Services, FTAs and BITS as well as ISDS and WTO jurisprudence, which in turn tend to be varied, lacking in clarity, and at times contradictory, especially in the case of ‘like’ definitions. For instance, concepts in trade agreements such as ‘prudential’, or in the case of BoP safeguards ‘necessary’, ‘temporary’, ‘avoid unnecessary damage’ lack clarity. ISDS jurisprudence has enabled a wide-ranging interpretation of what constitutes investment, investor etc. under the categories of the ‘Salini test’¹⁰⁴.

The contents of a definition are significant in determining the validity of a claim, i.e. assets and persons covered, the boundaries of a state’s liability within a jurisdiction and the protection afforded to investors/financial service suppliers.

G. Responding to Key Questions of the PHD Thesis

In answer to the questions this thesis poses, the following is offered:

a) To what extent do certain aspects of post-crisis financial regulation conform to existing trade/investment commitments?

Answer: There are several points of inconsistency/non-conformity between the post-2008 crisis financial regulation and the existing trade/investment architecture. Given the growing tendency towards dispute settlement, financial sector trends such as fintech, BREXIT, dispute settlement changes in ISDS/

¹⁰⁴ Investment arbitral awards have found that varying financial instruments qualify as investments ranging from straightforward loans, negotiable instruments, sovereign bonds, oil price hedges, shareholdings, bank guarantees, promissory notes, and depository receipts, amongst others.

WTO, and a growth in financial-sector-related disputes, these inconsistencies are likely to be exacerbated. Serious inconsistencies between regulation and the trade and investment architecture could threaten the core of a mutually agreed rules based system and confuse investors/financial service suppliers and regulators.

b) Does conformity/lack thereof lead to possible trade/investment including FET violations? → Investor perspective.

Answer: Yes, contraventions of the trade and investment architecture exist thanks to new regulation, reregulation and trade barrier like effects. Theoretically, an argument for FET violations is based on investors' legitimate expectations and the need to maintain a stable business and legal environment. Furthermore, the costs incurred by banks in the post-2008 financial crisis environment can form the basis for compensatory damages. However, given the evolving elements of the FET standard in ISDS case law and the importance of non-discriminatory and proportional regulatory flexibility for maintaining financial sector stability, the application of the FET standard to financial sector disputes is likely to be limited.

c) How do 'inconsistencies' impact the flexibility of financial regulators? → Regulator perspective.

Answer: The flexibility of regulators is by and large protected within the existing WTO/FTA like prudential carve-out and BoP safeguards and upheld by tribunals. This is not a blanket provision, as regulatory measures are required not to avoid trade commitments undertaken. Furthermore, there is a lack of conceptual understanding of terms related to prudential concepts both in agreements and in jurisprudence and ISDS tribunals while generally upholding the state's regulatory flexibility have also held in favour of investors. The question of weighing the legitimacy of regulatory action versus investor/trade protection therefore remains unclear in law and in jurisprudence. Moreover, investors/financial service supplier costs must be balanced against the larger cost accruing to taxpayers in the event of a financial or banking crisis and the 'public good' nature of the financial sector nationally and globally.

d) A linked question is how important are inconsistencies/contradictions between financial regulation and the trade/investment architecture and within and between trade and investment agreements as they relate to the financial sector?

Inconsistency between the international trade and investment architecture and post-2008 crisis financial regulation has the following effects: (i) it creates uncertainty, costs and barriers for investors and financial service suppliers in

terms of their investment, and may impact third-party rights; (ii) it creates uncertainty for states in terms of the implementation of new regulation, e.g. fintech, sustainable finance, etc.; (iii) it creates the possibility of financial disputes and rising ISDS, as well as creating a ‘regulatory chill’ factor that potentially prevents regulatory flexibility and stops financial regulators from taking the necessary steps to ensure preservation of the financial system; and (iv) it can become an actionable claim.

While issues of inconsistency are not new – indeed, they have already been raised in academia and within the UN¹⁰⁵ – it is important to uphold the agreed trade/investment rules and standards in order to ensure the system coheres and there is predictability for both financial regulators and financial service suppliers and investors¹⁰⁶.

The overlapping issues and contradictions, though not new, have been exacerbated by new developments in an evolving financial system and a (currently) static trade and investment architecture, and therefore warrant systemic discussions. Based on the analysis of this PhD thesis, suggestions for **global approaches, especially in terms of global modalities or a common platform**, are set out below. (*See also Table 35: Potential Areas for Global Discussion at the Interface of Emerging Financial Regulation and the Trade and Investment Architecture*)

Global coordination and collaboration, including through global platforms in the following areas, may be useful to address some of the broad and specific issues identified:

- i. Financial regulation as it impacts the trade and investment architecture.
 - a) Evaluate the financial market, regulatory developments e.g., proprietary trading, legal form, fintech, etc. to ascertain their trade/investment implications.
 - b) Take stock of inefficiencies and changes in the dispute settlement regimes. The two parallel streams of dispute settlement state-to-state and ISDS raise questions in terms of hierarchy of law, jurisprudence, and interpretation, amongst other factors. Several BITS/FTAs do not reflect current market

¹⁰⁵ See deliberations of UNCITRAL Working Group 3 on Investor-State Dispute Settlement Reform, last accessed 15th September 2021 at https://uncitral.un.org/en/working_groups/3/investor-state.

¹⁰⁶ See Julian Arato, Chester Brown, and Federico Ortino, (2020), ‘Parsing and Managing Inconsistency in Investor-State Dispute Settlement’, 22nd June, 2020, *The Journal of World Investment and Trade*, 21(2–3), Pages 336–373.

realities, having been concluded solely for the purposes of trade/investment in goods and natural resources. Furthermore, several dispute settlement regimes/positions are undergoing changes (WTO, ISDS, EU, US, South Africa, NAFTA, India, Brazil). An exchange of views and potential agreement on modalities moving forward is important. Current suggestions include the creation of a multilateral mechanism for ‘plurilateral interpretative statements’ whereby governments clarify and define positions on contentious clauses in their existing investment treaties¹⁰⁷, they impose a moratorium on fresh ISDS cases and enforce pending judgments,¹⁰⁸ and establish joint interpretative committees alongside arbitral tribunals, publishing treaty-based ISDS pleadings and awards¹⁰⁹.

- c) Clarity on legal principles and concepts, such as the silo or coherence approach, the application of *lex specialis*, CIL and soft law implications, original intention of state parties vis-à-vis current economic, political, market and legal developments, conceptual clarifications, cross-treaty and intra-treaty references, regulatory flexibility versus investor/trade protections in the financial sector, evaluation of economic costs accruing to investors/financial service suppliers as opposed to taxpayers, quantification of relief measures and damages, amongst others.
- d) Procedural issues such as the need for specialist tribunals and arbitrators, appreciation of larger public policy objectives, and transparency in proceedings.

¹⁰⁷ Lauge Skovgaard Poulsen and Geoffrey Gertz, ‘Reforming the Investment Treaty Regime: A backward-looking approach’, March, 2021, Chatham House Briefing Paper. See also UNCITRAL Secretariat Note, ‘Possible reform of investor-state dispute settlement (ISDS) interpretation of investment treaties by treaty parties’, Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-ninth session (New York, 30 March–3 April 2020), 17th January 2020, Paragraphs 8–12, A/CN.9/WG.III/WP.191.

¹⁰⁸ James Bacchus and Jeffrey Sachs, ‘Why we need a moratorium on investment disputes during COVID-19’, The Hill, Last visited 23rd April, 2021 at <https://thehill.com/opinion/international/501872-why-we-need-a-moratorium-on-trade-disputes-during-covid-19>.

¹⁰⁹ UNCITRAL Secretariat Note, ‘Possible reform of investor-State dispute settlement (ISDS) Interpretation of investment treaties by treaty Parties’, Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-ninth session (New York, 30 March–3 April 2020), 17th January, 2020, Paragraphs 8–12, A/CN.9/WG.III/WP.191

- ii. The financial marketplace does not have access to a global or centralised dispute settlement mechanism. Arguments have been made for an independent financial-sector-linked dispute settlement mechanism¹¹⁰. This area may require further consideration in the future.

¹¹⁰ Rosa Lastra, 'Do We Need a World Financial Organization?', December 2014, *Journal of International Economic Law*, Volume 17, Issue 4, Pages 787–805.

II. The International Trade and Investment Architecture as it relates to the Financial Sector

A. Introduction

Chapter 2 outlines the structure of the international trade and investment architecture as is relevant to the financial sector. Part B, covers definition and conceptual considerations. Part C, which deals primarily with the international trade architecture, outlines the key elements of the GATS and select FTAs relevant to the financial sector. The provisions of the WTO's GATS and related agreements cover areas such as the Annex on Financial Services, the Understanding on Financial Services, market access, national treatment, specific sectoral commitments for financial services, capital transfers, regulatory flexibility and dispute settlement. FTAs contain specific provisions/chapters relating to investment, trade in services, cross-border services or financial services.

Part D of Chapter 2 then focuses on the international investment architecture as contained in BITS. It aims to provide a broad understanding of the applicability of the fair and equitable treatment standard to post-crisis financial regulation. It does this by providing a conceptual understanding of FET and key elements relevant to the financial sector, and outlining existing FET provisions in BITS/FTAs as well as the development of the FET concept under case law.

The international trade and investment architecture is well developed and binding at the global level through the WTO and nearly 3,400 bilateral and regional trade and investment agreements¹¹¹. FTAs and BITS tend to be structured in a similar manner as the GATS, with provisions for investor/financial service supplier protection as well as regulatory flexibility. Most FTAs, specifically the more recent ones, tend to reflect the GATS provisions to varying degrees.

Almost all agreements within the international trade and investment architecture contain relevant definitions – e.g. investment, financial services, trade in services, etc. – and provisions for dispute settlement either on a state-to-state or investor-state basis. State-to-state dispute settlement provisions are covered by the GATS, while investor-state dispute settlement provisions are generally covered under FTAs and BITS¹¹².

¹¹¹ UNCTAD, Recent Developments in the International Investment Regime, 2018, International Investment Agreement Issues Note. No. 1.

¹¹² Table 4: Overview Of Provisions In The GATS And Select FTAs Relating To Macro (Capital Transfer) And Micro (Market Access) Prudential Regulation, Prudential Flex-

The emphasis on investment, services, and movement of capital in trade agreements corresponds to the five economic integration rights: free movement of goods, services, capital, people, and ideas. The EU best exemplifies the operation of these five economic integration rights. A closer look at FTAs and RTAs also indicates a varied reflection of these economic integration rights, particularly in relation to capital, services, goods and, to a lesser extent, people. An analysis based on the World Bank Deep Trade Agreements Database¹¹³, found that over 50% of preferential trade agreements contain trade-in-services provisions and movement-of-capital-linked provisions. Moreover, nearly 30% contain provisions linked to investment. BITs are almost entirely focused on investment and movement of capital.

The binding trade and investment architecture can be considered to be general commitments made to investors and financial services suppliers, since they are directly linked to ‘covered investments’ and ‘financial services commitments’ undertaken in the WTO, FTAs or BITS. Investors and financial services suppliers make decisions on investment and services supply based on this trade and investment architecture. However, the same agreements also contain provisions to protect regulatory flexibility, including through exceptions and safeguards.

A more in-depth overview of preferential trade agreements illustrates a wide coverage of services, investment and capital transfers. Movement of capital provisions are widely covered, emphasizing the importance of PTA linked movement of capital and focusing almost entirely on exceptions and BoP safeguard measures. In the case of investment provisions in FTAs, the focus tends to be on the scope and definition and substantive commitments but also on liberalisation/integration measures. It is important to recall that the investment part of FTAs tends to include investment in trade in services and trade in goods. Similarly, services provisions in FTAs tend to focus on scope and definition, substantive commitments, as well as conditions/obligations, procedural requirements and, to a lesser extent, exceptions.¹¹⁴

ibility, Fair And Equitable Treatment Provisions And Dispute Settlement of Chapter 1 provides an overview of disputes settlement provisions in select FTAs. Dispute Settlement processes are further discussed in detail under Chapter 5 of this PhD thesis.

¹¹³ Claudia Hofmann, Alberto Osnago, and Michele Ruta, ‘Horizontal depth: A new database on the content of preferential trade agreements’, 2017, Policy Research Working Paper 7981, World Bank, Washington, DC. The analysis covers preferential trade agreements notified to the WTO by the end of 2017. It therefore does not cover all FTAs and does not cover BITS.

¹¹⁴ See Claudia Hofmann, Alberto Osnago, and Michele Ruta, ‘Horizontal depth: A new database on the content of preferential trade agreements’, 2017, Policy Research

B. The Trade and Investment Architecture as relevant to the Financial Sector

1. Definitions and Coverage within the International Trade and Investment Architecture and Investor State Dispute Settlement

Definitions within the trade and investment architecture are crucial in determining the applicability of WTO and FTA/BITS provisions to macro and microprudential regulation, as well as identifying obligations of member states and points of conflict between financial regulation and the trade and investment architecture. Determining whether an investor or financial services provider can seek the protection of an investment or trade agreement depends on the scope of treaty definitions, relating to (a) the object/target of investment or financial service provision and (b) the person making or regulating the investment or the financial service.

a. Definitions linked to the Object/Target of Investment or Financial Service Provision

The GATS covers measures and regulation taken by WTO members. The definition of ‘measures’ is set out in GATS Article XXVIII (a): “‘measure’ means any measure by a Member, whether in the form of a law, regulation, rule, procedure, decision, administrative action, or any other form’.

The GATS Annex on FS further specifies that its provisions would apply to ‘measures affecting the supply of financial services’¹¹⁵, as defined under the GATS. The term ‘affecting’ has been interpreted broadly in WTO jurisprudence to encompass any measure of a Member that affects the supply of a service directly or even if it regulates other matters but nevertheless affects trade in services¹¹⁶.

Working Paper 7981, World Bank, Washington, DC. The analysis covers preferential trade agreements notified to the WTO by the end of 2017. It therefore does not cover all FTAs and does not cover BITS.

¹¹⁵ GATS Annex on Financial Services, Paragraph 1 (a) sets out the following: ‘This Annex applies to measures affecting the supply of financial services. Reference to the supply of a financial service in this Annex shall mean the supply of a service as defined in paragraph 2 of Article I of the Agreement.

¹¹⁶ WTO Panel Report, ‘European Communities – Regime for the Importation, Sale and Distribution of Bananas’, 22 May 1997, Paragraph 7.285, WT/DS27/R/ECU and WTO Appellate Body Report, ‘European Communities – Regime for the Importation, Sale and Distribution of Bananas’, 9 September 1997, Paragraph 220, WT/DS27/AB/R.

The GATS further specifies the kind of measures implemented by government bodies that would be covered, including measures undertaken by financial service regulators and government entities issuing investment-related regulation. GATS Article I (3) (a) ‘measures by members means measures taken by: (i) central, regional or local governments and authorities; and (ii) non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities’.

GATS Article 1 (3) (b), meanwhile, defines services as follows: ‘services includes any service in any sector except services supplied in the exercise of governmental authority’. The GATS covers financial services as one of the sectors in the GATS W120 classifications as well as through the Annex on Financial Services and the Understanding on Financial Services Commitments. Financial services are defined under the GATS Annex on Financial Services, Paragraph 5 (b) as follows: ‘A financial service is any service of a financial nature offered by a financial service supplier of a Member. Financial services include all insurance and insurance-related services, and all banking and other financial services (excluding insurance)’. The paragraph then goes on to provide a detailed list of over 16 sub-sectors of financial services¹¹⁷. Thus, the GATS contains a very broad definition of financial services which encompasses a range of banking, securities and capital-market-linked financial services.

¹¹⁷ Annex on Financial Services, Paragraph 5 (a) (i-xvi): Apart from insurance and insurance-related services, they include under banking and other financial services (excluding insurance) acceptance of deposits and other repayable funds from the public; lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction; financial leasing; payment and money transmission services, including credit, charge and debit cards, travelers’ cheques and bankers’ drafts; guarantees and commitments; trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following: (A) money market instruments (including cheques, bills, certificates of deposits); (B) foreign exchange; (C) derivative products including, but not limited to, futures and options; (D) exchange rate and interest rate instruments, including products such as swaps and forward rate agreements; (E) transferable securities; (F) other negotiable instruments and financial assets, including bullion. (xi) Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues; (xii) money broking; (xiii) asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services; (xiv) settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments; (xv) provision and transfer of financial information, and financial data; (xvi) advisory, intermediation and other auxiliary financial services

b. Definitions linked to the Person/Entity making the investment or providing the financial Service

In terms of who is defined as a service supplier, GATS Article XXVIII (g) sets out that ‘a service supplier’ means any person that supplies a service, whilst a ‘financial service supplier’ means any natural or juridical person or a Member wishing to supply or supplying financial services, but this does not include a public entity¹¹⁸. Therefore, any person or corporate entity supplying financial services would fall within this definition.

Trade in services, including financial services, is supplied through four modes of service supply identified under the GATS¹¹⁹. Financial services is primarily supplied through two modes, Mode 1 or cross-border supply of financial services, which is defined as the ‘supply of a service from the territory of one Member into the territory of any other Member’¹²⁰. Mode 3 or commercial presence akin to investment is defined as supply of a service by a service supplier of one Member, through commercial presence in the territory of any other Member’¹²¹. Commercial presence is defined as ‘any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service’¹²².

From the interpretation of the definitions set out above, both macroprudential regulation, such as capital controls and microprudential regulation as it applies to legal form and separation of risky financial activities, would technically be covered under the GATS definitions of trade in services, measures affecting financial services, and modes of supply (either cross-border or commercial presence).

There is substantial coverage of investment, trade in services and financial services within FTAs as *Table 8: Coverage of Investment, Trade in Services, Financial Services and Cross-Border Services in select FTAs* indicates. The way in which trade in services and financial services are defined in FTAs tends to follow the GATS model. Consequently, there is a comprehensive attempt to define investment and

¹¹⁸ Annex on Financial Services, Paragraph 5 (b).

¹¹⁹ The GATS Article 1.2 defines trade in services as the supply of a service through four modes of supply: cross-border (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3), and the presence of natural persons (Mode 4).

¹²⁰ GATS Article 1 (2) (a).

¹²¹ GATS Article 1 (2) (c).

¹²² GATS Article XXVIII (d).

II. The International Trade and Investment Architecture as it relates to the Financial Sector

trade in services. As with the GATS, most ‘investment definitions’ cover not only physical assets located in the host country, but also other intangible assets such as mortgages, liens, and pledges, as well as portfolio investment in the form of shares, stocks, debts, or interests in the property of local companies¹²³.

Table 8: Coverage of Investment, Trade in Services, Financial Services and Cross-Border Services in select FTAS

Agreement	Investment	Trade in services	Financial services	Cross-border trade in services
TPP 2016	Chapter	Chapter	Chapter	Chapter
EU-Singapore 2015	Chapter	Chapter	Within investment	Chapter
US-Korea 2007	Chapter	-	Chapter	Chapter
US-Singapore 2003	Chapter	- -	Chapter	Chapter
EFTA-Singapore 2002		Chapter	--	
India-Singapore CECA 2005	Chapter	Chapter	--	--
ASEAN ASEAN Investment Agreements (1987, 1998, 2009) ASEAN Framework Agreement on Trade in Services (1995)	ASEAN Investment Agreement	ASEAN Trade in Services Agreement	--	--

Source: Author Compilation

Note: Coverage refers to coverage by way of specific provisions or chapters within the FTA

¹²³ As an example, Article 1(3) of the ASEAN Agreement for the Promotion and Protection of Investment defines the term ‘investment’ as ‘every kind of asset and in particular shall include though not exclusively: a) Movable and immovable property and any other property rights such as mortgages, liens and pledges; b) Shares, stocks and debentures of companies or interests in the property of such companies; c) Claims to money or to any performance under contract having a financial value; d) Intellectual property rights and goodwill; e) Business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources.’

Some agreements include portfolio investment, which by extension covers financial assets, and even if portfolio investments are not included, investments in the financial sector would be.

In most BITs and FTAs, the definitions of ‘investment’ falls into four broad categories (or a mixture of categories), which are as follows: ‘asset-based’ (which includes various kinds of assets and interests such as shares, moveable and immovable property, bonds, etc.), ‘list-based’ (with finite examples of assets covered by the treaty), ‘enterprise-based’ (which comprises the establishment or acquisition of a business enterprise, as well as a share that affords the investor control over an enterprise, broadly utilised in US FTAs), and ‘commercial-presence-based’ (based on commercial presence services and liberalisation provision of the GATS broadly utilised in EU FTAs *Table 9: Examples of Investment Definitions found in FTAs and Investment Treaties* provides examples of each kind of definition.

The approach adopted in terms of the investment definition depends on the intentions of the parties concerned and is often reflective of the structure of their investment or financial regime as well as the trade/investment volumes and interests of the countries involved.

A second important factor is whether the ‘investor’ making the investment falls within the definition of ‘investor’ and/or ‘financial services supplier’ within the context of treaties, i.e. BITS/FTAs or national law, as the case may be. This will determine whether the ‘investor’ or ‘financial service supplier’ can seek the protection of the concerned BIT or FTA. Most BITS define investors as natural or legal persons having a certain degree of connection with the contracting states in the agreement¹²⁴. While natural persons include nationals, citizens, and in some cases even permanent residents, legal persons generally include those entities whose principal place of incorporation or business is the investor state¹²⁵. Depending on the treaty, incorporation in the home state is often sufficient to qualify as an ‘investor’.¹²⁶

¹²⁴ OECD, ‘Definition of Investor and Investment in International Investment Agreements International Investment Law: Understanding Concepts and Tracking Innovations’, 2008, last accessed 5th October 2020 at <http://www.oecd.org/investment/international-investmentagreements/40471468.pdf>.

¹²⁵ UNCTAD, ‘Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking’, February 2, 2007, Page 15, Last accessed 5th October 2020 at http://www.unctad.org/en/docs/iteiia20065_en.pdf at 7–11.

¹²⁶ For an overview of the kind and depth of investment definitions contained in investment chapters of PTAs notified to the WTO, see Jo-Ann Crawford and Barbara Kotschwar, ‘Investment Provisions in Preferential Trade Agreements: Evolution and Current Trends’, 14th December 2018, WTO Staff Working Paper ERSD-2018-14

Table 9: Examples of Investment Definitions found in FTAs and Investment Treaties

Type of investment definition	Clause/Provision related to investment definition
Asset-based	German Model BIT, 2009 (Article 1): ‘The term “investments” comprises every kind of asset which is directly or indirectly invested by investors of one Contracting State in the territory of the other Contracting State. The investments include in particular: a) movable and immovable property as well as any other rights in rem, such as mortgages, liens and pledges; (b) shares of companies and other kinds of interest in companies; (c) claims to money which has been used to create an economic value or claims to any performance having an economic value; (d) intellectual property rights, in particular copyrights and related rights, patents, utility-model patents, industrial designs, trademarks, plant variety rights; (e) trade-names, trade and business secrets, technical processes, know-how, and good-will; (f) business concessions under public law, including concessions to search for, extract or exploit natural resources.’
List-based	Belarus-Mexico BIT, 2008 (Article 1.5): “Investment” means the following assets owned or controlled by investors of one Contracting Party and established or acquired in accordance with the national legislation of the other Contracting Party in whose territory the investment is made ...’
Commercial-presence-based	EFTA-Colombia FTA (Article 5.2) defines ‘commercial presence’ as ‘any type of business establishment, including through: (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of another Party for the purpose of performing an economic activity.’
Enterprise-based	NAFTA (Article 1139) defines investment as ‘(a) an enterprise; (b) an equity security of an enterprise; (c) a debt security of an enterprise ...’
Broader definition, covering economic, business, financial, accounting notions	Swiss Model BIT (1995) definition of investment Article 1(2): ‘The term “investments” shall include every kind in particular: (a) movable and immovable property as well as any other rights in rem, such as servitudes, mortgages, liens, pledges and usufructs; (b) shares, parts or any other kinds of participation in companies; (c) claims to money or to any performance having an economic value; (d) copyrights, industrial property rights (such as patents, utility models, industrial designs or models, trade or service marks, trade names, indications of origin), know-how and goodwill; (e) concessions under public law, including concessions for search for, extract or exploit natural resources as well as all other rights by law, by contract or by decision of the authority in accordance with the law.’

Source: Author Compilation, drawn from specific provisions of select FTAs and BITs

c. Definitions as interpreted in Investor State Dispute Settlement Case Law

Definitions may be set in BITs or FTAs, but at the point of dispute settlement their interpretation lies with a dispute settlement tribunal. For ISDS disputes, this is normally ICSID. ICSID provides a procedural framework for settlement of investor-state disputes through conciliation and arbitration. Article 25(1) of the ICSID Convention provides the grounds for ICSID jurisdiction: ‘The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre and by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre.’

In the case of ICSID jurisprudence, definitions relating to investment have not only been relatively broad and varied but also at times contradictory. In *Salini v. Morocco* an ICSID tribunal set out the so-called ‘Salini test’, highlighting inherent properties of a protected investment including a substantial commitment of resources or capital, a sufficient duration, the assumption of risk and a contribution to the development of the host state¹²⁷. Most investment in the financial sector and the provision of financial services are likely to fall within the criteria set out in the Salini test, which can also be used as a basis to determine the types of financial products that may qualify as an investment attracting protection under a treaty¹²⁸.

Several investment arbitral awards found that a range of financial instruments qualify as investments. Financial instruments considered to be qualifying investments include straightforward loans¹²⁹, negotiable instruments, i.e. promissory

¹²⁷ *Salini Costruttori S.p.A. and Italstrade S.p.A. v. The Kingdom of Morocco*, ICSID Case No. ARB/00/4, Decision on Jurisdiction, 23 July 2001, hereinafter *Salini v. Morocco* or *Salini*. The so-called Salini test is set out in paragraphs 52–54.

¹²⁸ The Salini test has been questioned in subsequent ICSID jurisprudence. In *Bitwater Gauff (Tanzania) Ltd. v. United Republic of Tanzania*, ICSID Case No. ARB/05/22, Paragraph 314. The tribunal highlighted that the Salini test was potentially problematic if it were to be applied in a fixed and inflexible manner, as there was the risk of arbitrary exclusion of certain types of transactions from the scope of the ICSID Convention.

¹²⁹ *Oko Pankki Oyj v. Republic of Estonia* (ICSID Case ARB/04/6), Award, 19 November 2007.

notes¹³⁰ and sovereign bonds¹³¹. Loans have been found to be protected under treaties which contain a broad definition of investments that includes ‘claim to money’ or ‘obligations’¹³².

Shareholdings are frequently considered to be protected ‘investments under treaties’, with objections tending to focus on whether the shareholder qualifies as an investor¹³³. Government-issued endorsed promissory notes were found to constitute investments in *Fedax v. Venezuela*, as the treaty’s definition of investments included ‘titles to money’¹³⁴. Other inclusions have been depository receipts¹³⁵, Convertible debentures¹³⁶, bank guarantees¹³⁷ and dematerialised government bonds¹³⁸.

¹³⁰ *Fedax N.V. v. Bolivarian Republic of Venezuela* (ICSID Case ARB/96/3), Award, 9 March 1998.

¹³¹ *Abaclat v. Argentine Republic* (ICSID Case ARB/07/5), Decision on Jurisdiction and Admissibility, 4 August 2011.

¹³² *British Caribbean Bank Ltd. v. The Government of Belize*, PCA Case No. 2010-18, concerning a default under a loan. In *Standard Chartered Bank v. United Republic of Tanzania* (ICSID Case No. ARB/10/12); however, a loan held by a subsidiary did not qualify as an investment by the parent bank where the parent had had no involvement or knowledge of the decision to purchase the loan.

¹³³ *KT Asia Investment Group BV v. Kazakhstan*, (ICSID Case No. ARB/09/8) A shell corporation with no meaningful commercial activity or commitment of its own resources, but which simply moved shares from one entity to another, was found not to qualify as an investor.

¹³⁴ *Fedax N.V. v. Republic of Venezuela*, ICSID Case No. ARB/96/3(1), Decision on Jurisdiction, Paragraphs 18–43, 11 July 1997.

¹³⁵ These were held to fall within ‘all types of assets’ for purposes of the definition of investment in the Russia-Spain investment treaty at issue in *Renta 4 S.V.S.A v Russian Federation* (Stockholm Chamber of Commerce Case No. 24/2007). The tribunal considered that depository receipts represent a property interest covered by the Russia-Spain BIT, 1990, even though the recorded owner is a third-party intermediary and not the beneficiary.

¹³⁶ Convertible debentures were held to qualify as investments under NAFTA in *Fireman’s Fund Insurance Company v. The United Mexican States*, (ICSID Case No. ARB(AF)/02/1). Although loans were excluded from protection under the treaty, Mexican law, which governed the debentures, treated them as capital, which was subject to regulation in Mexico by the financial authorities.

¹³⁷ *Joy Mining Machinery Ltd. v. Arab Republic of Egypt* (ICSID Case ARB/03/11), Award on Jurisdiction, 6 August 2004.

¹³⁸ Dematerialised government bonds were found to qualify as investments in *Abaclat v. Argentina and Ambiente Ufficio S.p.A. v. Argentine Republic* (ICSID Case ARB/08/9),

ISDS arbitral interpretations can also at times be contradictory. Sovereign bonds were considered a qualifying investment in three ICSID cases but not in a fourth case¹³⁹. Similarly, a bank guarantee was considered a qualifying investment in a Permanent Court of Arbitration case under the UNCITRAL Arbitration Rules but was denied that benefit in an ICSID case¹⁴⁰.

Three important observations are therefore that ICSID jurisprudence has enabled a wide and detailed interpretation of what constitutes covered investment, investor, etc. Second, the ISDS jurisprudence on the definition of investment can vary and at times be contradictory; hence, there appears to be plenty of leeway in arbitrators' interpretations. Indeed, different tribunals may vary in their findings, even when faced with similar facts and treaties. Third, the definitions of trade and investment agreements cover a range of financial-sector-linked investments, services and transactions. Therefore, definitions in negotiations and dispute settlement under investment and trade treaties are important as they can have a direct impact on the possibility of filing and the outcome of future dispute settlement cases in the financial sector.

Decision on Jurisdiction and Admissibility (8 February 2013). In *Abaclat*, which was a mass claim on behalf of 60,000 bondholders, the tribunal held that the inclusion of 'obligations' within the Argentina-Italy treaty's definition of investment implicitly included sovereign debt and that this extended to the economic value incorporated in a credit title representing a loan, including bonds. The tribunal further noted that the sovereign debt could also constitute 'securities' – another example listed within the definition of investments in the treaty – and that bonds are covered investments in any event.

¹³⁹ In *Ambiente Ufficio S.p.A. v. Argentine Republic* (ICSID Case ARB/08/9), Decision on Jurisdiction and Admissibility (8 February 2013) and *Giovanni Alemanni v. Argentine Republic* (ICSID Case ARB/07/8), on Jurisdiction and Admissibility Decision (17 November 2014); the tribunal took an expansive interpretation of covered investment as compared to *Poštová banka, a.s. and ISTROKAPITAL SE v. Hellenic Republic* (ICSID Case ARB/13/8), Award (9 April 2015), where the Tribunal took a narrower reading of covered investment.

¹⁴⁰ *Joy Mining Machinery Ltd. v. Arab Republic of Egypt* (ICSID Case ARB/03/11), Award on Jurisdiction (6 August 2004).

C. The Trade and Investment Architecture as Contained in the WTO's General Agreement on Trade in Services and free Trade Agreements

1. General Principles and Rules

The trade architecture as contained in the GATS and FTAs is composed of (a) general principles or commitments, i.e. general rules that apply across the board to the entire agreement such as the scope and definitions of the agreement, most favoured nation ('MFN'), transparency, domestic regulation, market access and national treatment, and dispute settlement, amongst others¹⁴¹. Of these, two key principles relevant to a discussion on post-2008 financial crisis regulation are market access and national treatment. The trade architecture is also made up of (b) specific commitments, i.e. commitments made in respect of specific sectors or sub-sectors. WTO members or parties to an FTA undertake specific obligations encapsulated in a national schedule of liberalisation commitments, which specifies the sector, mode and terms on which such commitments are being undertaken. Using the positive list approach, members specify in their national schedules of commitments the degree and terms of access they are prepared to guarantee for foreign service suppliers based on market access and national treatment commitments¹⁴². Alternatively, some FTAs also contain negative listing whereby everything is liberalised unless specific exceptions are stated.

GATS Article XVI (2) sets out permissible market access limitations that a member may maintain in their schedules of commitments including limitations imposed on the number of services suppliers, service operations or employees in the sector; the value of transactions; the legal form of the service supplier; or the participation of foreign capital. Three notable provisions of Article XVI (2) which relate to macro and prudential regulation under discussion for this thesis under Article XVI (2) are:

- a) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test.

¹⁴¹ See GATS Objectives, Coverage and Disciplines, Accessible at: https://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm.

¹⁴² GATS Article XXIII sets out the terms, conditions, limitations and qualifications under which WTO members may schedule their commitments.

- b) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and
- c) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.

GATS Article XVII provides for national treatment of services suppliers where a commitment has been undertaken. WTO members are expected to accord to services and service suppliers of any other member treatment no less favourable than that it accords to its own like services and service suppliers. WTO members are, however, able to inscribe exceptions or qualifications in their schedules of commitments.

The exact impact of the post-crisis macro and microprudential regulation vis-à-vis GATS/FTA commitments would vary and must be read with WTO members' actual schedules of commitment¹⁴³. *Table 10: WTO Member Commitments on Bank Entry and Activities* provides an overview of some of the types of commitments undertaken by WTO members. The more liberalised the financial services commitments are, the greater the likelihood of roll back based on the financial regulation under consideration.

2. Specific Obligations-Schedules of Commitments in Financial Services

A key question in the wake of the 2008 financial crisis has been how post-crisis financial regulation measures conform with commitments undertaken by WTO members. While it is not possible to undertake an exhaustive study of individual WTO members' schedules of commitments, it is possible to rely on GATS commitments undertaken during Uruguay's round of negotiations in 1997 to form an understanding of the kind of financial services commitments WTO members have undertaken.

A substantial number of WTO members have made commitments in the financial services sector. An analysis of WTO members' financial services commitments on foreign bank entry and activities indicates that developing countries commit to a substantially greater degree of discrimination in regard to regulation for foreign banks versus domestic banks. By contrast, most of the developed countries

¹⁴³ For the purposes of this paper, it would be a lengthy process to go into individual members' schedules of commitments, so an illustrative example has been provided.

Table 10: WTO Member Commitments on Bank Entry and Activities

Measure	Number of commitments undertaken
Commitments made in banking	95
Market access restrictions for foreign banks	– Limitation on number of foreign banks allowed to operate in the territory – Total 38, 37 DCs – Foreign equity limitations – 41 all DCs – Foreign bank entry not permitted through (i) acquisitions – 33 (DCs 32), (ii) subsidiaries – 44(DCs 42), (iii) branching – 42, all DCs – Limitation on value of banking system assets that foreign banks can hold – 34, all DCs
Cross border supply of financial services permitted	– Acceptance of deposits – 24 – Lending – 25 – Financial leasing – 21 – Payment and transmission services – 18 – Guarantees and commitments – 24 – Participation in issuance of securities – 15 – Asset management – 12 – Money broking – 11 – Settlement and clearing services – 8 – Provision/transfer of financial information – 52 – Advisory intermediation, auxiliary financial services – 53
Minimum capital requirements being higher for foreign banks	Total 37, DCs – 36

Source: Barth James, Marchetti Juan, Nolle Daniel, Sawangngoenyuan Wanvimol, WTO Commitments versus Reported Practices on Foreign Bank Entry and Regulation: A Cross Country Analysis, Chapter 17, Oxford Handbook of Banking, (Editors Berger, Molyneux and Wilson), 2010. Data on Cross Border Supply of Financial Services drawn from Barth James, Marchetti Juan, Nolle Daniel, Sawangngoenyuan Wanvimol, Foreign Banking Do Countries WTO Commitments Match Actual Practices? WTO Staff Working Paper ESRD-2006-11, October 2006. The study was based on responses of 123 countries to a World Bank questionnaire on given activities/restrictions. DC – Developing country, IC – Industrialised country

have tended to be fairly permissive, in the sense of allowing for the operation of foreign branches and not requiring establishment as subsidiaries for operation in the domestic market (*Table 10: WTO Member Commitments on Bank Entry and Activities*). The question now is whether post-crisis financial regulation requires incorporation as a subsidiary for better regulatory oversight or limits the kind of activities that can be undertaken, i.e. ringfencing, then this can be considered contrary to financial services commitments undertaken, particularly by developed country members in the WTO or FTAs, depending on the exact nature of their national schedule of commitments.

3. Regulatory Flexibility under Trade and Investment Agreements: The Prudential Carve Out

Regulatory flexibility in the financial sector is protected under the GATS Annex on Financial Services 'Prudential Exception' or 'Prudential Carve-Out' clause and similar provisions in FTAs. Paragraph 2(a) of the GATS Annex on Financial Services states:

'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 prudential carve-out permits WTO members to introduce and maintain measures for prudential reasons for the protection of investors, depositors, policy holders, or to ensure the integrity and stability of the financial system. It is a specific exception for measures taken for prudential reasons which could include any domestic measure that is inconsistent with a WTO member's MFN, market access or national treatment obligations relating to financial services¹⁴⁴. The clause essentially allows for derogation from the general obligations of the GATS, based on the prevalence of macroeconomic stability against the positive effects of trade

¹⁴⁴ WTO Secretariat, Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services, 3 February 2010, S/C/W/312 S/FIN/W/73.

liberalisation¹⁴⁵. However, the prudential exception is conditional on a member not using it as a means of avoiding undertaken obligations/commitments.

There are two key questions surrounding the prudential carve-out. First, are micro and macroprudential regulations covered? Second, to what degree is regulatory flexibility protected under the prudential carve-out and under what circumstances are micro and macroprudential regulation covered?

a. Does the Prudential Carve-Out cover macro and microprudential Regulations?

The GATS Annex on FS applies to ‘measures affecting the supply of financial services’. The term ‘affecting’ has been interpreted broadly in WTO jurisprudence to encompass any measure of a member that affects the supply of a service directly or even if it regulates other matters but nevertheless affects trade in services¹⁴⁶. From the interpretation of this definition, it appears that both macroprudential regulation as it applies to capital controls and microprudential regulation as it applies to legal form and the segregation of financial activities are covered under the GATS definition of measures affecting financial services.

The prudential carve-out allows a member to breach their obligations or specific commitments in respect of financial services provided the measures are ‘not used as a means of avoiding’ commitments or obligations under the GATS. Thus, any measure falling within the prudential carve-out, even if it is inconsistent with provisions of the GATS, is legally permissible, affording post-crisis macro and microprudential regulatory measures a degree of protection.

b. What kind of macro and microprudential Regulations are covered and under what Circumstances?

The Annex on FS seems to adopt a seemingly broad definition (with a pro-regulation touch), allowing for wide discretion on the part of the authorities to adopt measures to protect the safety and soundness of the financial system, the integrity of financial markets, and the financial interests of investors and consumers, if they are applied even-handedly. Prudential rules refer to the financial soundness of financial service suppliers and aim to prevent the risk of suppliers not being

¹⁴⁵ Federico Lupo-Pasini, ‘International Regulatory Regime on Capital Flows and Trade in Services’, January 4, 2012, ADBI Working Paper 338.

¹⁴⁶ WTO Panel Report EC-Bananas III, paragraph 7.285, WTO Appellate Body Report EC-Bananas III paragraph 220

able to meet their liabilities as they fall due¹⁴⁷. Furthermore, the list of 'prudential reasons' contained in the Annex on FS is only indicative, as evidenced by the term 'including' that precedes it. Other 'prudential reasons' or more specific formulations or elaborations of the reasons mentioned in the carve-out are therefore possible, particularly considering that what might be perceived to constitute 'prudential reasons' may evolve over time¹⁴⁸.

The macro and microprudential regulation set out by financial regulators after the financial crisis are linked to clear prudential reasons (namely protecting the stability of the financial system in response to the 2008 financial crisis) and should fall within the scope of the prudential carve-out (*Table 11: Examples of macroprudential and microprudential Regulation that could fall within the Scope of the Prudential Carve-Out in the GATS and select FTAs*). Macroprudential regulation protects systemic stability, whilst microprudential regulation ensures the viability of individual financial institutions, thereby protecting depositors and investors. Moreover, since the 2008 financial crisis, the inseparable and complementary role of both macro and microprudential regulation in protecting systemic stability has been highlighted (Freixas, Laeven and Peydro, 2015).

However, the prudential carve-out is not an unqualified exception. It is expected that the measure undertaken for prudential reasons is not used as a means of avoiding GATS obligations/commitments. The prudential carve-out is clearly intended to avoid abuse in the use of the exception and, at a minimum, it imposes an obligation of good faith with respect to the adoption and application of prudential measures¹⁴⁹. A similar view is substantiated by the WTO Secretariat: 'In light of the object and purpose of the GATS, particularly Recs 3 and 4 of the GATS Preamble, it seems reasonable to interpret the prudential carve-out as affording the Members a high level of discretion regarding measures for prudential reasons including, but not limited to, the ones listed, but at the same time not permitting measures that are purely or primarily protectionist in effect¹⁵⁰.'

¹⁴⁷ Paul Sharma, 'The Integrated Prudential Sourcebook', 2006, in M Blair QC and G Walker (eds), *Financial Services Law*, Page 369, Oxford University Press.

¹⁴⁸ WTO Secretariat, Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services, 3 February 2010, S/C/W/312 S/FIN/W/73.

¹⁴⁹ Armin von Bogdandy and Joseph Windsor, 'Annex on Financial Services', in VI Max Planck Commentaries on World Trade Law, Pages 640–666, 2008, Editors: Rüdiger Wolfrum, Peter-Tobias Stoll, and Clemens Feināugle.

¹⁵⁰ WTO Secretariat, Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services, S/C/W/312 S/FIN/W/73, 3 February 2010.

Table 11: Examples of macroprudential and microprudential Regulation that could fall within the Scope of the Prudential Carve-Out in the GATS and select FTAS

Measure	Rationale	Example
Regulators' preference for certain kinds of legal forms or regulatory structures, e.g. subsidiary as opposed to a branch	Microprudential measure for the prevention of branch-based contagion from branches to parents and vice versa from parents to branches.	Preference of Spanish regulators vis-à-vis Latin American operations.
Separation of financial activities through proprietary trading and ringfencing	Microprudential measure ring-fence or separate deposit-taking activity from more risky investment-like activities, with greater control on supervision and deposits	– UK ringfencing – US Volcker Rule on proprietary trading
Capital controls: taxes, quotas etc.	Macroprudential measure to prevent unpredictable and sudden inflows or outflows of capital that can affect the economy	Country examples

Source: Author Construction

While the prudential carve-out is an exception to the GATS rules, it is not on a par with other GATS exceptions related to security or environment¹⁵¹. This is because the prudential carve-out does not contain the requirement for a 'necessity test', unlike the GATS and even GATT exceptions on security, environment, public morals and order. GATS Article XIV, for instance, allows measures inconsistent with a member's obligation provided they are 'necessary' to maintain public morals and public order as well as to protect human, animal, and plant life. Thus, GATS Article XIV presupposes a kind of necessity test. Key (2003) and others point out that a result of this is that prudential measures may not be challenged on the grounds of whether they are 'necessary' or 'least trade restrictive'¹⁵².

¹⁵¹ See GATS Article XIV on General Exceptions.

¹⁵² Sydney Key, *The Doha Round and Financial Services Negotiations*, American Enterprise Institute Press, 2003. See also Piritta Sorsa, 'The GATS Agreement on financial services – A modest start to multilateral liberalization?', 1997, IMF Working Paper, Page 11, WP/97/55.

c. What Degree of Regulatory Flexibility is afforded by the Prudential Carve-Out and under what Circumstances? A look at Key Case Law covering the Prudential Carve-Out Clause

While the general academic view is that the prudential carve-out offers members a high level of flexibility regarding adoption of prudential measures with the expectation that WTO members will act in good faith¹⁵³, the prudential carve-out is still to be fully interpreted by a WTO dispute settlement body. The first case to attempt to address the issue of the prudential carve-out is the WTO dispute 'Argentina – Measures relating to Trade in Goods and Services' ('Argentina Financial Services Dispute')¹⁵⁴.

The dispute was initially brought by Panama to challenge actions taken by Argentina against services and service suppliers from jurisdictions – like Panama – that do not exchange information for purposes of tax transparency and the prevention of money laundering and terrorist financing. These jurisdictions were labeled 'non-cooperative' based on Argentina's classification system under its 2013 law¹⁵⁵. On the basis of its 'non-cooperative' and 'cooperative' classification, Argentina put in place eight measures that affect the cross-border financial services trade between Argentine customers and taxpayers and Panamanian financial service suppliers. Some of the measures covered related to tax; access to the reinsurance sector, foreign exchange, access to capital markets; and the registration of branches of foreign companies¹⁵⁶.

¹⁵³ See Kern Alexander, 'The World Trade Organization and financial stability: the balance between liberalisation and regulation in the GATS', May 2010, and Armin Von Bogdandy and Joseph Windsor, 'Annex on Financial Services', 2008, in Rüdiger Wolfrum, Peter-Tobias Stoll, and Clemens Feinäugle (eds.) *WTO – Trade in Services* (Koninklijke Brill N.V., Leiden).

¹⁵⁴ See dispute before the Panel (Panel Report, WT/DS453/R) and Appellate Body WTO Appellate Body Report, *Argentina – Measures relating to Trade in Goods and Services*, WT/DS453/AB/R, 14th April 2016.

¹⁵⁵ Under that law, a 'cooperative jurisdiction' is one that has an agreement with Argentina for the effective exchange of information or fulfills certain requirements for starting negotiations on this issue.

¹⁵⁶ The eight specific measures are related to withholding tax on payments of interest or remuneration (measure 1); presumption of unjustified increase in wealth (measure 2); transaction valuation based on transfer prices (measure 3); payment received rule for the allocation of expenditures (measure 4); requirements relating to reinsurance services (measure 5); requirements for access to the Argentine capital market (measure 6); requirements for the registration of branches (measure 7); and foreign exchange authorisation requirement (measure 8). For a further description of the measures, see Appellate Body Report, Section 5.

One of the key outcomes of the Panel's findings in its report of 2015, as modified by the Appellate Body Report, was to signal to WTO members that they will be accorded wide – but not unrestrained – latitude in adopting and implementing measures taken for prudential reasons and affecting the financial services sector¹⁵⁷.

BOX 2: KEY POINTS FROM THE ARGENTINA CASE AND ITS IMPLICATIONS

CONCEPTS

'Prudential reasons' refers to 'causes' or 'reasons' that motivate financial sector regulators to act to prevent a risk, injury or danger, which does not have to be imminent.

CRITERIA

Rational relation linking CAUSE (prudential reason) and EFFECT (measure).

Risk, injury to danger does not have to be IMMINENT.

To be decided on a CASE BY CASE basis according to design, structure and architecture of the measure.

SOME OBSERVATIONS

- Signal to WTO members that they have wide – though not unrestrained -Latitude in prudential regulation adoption and implementation.
- Can be used to justify derogation from MA, NT and MFN.

Potential prudential reasons accepted by the Panel include solvency of insurers/reinsurers, failure of direct insurance companies, investor protection, and reduction/avoidance of systemic risk.

The Panel explored whether Argentina could justify two remaining measures (measures 5 and 6 relate to requirements relating to reinsurance services and requirements for access to the Argentine capital market, respectively) under the so-called 'prudential carve-out' contained in paragraph 2(a) of the GATS Annex on Financial Services. Both the Panel and the Appellate Body found that both measures 5 and 6 affect the supply of financial services within the meaning of paragraph 1(a) of the Annex on Financial Services¹⁵⁸. The Panel found that since paragraph 2(a)

¹⁵⁷ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, Paragraph 7.849, Page 202, WT/DS453/R, 30th September, 2015.

WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, Paragraph 6.260, Page 84, 14th April, 2016.

¹⁵⁸ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, Paragraph 7.858, Page 204, WT/DS453/R, 30th September, 2015, WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, Paragraphs 6. 6.256–6.258, 6.272, Pages 83, 87, WT/DS453/AB/R, 14th April 2016.

is an 'exception', the burden of proof lies with the respondent Member to demonstrate that the relevant measures are covered by the provision¹⁵⁹.

The Panel also found that a measure taken 'for' prudential reasons denotes a rational relationship of cause and effect between the measure and the prudential reason and would be determined according to a case-by-case analysis of the design, structure, and architecture of the measure. Here, the Panel accepted as 'prudential' the reasons given by Argentina with respect to measure 5 (the protection of the insured, the solvency of insurers and reinsurers, and the avoidance of the possible systemic risk of the insolvency and failure of direct insurance companies) and with respect to measure 6 (investor protection, the reduction of systemic risk, and the prevention of money laundering and terrorist financing offenses). Many macro and microprudential measures taken after the 2008 financial crisis can be argued to have similar prudential objectives.

However, despite the Panel's deference to financial regulators in determining the prudential motivations that they choose to pursue, the Panel found that measures 5 and 6 were not designed rationally to serve the stated prudential reasons¹⁶⁰. On that basis, the Panel found that the prudential carve-out did not justify the distinction that Argentina made in the way it treated service suppliers from cooperative and non-cooperative jurisdictions¹⁶¹.

Panama unsuccessfully appealed the threshold issue of whether measures 5 and 6 fall within the scope of paragraph 2(a). On April 14, 2016, the Appellate Body of the WTO circulated its report in the Argentina – Financial Services dispute (DS453)¹⁶².

The Appellate Body disagreed with an argument by Panama that the prudential carve-out covers only measures constituting 'domestic regulation,' finding instead that the provision covers all types of measures affecting the supply of financial services within the meaning of paragraph 1(a) of the GATS Annex on Financial Services¹⁶³.

¹⁵⁹ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, Paragraph 7.816, Page 197, WT/DS453/R, 30th September 2015.

¹⁶⁰ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, See discussions of the Panel at pages 205–212, WT/DS453/R, 30th September 2015.

¹⁶¹ WTO Panel Report, Argentina – Measures relating to Trade in Goods and Services, See discussions of the Panel at pages 205–212, WT/DS453/R, 30th September 2015.

¹⁶² WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, WT/DS453/AB/R, 14th April 2016.

¹⁶³ WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, Paragraphs 6. 6.256–6.258, Pages 83, WT/DS453/AB/R, 14th April 2016.

The Appellate Body reasoned that the provisions of paragraph 2(a) mean that it could be invoked to justify inconsistencies with all of a member's obligations under the GATS. These include, for example, a member's most-favoured-nation treatment obligation under Article II, market access commitments under Article XVI, or national treatment obligation under Article XVII¹⁶⁴.

While the Argentina Financial Services dispute does not delve in great depth into several aspects of the prudential carve-out, it does for the first time consider aspects of the prudential carve-out and may inform future panel interpretations on the prudential carve-out coverage of regulators' flexibility vis-à-vis covered trade and investment commitments. As set out in Box 1, the flexibility of the regulator is clearly protected and a kind of criteria consisting of establishing a rational reason between the measure and the prudential reason and considering each case on an individual basis is set out. Two interesting observations based on the Panel decision are that the avoidance or minimization of systemic risk was accepted as a prudential reason, whilst at the same time the protection of investor rights was also recognized. This in effect would mean most post-2008 financial crisis regulation could potentially be exempted under the GATS prudential carve-out.

The Argentina – Financial Services dispute highlights that all WTO members have an interest in the work of international financial regulatory bodies, and that all countries that stand to be affected should be part of the global dialogue in those bodies¹⁶⁵.

d. Prudential Carve-Out in FTAs

Most FTAs include a GATS-like prudential carve-out, whereas BITS, especially the older ones, do not tend to contain 'prudential exception' clauses. As indicated in *Table 12: Prudential Carve-Out Provisions in select FTAs*, most FTAs generally follow a similar GATS formulation of the Prudential Exception, focusing on two objectives: protection of persons to whom a fiduciary duty is owed and ensuring the stability of the financial system.

¹⁶⁴ WTO Appellate Body Report, Argentina – Measures relating to Trade in Goods and Services, Paragraph 6.262–6.270, Pages 84–86, WT/DS453/AB/R, 14th April 2016.

¹⁶⁵ WTO Secretariat, Report of Committee on Trade in Financial Services, Meeting of 26th February 2014, S/FIN/M/79, 28 March 2014.

Table 12: Prudential Carve-Out Provisions in select FTAS

Agreement	Coverage of prudential regulation
TPP 2016	Article 11.11 Prudential exception permitted for: – Integrity of financial system (similar to GATS), financial institutions, cross-border financial services suppliers and the payment and clearing systems. Requirement for investment-related prudential measures (subject to investment disputes in FS article 11.22) to be found consistent with party's agreement obligations without the award of damages. – Shall not apply to non-discriminatory measures adopted by public entities in pursuit of monetary, credit, exchange rate policies. – A party may prevent or limit transfers by a financial institution or cross-border financial service supplier to, or for the benefit of, an affiliate of or person related to such an institution or supplier, through the equitable, non-discriminatory and good-faith application of measures relating to the maintenance of the safety of the financial system (to be read with chapters relating to transfer). – Parties may adopt measures relating to the prevention of deceptive and fraudulent practices or to deal with the effects of a default on financial services contracts, if consistent with the FS chapter and non-discriminatory.
EU-Singapore 2015	Article 8.5 of cross-border services chapter specifies prudential carve-out as per GATS, for the protection of investors, depositors, policy holders and beyond to ensure the safety, soundness, and integrity of financial services suppliers, as well as the integrity and stability of financial systems. Measures are not more burdensome than necessary and are neither arbitrary nor act as disguised barriers (Article 8.5 (2)).
US-Korea 2007	Financial services chapter: exceptions include: – GATS-like prudential carve-out in respect of measures adopted for prudential reason for 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, provided they are not used to circumvent obligations undertaken (Article 13.10 (1)). – Non-discriminatory measures may be undertaken by public entities in pursuit of monetary and related credit policies or exchange rate policies (Article 13.10 (2)). – Measures to prevent deceptive/fraudulent practices or effects of default on FS contracts provided they are not implemented in an arbitrary manner or a disguised restriction on investment in FI and cross-border FS suppliers (Article 13.10 (4)).

(Continued)

Table 12: (Continued)

Agreement	Coverage of prudential regulation
US-Singapore 2003	Financial services chapter: exceptions include: – GATS-like prudential carve-out in respect of measures adopted for prudential reason for 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, provided they are not used to circumvent obligations undertaken (Article 10.10 (1)). – Non-discriminatory measures may be undertaken by public entities in pursuit of monetary and related credit policies or exchange rate policies (Article 10.10 (2)). – Measures to prevent deceptive/fraudulent practices or effects of default on FS contracts provided they are not implemented in an arbitrary manner or as a disguised restriction on investment in FI and cross-border FS suppliers (Article 10.10 (4)).
EFTA-Singapore 2002	– Services chapter Annex VIII, Article 3 (1) and (2): GATS-like prudential carve-out.
India-Singapore CECA 2005	– Investment chapter: Need for restrictions to be consistent with IMF Articles of Agreement, avoid unnecessary commercial, economic, financial interest damage, not be excessive, be temporary and applied on a national treatment basis (Article 6.7 (2)). Requirement for notification and consultation (Article 6.7 (3 and 4)). – Services chapter: GATS-like prudential measure clause (Annex 7 C, paragraph 2).
ASEAN ASEAN Investment Agreements (1987, 1998, 2009) ASEAN Framework Agreement on Trade in Services (1995)	– Explicit incorporation of GATS prudential carve-out by Singapore in its schedule of commitments, which forms part of the AFAS 5th Financial Services Protocol in both insurance and banking headnotes. Furthermore, explicit incorporation of financial regulatory authorities' power to make regulation as under the GATS prudential carve-out. – Safeguard measures for serious BoP/financial difficulties. Measures/restrictions on investment permitted in case of economic development/transition/maintenance of financial reserves difficulties (ASEAN framework agreement on AIA 1998, Article 15(1)). Such measures should give 14 days' notice to AIA Council; not discriminate between member states; be consistent with IMF Article of Agreement; avoid unnecessary damage to the commercial, economic, and financial interests of other member states; not be more excessive than necessary in dealing with specified circumstances; and be progressively phased out (ASEAN framework agreement on AIA 1998, Article 15(3)). Repeated in Article 16 of the ASEAN Comprehensive Agreement.

Source: Author Compilation

Given the similar structure to the GATS prudential carve-out and fact that most FTA Parties are also WTO members, the issues arising in FTA prudential carve-out are similar to those arising from the GATS prudential carve-out, as highlighted earlier. Some US FTAs, however, while providing for a prudential exception, may have variations on its formulation. Indeed, US treaties tie the definition of 'prudential' more closely to policies pertaining to 'individual financial institutions'. The TPP Chapter on Financial Services, for instance, sets out the following:

TPP Article 11.11: Prudential Exceptions

'Notwithstanding any other provisions of this Chapter and Agreement except for Chapter 2 (National Treatment and Market Access for Goods), (Rules of Origin and Origin Procedures), Chapter 4 (Textiles and Apparel), etc., a Party shall not be prevented from adopting or maintaining measures for prudential reasons^{166, 167} 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. If these measures do not conform with the provisions of this Agreement to which this exception applies, they shall not be used as a means of avoiding the Party's commitments or obligations under those provisions.'

Footnote 10 of Article 11.11 (1) specifies:

'The Parties understand 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 as well as the safety and financial and operational integrity of payment and clearing systems.'

This narrow interpretation, which focuses on individual financial institutions, may not cover systemic considerations or macroprudential regulation, such as capital controls. Footnote 11 of Article 11. 11 (1) goes on to explain that if a measure adopted by a Party is deemed to be for prudential reasons in accordance with the provisions for investment disputes in financial services, then the tribunal shall not

¹⁶⁶ Article 11.11 (1) Footnote 10: The Parties understand 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 as well as the safety and financial and operational integrity of payment and clearing systems.

¹⁶⁷ Article 11.11 (1) Footnote 11: For greater certainty, if a measure challenged under Section B of Chapter 9 (Investment) is determined to have been adopted or maintained by a Party for prudential reasons in accordance with procedures in Article 11.22 (Investment Disputes in Financial Services), a tribunal shall find that the measure is not inconsistent with the Party's obligations in the Agreement and accordingly shall not award any damages with respect to that measure.

consider the measure to be inconsistent with a WTO Member's obligation. While the provision offers some flexibility as far as ISDS is concerned, it first provides for ISDS in what could be a key area of regulatory flexibility and, second, measures what must be determined as 'prudential' before exemption under ISDS can be sought.

4. Understanding on Commitments in Financial Services¹⁶⁸

Several countries¹⁶⁹ desirous of faster liberalisation of their financial sectors decided to use the Understanding on Commitments in Financial Services, which offers an alternative mechanism for making deeper commitments in the financial services sector¹⁷⁰. It sought to achieve this by including provisions relating to greater detail on cross-border trade in financial services¹⁷¹(Part B paragraphs 3, 4), commercial presence¹⁷²(Part B paragraphs 5, 6) and other areas of sectoral/modal

¹⁶⁸ The Understanding on Commitments in Financial Services is an optional and alternative approach to making specific commitments on financial services. It is not part of the GATS but was appended to the Final Act of the Uruguay Round.

¹⁶⁹ It is estimated that some 30 Members (counting the then EC 15 as one) have scheduled financial services commitments as per the Understanding on Commitments in Financial Services. The Understanding provided a common template to harmonise GATS commitments and assume additional obligations beyond those currently contained in the Agreement.

¹⁷⁰ Features of the Understanding are a standstill on restrictions in areas specified, liberal rules regarding market access through Mode 3 (commercial presence), permission for suppliers of financial services to supply new financial services in the territory of any other member country (a particularly interesting provision for a sector that continues to be subject to rapid innovation), liberal rules concerning the granting of temporary entry of managerial and specialist personnel of foreign suppliers, and rules designed to ensure that non-discriminatory measures do not in practice adversely affect the ability of foreign suppliers to establish and expand their operations in a member country.

¹⁷¹ Understanding on Financial Services, Paragraphs 3, 4, which focus on cross-border trade in the insurance and reinsurance sectors and the provision and transfer of financial information and financial data processing.

¹⁷² Understanding on Financial Services, Paragraphs 5, 6, which set out the following: '5. Each Member shall grant financial service suppliers of any other Member the right to establish or expand within its territory, including through the acquisition of existing enterprises, a commercial presence.' '6. A Member may impose terms, conditions and procedures for authorization of the establishment and expansion of a commercial presence in so far as they do not circumvent the Member's obligation under paragraph 5, and they are consistent with the other obligations of the Agreement. Part D further clarifies the conceptual understanding of commercial presence in the following manner:

scope/nature of commitments. The Understanding also contains additional obligations such as standstill Part A (paragraphs 3, 4), government-procurement (Part A paragraphs 3, 4), new FS (Part B paragraph 7), transfer/processing of information (Part B paragraph 8) and non-discriminatory measures (Part B paragraphs 10, 11).

Paragraph A of the Understanding states that '[a]ny conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures'. The Understanding on FS's 'standstill provision' in effect requires the non-creation of new regulations (or reverse liberalisation). This would in effect prohibit the implementation of prudential measures that result in the reversal of financial services commitments undertaken. For instance, Korea, in its schedule of commitments, undertakes standstill provisions in its financial services commitments in Modes (1), (2), and (3) for both market access and national treatment commitments, with effect 31 August 1997. Hypothetically, if Korea were to implement financial regulation in the wake of the 2008 financial crisis, whether it be macro or microprudential regulation (e.g. restrictions on legal form or proprietary trading) it could in effect amount to a roll back on financial services commitments undertaken under the Understanding on Financial Services.

a. New Financial Services

The WTO's Understanding on Financial Services defines new financial services as follows: 'A new financial service is a service of a financial nature, including services related to existing and new products or the manner in which a product is delivered, that is not supplied by any financial service supplier in the territory of a particular Member but which is supplied in the territory of another Member'¹⁷³. From a reading of the definition, it can be argued that a new microprudential regulation requiring a company to incorporate as a subsidiary or to segregate the provision of a financial entity's activities could potentially amount to a new financial service as it would relate to existing products as well as a change in manner in which a product is being delivered. If this is the case, then the provision relating to authorisation and registration as contained in several FTAs would apply (see *Table 13: Provisions relating to financial Form/Introduction of new financial Product and Cross Border Provision of Financial Services in select FTAs and BITS*).

"Commercial presence" means an enterprise within a member's territory for the supply of financial services and includes wholly- or partly-owned subsidiaries, joint ventures, partnerships, sole proprietorships, franchising operations, branches, agencies, representative offices or other organizations.'

¹⁷³ WTO Understanding on Commitments in Financial Services, Part D, paragraph 3.

Table 13: Provisions relating to financial Form/Introduction of new financial Product and Cross Border Provision of Financial Services in select FTAS and BITS

TPP	Article 11.7: New Financial Services Each Party shall permit a financial institution of another Party to supply a new financial service that the Party would permit its own financial institutions, in like circumstances, to supply without adopting a law or modifying an existing law. Notwithstanding Article 11.5(b) (Market Access for Financial Institutions), a Party may determine the institutional and juridical form through which the new financial service may be supplied and may require authorisation for the supply of the service. If a Party requires a financial institution to obtain authorisation to supply a new financial service, the Party shall decide within a reasonable period of time whether to issue the authorisation and may refuse the authorisation only for prudential reasons. 11.6 Cross-Border Trade 11.6 (3) Without prejudice to other means of prudential regulation of cross-border trade in FS, a Party may require the registration or authorisation of cross-border financial services suppliers of another Party and of financial instruments.
EU-Singapore	Yes, for permission for cross-border and new FS Article 8.53: permitted for like financial services suppliers, institutional/juridical form may require authorization, given within reasonable time and can only be refused on prudential grounds. Possible requirement for registration or authorisation of cross-border financial suppliers/financial instruments subject to national treatment and prudential regulation requirements (Article 8.5 (5)).
US-Korea	New financial products: permitted; parties can, however, require specific juridical forms and authorisation prior to operation. Moreover, permissions can be denied only on prudential reasons, with decisions to be made within a reasonable period of time (Article 13.6). Registration of cross-border providers of FS and FS products may be required (Article 13.5(3)).
US-Singapore	New financial products: permitted; parties can, however, require specific juridical forms and authorisation prior to operation. Permissions can be denied only for prudential reasons, with decisions to be made within a reasonable period of time (Article 13.6).

(Continued)

Table 13: (Continued)

India-Singapore	Like the GATS Understanding provision to allow new financial service/products if authorised to do business by a public entity and if such an FS is permitted within the accepting jurisdiction to its domestic suppliers. Specification on juridical/institutional form as well as authorisation may be required. Authorisation can only be refused on prudential grounds (Annex 7C, paragraph 4). Possibility for incorporation of new financial services including those that become technologically feasible at a later stage in future reviews (Article 7.2 (4)).
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Source: Author Compilation

This raises two questions. First, as businesses are being restructured and remodeled as a result of regulation relating to the legal form and the segregation of activities, would the services supplied by the new entities be considered a new financial service? For instance, would the separation of commercial and deposit-taking activities of banks from trading and riskier activities amount to the provision of a new financial product or a new financial service. Second, with discussion on fintech and emerging financial services and modes of delivery, would these amount to new financial services and on what terms would they be permitted to enter the market?

Similar provisions permitting new financial services and products are contained in several of the FTAs (see *Table 13: Provisions relating to financial Form/Introduction of new financial Product and Cross Border Provision of Financial Services in select FTAs and BITS*) but subject to certain authorisation and qualification requirements. Moreover, as greater regulatory attention is paid to financial product safety, consumer protection, and risk management, regulation relating to the kind of legal form and proprietary trading could be subject to additional regulatory requirements.

5. Capital Transfer Provisions in the GATS/FTAs/BITS

GATS Article XI relates to payments and transfers and specifies the following:

1. Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments.

2. Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund.

Article XII of the GATS relates to circumstances under which restrictions on international payments can be maintained. It is a balance-of-payment safeguard mechanism which enables members with developing or transitioning economies to adopt or maintain restrictions on trade-in-services commitments undertaken, including related payments/transfers for transactions in the event of serious balance-of-payments and external financial difficulties or threat thereof, subject to specified conditions.

Most BITS and FTAs advocate free movement of capital linked to covered investments or trade-in-services commitments undertaken without restriction, with similar kinds of exceptions in the case of payments and transfers and balance of payment safeguards. *See Table 24: Coverage of Capital Transfer and Balance of Payment Safeguard Provisions in select FTAs.* A more in-depth discussion on capital transfer provisions and balance-of-payment safeguard measures under the GATS and FTAs/BITS is covered in Chapter 3 of this thesis, which relates to macroprudential regulation – specifically the usage of capital controls.

D. The Investment Architecture as contained in the Fair and Equitable Standard in FTAs/BITS and its Interpretation in Case Law.

The investment architecture is contained in select provisions/chapters of FTAs (*Figure 8: FET and other Investment Provisions in preferential Trade Agreement*) as well as BITS¹⁷⁴. BITS and FTAs contain several clauses designed to protect investors against arbitrary and discriminatory treatment by the host government. These include the most-favoured-nation clause, the non-discrimination clause, the fair and equitable treatment clause and the expropriation clause. Depending on the

¹⁷⁴ Most of the older BITS dating back to the 1980s were created to address foreign direct investment considerations directed towards mineral, natural resources and utilities industries.

specific provisions in the treaty and their application, these provisions could, in the current situation, undermine the flexibility of the host government to undertake prudential regulation measures.

Most FTAs and BITS include FET provisions, with degrees of variations, each with implications regarding its scope and content¹⁷⁵. In a recent study of PTAs notified to the WTO, it was found that approximately one-quarter of the agreements in the sample include no FET provision, while 76% of agreements include FET provisions, of these, around two-thirds (66%) reference international law¹⁷⁶.

In ISDS cases, the FET standard is one of the most relied-upon standards by tribunals, including for decisions related to the financial sector. Given the changing policy stance on micro and macroprudential regulation, the ambiguity of financial regulation provisions in BITS and FTAs, and the simultaneous investor protection afforded by the FET standard coupled with ISDS, there is the strong possibility of the FET standard being used as a basis for challenging the adoption of post-2008 crisis prudential regulation.

1. Conceptual Understanding of the fair and equitable Treatment Standard

The FET standard is one of several general standards of treatment that appears in most BITS, FTAs, and several international agreements on the promotion and protection of foreign investment. Broadly, it provides for the treatment of a foreign investor in a manner that is fair and equitable, thereby providing a yardstick by which relations between foreign direct investors and governments of capital-importing countries may be assessed.

The FET standard is an absolute or non-contingent standard of investment protection in a given situation without reference to how other investments or entities are treated by the host state¹⁷⁷. This is unlike other investment protection standards

¹⁷⁵ Jo-Ann Crawford and Barbara Kotschwar, 'Investment Provisions in Preferential Trade Agreements: Evolution and Current Trends', 14th December 2018, WTO Staff Working Paper ERSD-2018-14.

¹⁷⁶ Jo-Ann Crawford and Barbara Kotschwar, 'Investment Provisions in Preferential Trade Agreements: Evolution and Current Trends', 14th December 2018, WTO Staff Working Paper ERSD-2018-14.

¹⁷⁷ UNCTAD, 'Fair and Equitable Treatment – A Sequel', 2013, Page 6, UNCTAD Series on International Investment Agreements II, UN, New York.

¹⁷⁸such as MFN or national treatment, which are relative standards, contingent on the treatment of other investments and/or entities. In the financial sector it would therefore apply to investments made by financial entities into a given economy, where the FET standard would govern the terms and conduct of such an investment.

The origins of the FET standard can be found in the Havana Charter of 1948, which contemplates the ‘just and equitable treatment’ of foreign investment¹⁷⁹. Thereafter, the FET standard was further developed in BITs between developed and developing countries, where parties agreed to grant each other FET in investment matters, and was used to call upon an independent third party to settle disputes in cases of FET violation¹⁸⁰.

However, despite being in place since 1948, it was only in roughly the year 2000 that the FET standard started to be actively invoked in most investor arbitrations. In fact, a 2009 UNCTAD study noted that ‘FET remains the most relied upon and successful basis for a treaty claim’¹⁸¹. As a legal standard, it has replaced direct/indirect expropriation claims as the most invoked and successful provision in investor arbitration¹⁸², successfully used to challenge conduct by all branches and levels of government¹⁸³, including within the financial sector.

¹⁷⁸ Walker, H, ‘Modern treaties of friendship, commerce and navigation’, *Minnesota Law Review*, 1957–1958, Page 811, also pages 805–824, Vol. 42 (1957–1958).

¹⁷⁹ Article 11 (2) (a) (i) of the Havana Charter for an International Trade Organisation 1948, sets out ‘to assure just and equitable treatment for the enterprise, skills, capital, arts and technology brought from one Member country to another’. Though the Havana Charter did not enter into force, the term ‘just and equitable’ has served as a precedent for subsequent efforts to reach agreement on treatment standards for foreign investment in international law. Other earlier formulations of the FET standards can be found in bilateral friendship, commerce and navigation treaties concluded during the 1940s and 1950s. For a further in-depth history of the FET standard, see UNCTAD Series on International Investment Agreements II, Fair and Equitable Treatment, Page 6, 2012.

¹⁸⁰ UNCTAD Series on issues in international investment agreements, Vol.3.

¹⁸¹ UNCTAD, ‘Fair and Equitable Treatment – A Sequel’, 2013, Page 3, UNCTAD Series on International Investment Agreements II, UN, New York.

¹⁸² Christoph Schreuer, Fair and Equitable Treatment, See also: Review of recent investment arbitration decisions 2012–2013, by IISD.

¹⁸³ Lise Johnson, Lisa Sachs (November 2015), page 4. For example, out of 23 known (published) ‘wins’ by investors under U.S. trade and investment agreements, nearly 75% (17) have found violations of ‘fair and equitable treatment’ or ‘minimum standard of treatment’. Source: Public Citizen, Memo on “‘Fair and Equitable Treatment’ and

Table 14: Overview of Fair and Equitable Treatment Provisions in select FTAS

FTA/BIT	FET coverage
TPP	Yes, there is a minimum standard of treatment in accordance with customary international law and not beyond (i.e. no additional rights) for FET and full protection and security. This includes the obligation not to deny justice in accordance with principles of due process and police protection. Failure to act according to investor expectations and non-grant/renewal or maintenance of a subsidy/grant even if there is loss of damage does not necessarily-constitute a breach of FET (Article 9.6). Annex 9A sets out a definition of customary international law as results from a general and consistent practice of states arising from a sense of legal obligation. The minimum standard of treatment of aliens refers to all customary international law principles that protect the investments of aliens. Brunei Darussalam, Chile, Mexico and Peru did not accept submission of a claim to arbitration for a breach of Article 9.6 (Minimum Standard of Treatment) in relation to any act or fact that took place or any situation that ceased to exist before 5 years of signing the agreement in the case of Brunei, Chile and Peru and 7 years in the case of Mexico. Further arbitration claims for breach of minimum standard of treatment submitted for loss or damage cannot be claimed (Annex 11 E).
EU-Singapore	Article 9.2 ‘Standard of Treatment’: FET to include measures that deny justice, due process, arbitrary conduct, harassment, and breach of investor’s legitimate expectations arising from specific representations on which investment is based. Other measures can also be implemented if agreed by the Trade Committee. Moreover, where a contractual obligation has been given by a Party it should not be frustrated by the exercise of governmental authority deliberately or by altering the terms of the contract.
EFTA-Singapore	Article 39 (1) and (2): Requirement to create and maintain stable, equitable and favourable conditions for investors to make investments.

(Continued)

Investors’ Reasonable Expectations: Rulings in U.S. FTAs & BITs Demonstrate FET Definition Must be Narrowed’, September 2012, Accessible at <http://www.citizen.org/documents/MST-Memo.pdf>.

Table 14: *(Continued)*

FTA/BIT	FET coverage
US-Korea	FET in accordance with customary international law minimum standard (Article 11.5 (1). Customary international law is defined as resulting from general/consistent practice of states followed from a sense of legal obligation and protecting the economic rights and interests of aliens (Annex 11 A). Annex 11 B specifies that for greater certainty, whether an investor's investment-backed expectations are reasonable depends in part on the nature and extent of governmental regulation in the relevant sector. For example, an investor's expectations that regulations will not change are less likely to be reasonable in a heavily regulated sector than in a less heavily regulated sector. Considerations include whether the sacrifice expected by the investor exceeds what is considered to be in the public interest.
US-Singapore	FET in accordance with customary international law minimum standard Annex 15 B specifies that, for greater certainty, whether an investor's investment-backed expectations are reasonable depends in part on the nature and extent of governmental regulation in the relevant sector. For example, an investor's expectations that regulations will not change are less likely to be reasonable in a heavily regulated sector than in a less heavily regulated sector. Considerations include whether the sacrifice expected by the investor exceeds what is considered to be in the public interest.
India-Singapore	No obvious FET clause
ASEAN	Investment to be accorded FET Treatment, no less favourable than that granted to investors of MFN (ASEAN Agreement on Investment Article 3.2 and Article 4.2). FET reiterated in the 1998 Agreement (ASEAN framework agreement on AIA 1998, Article 5(a)) that it requires member states to not deny justice in legal/administrative processes in accordance with the principle of due process (ASEAN Comprehensive Agreement, Article 11(2)).

Source: Author Compilation

2. Fair and Equitable Treatment Standards in Free Trade Agreements, Bilateral Investment Treaties

In addition to several US and EU FTAs (*Table 14: Overview of fair and equitable Treatment Provisions in select FTAs*), several international agreements make reference to the FET standard, including the OECD Draft Convention on the Protection of Foreign Property adopted in 1967¹⁸⁴, the Multilateral Investment Guarantee Agency, the 1998 OECD multilateral draft treaty on investment issues¹⁸⁵, and the World Bank Guidelines on FDI¹⁸⁶.

The GATS and FTAs through national treatment and MFN clauses also indirectly incorporate the FET standard. A 2002 document prepared by the WTO Secretariat for the Working Group on the Relationship between Trade and Investment¹⁸⁷ states that the principle of ‘fair and equitable treatment’ has its roots in customary international law and is generally considered ‘to cover the principle of non-discrimination, along with other legal principles related to the treatment of foreign investors, but in a more abstract sense than the standards of MFN and national treatment’ (*Table 14: Overview of fair and equitable Treatment Provisions in select FTAs*).

Two general approaches recognised in FET standard formulation in FTAs/BITs are the minimum standard and autonomous standard approach. *Table 15: Kinds of FET Clauses in FTAs and BITS – Examples* sets out a classification of select FET standards based on these two approaches. The minimum standard approach establishes customary international law as the baseline, with some FET formulation going beyond customary international law. The autonomous standard approach is an unqualified formulation of the FET obligation and does not incorporate/make specific reference to international law. A recent WTO study indicates that most agreements have some manner of FET formulation, and 66% of those with an

¹⁸⁴ Article 1 (a) ‘Treatment of Foreign Property: Each Party shall at all times ensure fair and equitable treatment to the property of the nationals of the other Parties ...’ The Draft Convention was never opened for signature.

¹⁸⁵ The 1998 OECD multilateral draft treaty on investment issues also contemplated that, with respect to investment protection, the basic standard would include fair and equitable treatment.

¹⁸⁶ Article III (2) states that ‘each State will extend to investments established in its territory by nationals of any other State fair and equitable treatment according to the standards recommended in the Guidelines.’

¹⁸⁷ WTO, Working Group on the Relationship between Trade and Investment, Non-Discrimination, Most Favoured-Nation Treatment and National Treatment, 4 June 2002, Note by the Secretariat, WT/WGTI/W/118.

Table 15: Kinds of FET Clauses in FTAS and BITS-Examples

MINIMUM STANDARD APPROACH	
Focus on customary international law with FET as a subset of customary international law	
NAFTA (1992)	Article 1105(1) states that the parties ‘shall accord to investments of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.’ Each Party shall accord to covered investments treatment in accordance with customary international law including FET and full protection and security.
US Model BIT (2004)	Article 5 (1) The concepts of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights. Article 5 (2) This states that the fair and equitable treatment obligation ‘prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to covered investments’. <i>See also provisions of US-Singapore, US-Korea FTAs</i>
TPP	Article 9.6: Minimum Standard of Treatment Each Party shall accord to covered investment treatments in accordance with applicable customary international law principles, including fair and equitable treatment and full protection and security. For greater certainty, paragraph 1 prescribes the customary international law minimum standard of treatment of aliens as the standard of treatment to be afforded to covered investments. The concepts of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights. ‘Fair and equitable treatment’ includes the obligation not to deny justice in criminal, civil or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world; and, for greater certainty, the mere fact that a Party takes or fails to take an action that may be inconsistent with an investor’s expectations does not constitute a breach of this Article, even if there is loss or damage to the covered investment as a result.

(Continued)

Table 15: (Continued)

MINIMUM STANDARD APPROACH	
Focus on customary international law with FET as a subset of customary international law	
FET provided a protection above the customary international law baseline.	
US Model BIT 1994 Art. II(3)(a)	‘Each party shall at all times accord to covered investments FET and full protection and security and shall in no case accord treatment less favourable than that required by international law.’
Canada’s Foreign Investment Protection and Promotion Agreement model	‘The Minimum Standard of Treatment ensures investments of investors, fair and equitable treatment and full protection and security in accordance with the principles of customary international law. The minimum standard provides a “floor” to ensure that the treatment of an investment cannot fall below treatment considered as appropriate under generally accepted standards of customary international law.’
AUTONOMOUS STANDARD APPROACH	
Independent standard where the FET has no reference to customary or international law	
EU agreements	‘Investments and activities with investments of investors of either Contracting Party shall be accorded fair and equitable treatment ...’ Cambodia-Cuba BIT (2001) states: <i>‘Investments of investors of either Contracting Party shall at all times be accorded fair and equitable treatment and shall enjoy adequate protection and security in the territory of the other Contracting Party.’</i> See also provisions of EU-Singapore, EFTA-Singapore agreements in Table 5 and BIT between China and Zimbabwe Article 3(1).
No express FET clause	
India Model BIT Article 3.1	No Party shall ‘subject investments ... to measures which constitute a violation of customary international law through denial of justice in any judicial or administrative proceedings; or fundamental breach of due process; or targeted discrimination on manifestly unjustified grounds, such as gender, race or religious belief; or manifestly abusive treatment, such as coercion, duress and harassment’ (see Article 3.1). See also provisions of India-Singapore agreements in Table 5.

Source: Author Compilation

FET formulation reference international law¹⁸⁸. More recent treaties, meanwhile, have started to include some additional language that clarifies the meaning of the obligation.

The approaches taken in FTAs or BITs are relevant as they have implications for the determination of FET violation. For instance, FTAs/BITS with a minimum standard FET formulation would require a reference/application of customary international law, whereas FTAs/BITS that follow the autonomous standard approach are unlikely to require a similar application of customary international law. The approach taken as to whether micro or macroprudential regulation can amount to FET breaches may depend on the formulation of the specific treaty obligation.

a. Minimum Standard FET

FET has been identified as one of the elements of the minimum standard of treatment of foreigners and their property, as required by international law¹⁸⁹. The international minimum standard sets several basic rights established by international law that states must grant to aliens, independent of the treatment accorded to their own citizens. Violation of this norm engenders the international responsibility of the host state and may pave the way for international action on behalf of the injured alien provided that the alien has exhausted local remedies¹⁹⁰.

¹⁸⁸ Jo-Ann Crawford and Barbara Kotschwar, 'Investment Provisions in Preferential Trade Agreements: Evolution and Current Trends', 14th December 2018, WTO Staff Working Paper ERSD-2018-14.

¹⁸⁹ Gann, 'The US Bilateral Investment Treaty Program', 1985, *Stanford Journal of International Law*, 21. Also RK Paterson, 'Canadian Investment Promotion and Protection Treaties', 1991, *Canadian Yearbook of International Law*, 29. See also UNCTAD, 'Bilateral Investment Treaties in the Mid-1990s' (1998) '... this standard covers an array of international legal principles, including non-discrimination, the duty of protection of foreign property and the international minimum standard.'

¹⁹⁰ The classical monograph on the principle is A. H. Roth, 'The Minimum Standard of International Law Applied to Aliens', 1949, Leiden, where it is defined as follows (p. 127): '... the international standard is nothing else than a set of rules, correlated to each other and deriving from one particular norm of general international law, namely that the treatment of alien is regulated by the law of nations'. The American Law Institute's Restatement (Second) of Foreign Relations Law of the United States, 1965, paragraph 165.2, defines the standard in the following terms: 'The international standard of justice ... is the standard required for the treatment of aliens by: (a) the applicable principles of international law as established by international custom, judicial and arbitral decisions, and other recognized sources or, in the absence of such applicable

This would mean there is an express link between the requirement to accord FET and the customary international law minimum standard of treatment of aliens. Under customary international law, foreign investors are entitled to a certain level of treatment, which in turn gives rise to liability on the part of the state¹⁹¹. A breach of the FET minimum standard approach therefore appears to entail a more serious breach of international law as opposed to contractual understanding by Parties to an FTA.

From *Table 15: Kinds of FET Clauses in FTAs and BITS-Examples*, we can observe that the minimum standard FET in BITS and FTAs is generally found in the North American FTAs and BITS, e.g. TPP, US model BIT 2012, US-Korea, US-Singapore, etc. These minimum standard treaty formulations obligate the contracting parties to accord covered investments treatment in accordance with the minimum customary international law standard and expressly include the concepts of fair and equitable treatment and full protection and security (e.g. the BIT between US-Uruguay (2005))¹⁹².

The TPP elaborates on this through a non-exhaustive list of measures, including ‘the obligation not to deny justice in criminal, civil or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world ...’ This approach leaves ample leeway for the arbitral tribunals to expand on this non-exhaustive list¹⁹³.

The coverage of minimum standard approach FET generally specifies two elements. The first is the extension of FET coverage as per the principles of customary international law as a minimum treatment standard. For instance, NAFTA Article 1105(1) states that ‘Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.

principles, (b) analogous principles of justice generally recognized by States that have reasonably developed legal systems’

¹⁹¹ Matthew Coleman and Thomas Innes, ‘Investor State Arbitration and the Fair and Equitable Treatment Standard’, May 19, 2015, Last accessed 5th October 2020 at: <http://www.steptoe.com/publications-10464.html>.

¹⁹² US-Uruguay BIT, 2005, Article 5.

¹⁹³ See TPP Article 9.6.

NAFTA Free Trade Commission (FTC) clarified the interpretation of Article 1105 (1) on July 21, 2001¹⁹⁴ by prescribing the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party. The concepts of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that, although this is required by the customary international law minimum standard of treatment of aliens.

A second key element is the definition of customary international law, which is found within the FTA itself, as is the case for the TPP, US-Korea, US-Singapore FTAs and US-Uruguay (2005)¹⁹⁵. See *Table 15: Kinds of FET Clauses in FTAs and BITS-Examples*. It is important to note that while the TPP and most recent US FTAs state that customary international law ‘[results] from a general and consistent practice of States that they follow from a sense of legal obligation’, tribunals have ignored similar provisions contained in the Dominican Republic-Central America FTA¹⁹⁶, relying instead on an expansive interpretation that includes an obligation to honour the investor’s ‘expectations’¹⁹⁷.

International financial regulation is recognised as a system of ‘international soft law’ that includes non-binding standards, guidelines, and statements that have a powerful influence on the behaviour of countries, public entities, and private parties¹⁹⁸. An important question in the context of FET would be whether international financial regulation falls within the purview of customary international law and the general/consistent practice of states?

As per the UN, the following sources may act as forms of evidence of customary international law: treaties, decisions of national and international courts, national legislation, opinions of national legal advisors, diplomatic correspondence, and

¹⁹⁴ Such an interpretation was made pursuant to NAFTA Article 2001 (2) c which grants the FTC the power to resolve disputes that may arise regarding the Agreement interpretation or application. Article 1131 (2) stipulates that an interpretation by the Commission of a provision of the Agreement shall be binding on a tribunal established under Section B of Chapter XI.

¹⁹⁵ US-Uruguay BIT, 2005, Annex A.

¹⁹⁶ See Annex 10B of the Dominican Republic-Central America FTA.

¹⁹⁷ See: *Railroad Development Corporation v. Guatemala and TECO Guatemala Holdings v. Guatemala* referenced in Public Citizen (2015) ‘Secret TPP Investment Chapter Unveiled: It’s Worse than We Thought’, page 11.

¹⁹⁸ Kern Alexander, ‘Principles of Banking Regulation’, 2019, Chapter 3 ‘International Banking Regulation’, Pages 62, Cambridge University Press.

practice of international organisations¹⁹⁹. This in effect would mean national legislation, IMF Articles of Association, G20 Declarations, policy papers issued by international organisations, FSB policy papers ICSID as well as jurisprudence of national courts, investor-state and WTO tribunals could form customary international law and be used as a defense in future treaty-based disputes. (See Chapter 6 for an more in depth discussion on the potential applicability of customary international law)

b. Autonomous FET or no FET

The autonomous FET, as well as FTAs or BITS that do not contain an FET clause, do not create an express link between FET and the customary international law minimum standard of treatment or any other criteria to determine the content of the standard. European FTAs and BITS have traditionally opted for the unqualified ‘fair and equitable’ treatment standard, as indicated in *Table 15: Kinds of FET Clauses in FTAs and BITS-Examples*, which shows this is the case for the EU-Singapore, EFTA-Singapore, and the UK and Netherlands model BITS.

By not referring to a fixed reference point, i.e. customary international law, the autonomous FET standard approach creates a degree of uncertainty and ambiguity as to the standard of protection to be applied, i.e. customary international law or an independent standard. This in essence means a straightforward assessment is made as to whether a particular foreign investor has been treated fairly and equitably, without reference to any technical understanding of the meaning of ‘fair and equitable treatment’²⁰⁰.

The India model BIT, the Brazil-Malawi, as well as the India-Singapore CECA (2005) do not contain specific FET clauses in their investment chapters. The formulation of fair and equitable treatment in Article 11 of the ASEAN Comprehensive Investment Agreement (2009) includes greater detail but remains vague by not specifying the standard to be applied.

The reason behind non-inclusion of FET clauses in the India and Brazil approach appears to be the desire to limit the potential for an expansive interpretation of State Parties’ obligations in regard to the standard of treatment of the investment.

¹⁹⁹ See UN General Assembly Resolution on ‘Identification of customary international law’, 11th January 2019, UNGA A/RES/73/203.

²⁰⁰ Arghyrios A. Fatouros, ‘Government Guarantees to Foreign Investors’, 1962, Page 215, Columbia University Press.

The Indian model BIT, however, does seek to maintain an approach in line with practice under customary international law²⁰¹.

3. Fair and Equitable Treatment Interpretation in Investor State Dispute Settlement – relevant Elements of the FET Standard

While most legal systems strive to achieve fairness and equity as a matter of course, the precise meaning of the concept of FET has been open to discussion, which is primarily because the notions of ‘fairness’ and ‘equity’ fail to establish a clear set of legal prescriptions, making their applications difficult²⁰². As the case law set out below indicates, there are several elements that have been associated with FET through the decisions of arbitral tribunals. These elements include transparency, due process, stability, investors’ legitimate expectations, compliance with contractual obligations, action in good faith, and freedom from coercion/harassment, amongst others.

a. Host State should act in a transparent Manner

Table 16: Issue FET Requirement for Host to Act in a transparent Manner

Case	Finding
<i>Metalclad Corp v. Mexico</i> (2000)	Relevant legal requirements must be readily known to foreign investors, with no room for doubt. Set extraordinarily high standards for public regulation and upheld NAFTA transparency provision.

Source: *Author Compilation*

Foreign investors expect the state to act in a transparent manner. This seems to entail (i) the timely publication of relevant laws and regulations so that investors can discern conditions to be fulfilled in the host jurisdiction²⁰³ and (ii) in some cases the opportunity for prior comment in the case of new rules/regulations.

²⁰¹ The Indian Model recalls through a footnote that ‘customary international law’ only results from a general and consistent practice of States that follows from a sense of legal obligation. See footnote 1 in the Indian Model BIT.

²⁰² UNCTAD Series on issues in international investment agreements, Vol.3.

²⁰³ The general obligation of transparency is found in GATS Article III, which requires that members publish all relevant laws and regulations and set forth clear standards so that foreign traders can discern exactly what conditions must be fulfilled in order to conduct trade in the host jurisdiction. Moreover, national authorities must notify the

In *Metalclad v. Mexico*, the tribunal used NAFTA's treaty obligation of 'transparency'²⁰⁴ to set a high stringent standard of application for NAFTA Article 1105. The tribunal ruled that a NAFTA state should ensure that all relevant legal requirements must be capable of being readily known to foreign investors and that there should be no room for doubt or uncertainty on such matters²⁰⁵. The *Metalclad Award* has been criticised for setting extraordinarily high standards for public regulation, which are difficult to attain²⁰⁶.

A failure to act in a transparent manner in administrative decision-making was a central consideration for the tribunals in *Metalclad Corp v. Mexico* (2000) and *Genin et al. v. Estonia* (2001). A similar approach was adopted in the *Tecmed v. Mexico* award where the tribunal held that a state must 'act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor'²⁰⁷.

In the financial sector, excessively transparent regulation can potentially undermine the ability of the regulator to achieve prudential objectives, especially in crisis situations, as has been seen since the 2008 crisis. On the other hand, it has also been pointed out that in international trade regulation, transparency can be used to justify certain regulatory practices that might place some countries at a competitive disadvantage vis-à-vis other countries, thereby serving a protectionist agenda²⁰⁸.

Council for Trade in Services of any changes in regulations that apply to services that are subject to specific commitments. Similar provisions are reflected in several FTAs and BITS.

²⁰⁴ NAFTA Article 102 (1).

²⁰⁵ *Metalclad v. Mexico Award*, paragraph 76.

²⁰⁶ Julian Alvarez, 'Contemporary Foreign Investment Law: An Empire of the Law or the Law of the Empire? (2008–2009) 60 *Alabama Law Review* 944, 964–965 as quoted in Kurtz Jurgén, *The WTO and International Investment Law: Converging Systems*, 2016, Pages 136–137, Cambridge International Trade and Economic Law, Cambridge University Press.

²⁰⁷ *Tecnicas Medioambientales Tecmed SA v. Mexico*, Award (ICSID Case No. ARB (AF)/00/2, 29 May 2003), paragraph 154.

²⁰⁸ Kern Alexander, *The GATS and financial services: the role of regulatory transparency*, Cambridge Review of International Affairs, Volume 20, Number 1, Page 119, March 2007.

b. Host State should act in a consistent and non-arbitrary Manner

Table 17: Issue FET Requirement for Host to act in a consistent and non-arbitrary Manner

Case	Finding
<i>MTD v. Chile (2004)</i>	State should <i>act in good faith and in a consistent manner</i> so as not to affect the basic expectations that the foreign investor took into account while making his investment
<i>Genin v. Estonia (2001), also CME v. Czech Republic</i>	State actions against a foreign investor should not be arbitrary and must be founded on reason or fact

Source: Author Compilation

The State should act in good faith and in a consistent manner so as not to affect the basic expectations that the foreign investor took into account while making his investment. A decisive factor in the *MTD v. Chile (2004)* case was the inconsistency of conduct vis-à-vis the investor between the host state agencies: encouragement and approval of the investment by the Foreign Investment Commission on the one hand, and denial of the necessary zoning permits on the other.

Furthermore, the State should not act in an arbitrary manner²⁰⁹. The prohibition against manifestly arbitrary treatment requires that actions taken against a foreign investor must be founded on reason or fact and not on prejudice²¹⁰. Thus, whether an action is arbitrary or not depends on the motivations and objectives behind the action²¹¹.

For the financial sector and our discussion on post-2008 financial crisis regulation, such as capital controls, proprietary trading, etc., the assessment of administrative conduct under FET as being transparent, consistent, non-arbitrary, proportionate and in keeping with due process is most relevant.

²⁰⁹ Alex Genin, *Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia* (ICSID Case No. ARB/99/2).

²¹⁰ See also *CME v. the Czech Republic*, Partial Award, 13th September 2001.

²¹¹ Coleman Matthew, Innes Thomas, 'Investor State Arbitration and the Fair and Equitable Treatment Standard', May 19, 2015, Last accessed 5th October 2020 at: <http://www.steptoe.com/publications-10464.html>.

c. The Requirement to fulfill a foreign Investor's Legitimate Expectations

Table 18: Issue FET Requirement to fulfill a foreign Investor's Legitimate Expectations

Case	Finding
<i>Tecmed v. Mexico</i> (2003)	Treatment of foreign investors so as not to affect their basic expectations. States to act transparently and consistently, so that the investor can be aware in advance of the regulations governing investment and thus be able to plan.
<i>Rumeli Telekom A.S. and Telsim Mobil Telekomikasyon Hizmetleri A.S. v. Kazakhstan</i> (2008)	Investors have a legitimate expectation at the time when they make their investment that the host state, acting in good faith, will treat their investments in a <i>just, consistent, transparent, even-handed, non-arbitrary, and non-discriminatory manner</i> .

Source: Author Compilation

'Legitimate expectations' covers expectations arising from an investor's reliance on a host state's representations, promises and commitments. The tribunal in *Tecmed v. Mexico* (2003) stated that *'the good faith principle established by international law requires Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were considered by the foreign investor in making its investment. The foreign investor expects the host State to act in a consistent manner; free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.'*²¹²

Based on a reading of the *Rumeli Telekom A.S. and Telsim Mobil Telekomikasyon Hizmetleri A.S. v. Kazakhstan* (2008)²¹³ and *Tecmed v. Mexico* (2003) case, it can be said that investors have a legitimate expectation at the time they make their investment that the host state, acting in good faith, will treat their investments in a just, consistent, transparent, even-handed, non-arbitrary, and non-discriminatory manner, as well as following due process and acting proportionately without

²¹² *Tecmed v. Mexico* (2003) paragraph. 154). The *Tecmed v. Mexico* case defined the scope of the FET standard based on an autonomous interpretation under the Spain-Mexico BIT as well as principles of international law and the good faith principle.

²¹³ In this case, the relevant Turkey-Kazakhstan BIT did not contain a fair and equitable treatment standard, but the obligation was imported through the use of a most-favoured-nation (MFN) clause.

coercion or harassment. These requirements are not dependent on a representation from the state but are instead rooted in international norms (particularly the concept of good faith).

Assurances given by the host state which give rise to ‘legitimate expectations’ can take the form of (a) specific commitments addressed to the investor personally and (b) more general rules enacted with the specific aim of inducing foreign investment. The common factor in either case is that the investor must have relied on these assurances while making its investment. FET, market access, national treatment and liberalisation commitments undertaken in the GATS and other international instruments as well as BITS and FTA could therefore be considered to be general commitments made to investors in the financial sector given that they are directly linked to ‘covered investments’ and ‘financial services commitments’ undertaken.

d. Onus on the Host State to maintain a stable Business and Legal Environment

Table 19: Issue FET Requirement for Host to maintain a stable Business and Legal Environment

Case	Finding
<i>Occidental v. Ecuador</i> (2004)	Failure to provide a stable and predictable regulatory framework was a violation of both general international law and the US-Ecuador BIT which provided for FET that should not be less than international law the stability of the legal and business framework is an essential element of fair and equitable treatment
<i>CMS Gas Transmission Co v. Argentina</i> (2005)	‘Fair and equitable treatment is inseparable from stability and predictability’ founded on solemn legal and contractual commitments.

Source: Author Compilation

The transparency element of the FET standard potentially implies that there is an onus on the host state to maintain a stable business and legal environment. This has been upheld by several ICSID cases, e.g. *Occidental v. Ecuador* (2004) and *CMS Gas Transmission Co v. Argentina* (2005). In *Occidental v. Ecuador* (2004), the tribunal found that Ecuador had breached the FET standard when its tax agency decided that Occidental Exploration and Production Company was not

entitled to claim reimbursement for VAT on oil exports, despite the fact that it had been so entitled when it originally made its investment.

The tribunal found that Ecuador's failure to provide a stable and predictable regulatory framework was a violation of both general international law and the US-Ecuador BIT, which stated that FET should not be less than that expected under international law²¹⁴. Specifically, the tribunal held that '[t]he stability of the legal and business framework is ... an essential element of fair and equitable treatment'²¹⁵.

In *CMS Gas Transmission Co v. Argentina*, government measures were found to violate the FET standard because they altered the legal and business environment under which the investment was made²¹⁶. In the CMS case, following the monetary crisis in Argentina, emergency laws and arrangements, which imposed devaluation of the peso on tariff arrangements, were imposed. The claimant CMS challenged the emergency laws and arrangements, claiming that at the time it made its investment it was entitled to the calculation of tariffs in US dollars, conversion into pesos at the time of billing, and periodic adjustment of tariffs in accordance with the US Producer Price Index.

The tribunal found that the new laws and arrangements introduced by the Argentine government breached the FET standard as contained in the US-Argentina BIT²¹⁷, which dictates that such treatment be no less than that required under international law. The CMS tribunal stated that the '[T]reaty standard of fair and equitable treatment and its connection with the required stability and predictability of the business environment founded on solemn legal and contractual commitments, is not different from the international law minimum standard and its evolution under customary law.'²¹⁸

In the case of the financial sector, these interpretations of maintaining a stable legal and business environment can potentially contradict the existing trend in the financial sector towards reregulation and the current position on the acceptable use of macroprudential regulations such as capital controls as well as areas of microprudential regulation. It can be argued that the trade and investment architecture were relied upon by investors and financial services suppliers at the time

²¹⁴ Article 2(3)(a) of the US-Ecuador BIT.

²¹⁵ *Occidental v. Ecuador* (2004), Paragraph 183.

²¹⁶ *CMS Gas Transmission Co v. Argentina*, 2005, Paragraphs 273–281.

²¹⁷ Article 2(2)(a) of the US-Argentina BIT.

²¹⁸ *CMS Gas Transmission Co v. Argentina* (2005), Paragraph 284.

of making investments. However, after the 2008 financial crisis, the legal and business environment has changed substantially as a result of market conditions and regulatory action.

e. Investor Protection versus Host State's Regulatory Policy Space

In light of the above, a key issue linked to the investor's legitimate expectation is whether the FET provision can act as a standstill provision in the regulatory context. The onus under the FET standard to maintain a stable legal and business environment for foreign investors can inhibit or come in the way of the host state's ability to regulate, which in the case of the financial sector is crucial for maintaining financial market stability.

Table 20: Issue FET Requirement for Investor Protection vis-à-vis Legitimacy of Host State's Regulatory Action and Host State's Regulatory Flexibility

Case	Finding
Saluka (2006)	Foreign investors' expectations for unchanged regulatory circumstances to be weighed against Host State's right to regulate in public interest.
<i>Duke Energy et al. v. Ecuador</i> (2008)	Investors' expectations must be reasonable and legitimate at the time of investment, and the investor must have relied on the State's conditions while making an investment.
<i>Alex Genin et al. v. Republic of Estonia</i> (2001)	Administrative/regulatory action was objective and reasonable.
<i>Pope & Talbot Incorporated v. Canada</i> , 2002	Regulatory action must have a proportionate impact on the foreign investor, falling equally on everyone.
<i>International Thunderbird v. Mexico</i> (2006)	Investor due diligence is required, and the investor should take responsibility for meeting the requirements of local law, with ignorance of the law being no defense.

Source: Author Compilation

While upholding the protection of investors' legitimate expectations, tribunals have also sought to ensure that the host state has a reasonable degree of regulatory flexibility such that it can respond to changing circumstances in the public interest. For instance, Saluka (2006) observed that 'No investor may reasonably expect that the circumstances prevailing at the time the investment is made, will remain totally unchanged. In order to determine whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right

subsequently to regulate domestic matters in the public interest must be taken into consideration as well.²¹⁹

In *Duke Energy et al. v. Ecuador* (2008), the tribunal emphasised the following limitations:

*'To be protected, the investor's expectations must be legitimate and reasonable at the time when the investor makes the investment. The assessment of the reasonableness or legitimacy must take into account all circumstances, including not only the facts surrounding the investment, but also the political, socioeconomic, cultural and historical conditions prevailing in the host State. In addition, such expectations must arise from the conditions that the State offered the investor, and the latter must have relied upon them when deciding to invest.'*²²⁰

These tribunal proceedings, alongside the 'prudential exceptions' and balance-of-payment safeguards contained in international trade and investment agreements, as well as the special case of the financial sector, which warrants greater regulatory flexibility, can provide a defense in ISDS cases, where the claim is based on the FET standard and questions macro and macroprudential regulation.

This approach of protecting regulatory flexibility in the face of an investor's legitimate expectations is also reflected in some FTAs, such as the US-Singapore and US-Korea agreements²²¹. The TPP further clarifies this, noting that 'the mere fact that a Party takes or fails to take an action that may be inconsistent with an investor's expectations does not constitute a breach of the Article [on minimum standard of protection] ...'²²²

f. Measuring the Legitimacy of the Host States Regulatory Action

FET elements of consistency, good faith, and transparency raise the question as to the manner in which the legitimacy of regulatory action undertaken by the Host state is likely to be assessed? In weighing the state's regulatory interest, tribunals have considered the following as mitigating factors: (i) Objectivity of the administrative/regulatory action: In *Alex Genin et al. v. Republic of Estonia* (2001), the tribunal held that the Bank of Estonia's revocation of the claimant's license did not violate the FET standard. The tribunal found that even though the Bank's conduct

²¹⁹ *Saluka v. Czech Republic*, paragraph 305.

²²⁰ *Duke Energy et al. v. Ecuador* (2008), Paragraph 320.

²²¹ See Annex 11 B of the US-Singapore agreement.

²²² See TPP Article 9.6.4.

failed to meet the standards of international best practice, the Bank had good cause to revoke the license and had acted reasonably²²³. (ii) Proportionality of the impact on the foreign investor: If the regulatory action does not have a disproportionate impact on the foreign investor, but rather falls equally on everyone, the probability of a tribunal identifying a breach is likely to be less. (*Pope & Talbot Incorporated v. Canada*, 2002).²²⁴

Investor due diligence and conduct: In *International Thunderbird v. Mexico* (2006), the investor provided incomplete and misleading information to the State regulator and knew that there was a risk that its planned investment, which involved gaming activities, might breach host state law. The tribunal held that the investor should take responsibility for meeting the requirements of local law, with ignorance of the law being no defense²²⁵.

These instances are potential areas of defense that can be transposed to the financial sector in defense of government action, in the event of a dispute involving the use of micro or macroprudential regulation. For instance, in the case of capital controls, if the host state or the region in question has a history of use of capital controls habitually, e.g. China or in anticipation of or after a financial crisis, e.g. several ASEAN and Latin American countries, then it is possible that the onus of showing adequate due diligence had been undertaken would lie with the investor.

Furthermore, where the investor moved ahead with an investment in the financial sector in spite of bad market conditions, e.g. subprime mortgage, Argentinean debt purchase, or the bad state of a particular financial entity (e.g. buying into a crisis-hit public sector bank such as RBS or JP Morgan), an investor's argument of FET is unlikely to hold.

²²³ *Genin v. Estonia*, Award, 25 June 2001, paragraphs 363–365.

²²⁴ *Pope & Talbot Incorporated v. Canada*, 2002, paragraphs 71–72.

²²⁵ *International Thunderbird Gaming Corporation v. Mexico*, NAFTA/UNCITRAL, Award, 26 January 2006, paragraphs 151–159.

g. Impact on treaty Interpretation: Customary International Law in both the Minimum and Autonomous FET Standard

Table 21: Issue FET Requirement for Application of Customary International Law in Minimum and Autonomous FET Standard

Case	Finding
<i>Neer v. Mexico</i> (1926)	– ‘The treatment of an alien, in order to constitute an international delinquency, should amount to an outrage, to bad faith, to willful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency.’
<i>ADF Group v. USA</i> (2003)	– Requirement to accord FET ‘must be disciplined by being based upon State practice and judicial or arbitral case law or other sources of customary or general international law’.
<i>Pope and Talbot</i> (2001)	– Customary international law is evolving. Tribunal noted that the ICJ had ‘moved away from the Neer formulation’, highlighting the evolution towards a higher threshold of investor protection against state conduct.
<i>Mondev v. U.S.</i> (2002)	– Customary international law evolved beyond Neer decision.
<i>Glamis Gold</i> (2009)	– An act must be sufficiently egregious and shocking – a gross denial of justice, manifest arbitrariness, blatant unfairness, a complete lack of due process, evident discrimination or a manifest lack of reasons, so as to fall below accepted international standards and constitute a breach of NAFTA Article 1105 (a). – Customary international law is evolving. Tribunal required the claimant to provide evidence that custom had moved in the direction pleaded by it.

Source: Author Compilation

The treaty formulation of the FET, i.e. minimum standard versus autonomous standard is important as it determines the scope of application of the FET standard and the extent the FET standard would apply to prudential measures. The minimum standard approach contained in US FTAs and BITS follows a narrow interpretation of FET linked directly to customary international law. In the case where FET is a subset of customary international law, it would mean that FET cannot operate independently of customary international law. This raises two issues: (i) What

customary international law is to be adhered to? (ii) To what extent is customary international law to be applied?

The application of traditional customary international law on FET can be traced back to the *Neer v. Mexico* (1926) case, in which the Mexico/United States Claims Commissioners held that ‘the treatment of an alien, in order to constitute an international delinquency, should amount to an outrage, to bad faith, to willful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency.’²²⁶ Since the *Neer* decision customary international law has evolved; however, the question of the international law standard, which the host state is required to meet, is a recurring question.

With the requirement of the host state to meet an international standard, the question arises as to what exactly the international standard is. The tribunal in *ADF Group* set out that the requirement to accord FET does not allow a tribunal to adopt its own idiosyncratic standard but ‘must be disciplined by being based upon State practice and judicial or arbitral case law or other sources of customary or general international law’²²⁷. Given the dichotomy in opinions on the use of capital controls, the recent reemergence of the use of capital controls, and pronouncements of the IMF and G20 on this issue, this is a moot question. On the other side is the established provisions on capital transfer contained in FTAS and BITS.

A second issue is that customary international law is constantly evolving. The application of the *Neer* test has evolved over time, a fact highlighted in *Pope v. Talbot* (2002), in which the tribunal noted that the ICJ had ‘moved away from the *Neer* formulation’, highlighting the evolution towards a higher threshold of investor protection against state conduct²²⁸. Later, in *Mondev v. U.S.* (2002), the tribunal rejected the standard as formulated in the *Neer* case and stated that ‘the

²²⁶ The issue for the tribunal was whether the failures of the Mexican authorities in apprehending and punishing the murderers of an American citizen were sufficient to give rise to ‘an international delinquency’. The Commission ultimately found that it was not so.

²²⁷ *ADF Group, Inc. v. United States of America*, Award, 9 January 2003, 6 ICSID Reports 470, paragraph 184. See also *Mondev International Ltd. v. United States of America*, Award, 11 October 2002, ICSID Reports 192, paragraph 119.

²²⁸ *Pope v. Talbot*, 2002 UNCITRAL/NAFTA, Award in Respect of Damages (May 31, 2002), paragraphs 57–60.

content of the minimum standard today cannot be limited to the content of customary international law as recognized in arbitral decisions in the 1920s.’²²⁹

h. Autonomous FET Approach

In cases where the FTA/BITS does not refer to customary international law, the autonomous or plain-meaning approach is applied. Adopting the autonomous approach, the tribunal makes an objective assessment based on the facts of the case and the underlying rationality of host state regulatory choice²³⁰. The autonomous approach therefore permits the tribunal considerable discretion in its assessment as to whether a breach of the FET standard has occurred.

The ‘plain meaning’ approach is likely to provide limited guidance to tribunals, as the tribunal in MTD (2004) found by quoting the Concise Oxford English Dictionary: ‘In their ordinary meaning, the terms “fair and equitable” [...] mean “just,” “even-handed,” “unbiased,” “legitimate.”’

The difference in the application of the interpretative approaches is significant because if the FET standard is seen as equivalent to the customary international law standard, then it will be subject to an objective test. In general, with the minimum standard approach, tribunals are less likely to identify a breach of the standard in circumstances where the FET is a linked FET standard; indeed, in such circumstances, tribunals have held that there must be a high level of shock, arbitrariness, unfairness, or discrimination before the host state will be held to have breached the standard. The customary international law standard provides comparatively more predictability, though certainty is not absolute since arbitral tribunals have treated its evolution in different ways²³¹.

By contrast, in circumstances where the standard is an autonomous FET standard, the threshold for breach is lower and has been expressed in terms such as ‘mani-

²²⁹ *Mondev International Ltd. v. United States of America*, Award, 11 October 2002, ICSID Reports 192, paragraph 119.

²³⁰ This approach has been suggested by Jurgen Kurtz in the context of a state’s invocation of scientific justification for measures undertaken. See Kurtz Jurgen, *The WTO and International Investment Law: Converging Systems*, 136–137, Cambridge 2016, page 137.

²³¹ Edwin Borchard, ‘The “Minimum Standard” of the Treatment of Aliens’, 1940, 38 Mich LR 445.

festly unfair or unreasonable'²³². On the positive side, the tribunal has the option of interpreting the FET standard based on the specifics of the dispute. In *Rumeli Telekom A.S. and Telsim Mobil Telekomikasyon Hizmetleri A.S. v. Kazakhstan* (2008), the tribunal noted that the FET standard in treaties is 'intentionally vague in order to give tribunals the possibility to articulate the range of principles to achieve the treaty's purpose in particular disputes'.²³³

Customary international law is inherently evolutionary. The direction of its movements in the case FET is applied to the financial sector would have to be proved. In *Glamis Gold Ltd. v. US*, the tribunal required the claimant to provide evidence that custom had moved in the direction pleaded by it.²³⁴

Whether following the minimum standard or autonomous approach to the application of the FET standard, there are several implications for the financial sector. The first is based on the FTA/BITS under consideration, i.e. the application of the more restrictive minimum standard (US FTAs/BITS), which makes a reference to the international standard of law or customary international law or the fact/circumstance-oriented autonomous standard (more EU FTAs/BITS), which gives effect to the intention of the Parties to the treaty.

Second, which customary international law is to be adhered to and to what extent is it to be applied? Would the principles, guidelines, decisions, and even research of international standards-setting bodies (Basel Committee, IAIS, IOSCO, FSB, IMF) provide a basis for customary international law application and its evolution, given that they act as standards for national governments to incorporate? The IMF, for instance, permitted capital control on outflows in Iceland, Ukraine, and Latvia as the crisis hit, and has recommended that nations such as Brazil, Colombia, and India use controls on inflows to tame the mass influx of capital that herded to emerging markets in 2009–2010. In 2010, the IMF went a step further and recommended that a system of global coordination be put in place for capital controls, an initiative the G-20 took up in 2011. For the financial sector and particularly in relation to capital controls, it is highly likely that a tribunal would defer to interna-

²³² Coleman Matthew, Innes Thomas, 'Investor State Arbitration and the Fair and Equitable Treatment Standard', May 19, 2015, Last accessed 5th October 2020 at: <http://www.steptoe.com/publications-10464.html>.

²³³ *Rumeli Telekom A.S. and Telsim Mobil Telekomikasyon Hizmetleri A.S. v. Kazakhstan*, paragraph 583. In this case, the relevant Turkey-Kazakhstan BIT did not contain a fair and equitable treatment standard, but the obligation was imported through the use of a most-favoured-nation (MFN) clause.

²³⁴ *Glamis Gold Ltd. v. US*, Award (UNCITRAL, 8 June 2009) paragraph 601.

tional bodies such as the IMF and Basel Committee and to international standards such as Basel 3.

4. Conclusions

Definitions in GATS, FTAs, and BITS determine the application and scope of trade and investment architecture. Given the wide scope and coverage of the GATS and more recent FTAs and BITS, several definitions relating to investors, financial services suppliers, investment, regulation, measures, services, financial services, regulators apply to post-2008 financial crisis micro and macroprudential regulation. ISDS jurisprudence has also been expansive on several aspects of definitions, particularly those relating to ‘investment’, e.g. the Salini test. However, ISDS jurisprudence on the definition of investment can and has varied and at times been contradictory, thereby giving arbitrators ample leeway in their interpretation. Therefore, definitions in negotiations and dispute settlement under investment and trade treaties are important as it is crucial to have a clear understanding of their application to prudential regulation, particularly in the dispute settlement context.

The general and specific obligations contained in the trade and investment architecture maintain a balance between protecting investor/financial services suppliers’ rights/interests, while at the same time upholding regulatory flexibility, particularly for financial regulators. Given the existing trade and investment architecture there are several points of incompatibility between post-2008 financial crisis regulation and existing trade and investment architecture. For instance, the Understanding on FS’s ‘standstill provision’ in effect requires the non-creation of new regulations (or reverse liberalisation); however, depending on WTO members’ commitments under the Understanding and the fact that certain aspects of post-2008 financial regulation amounts to reregulation or new regulation, this is a point of contradiction. Furthermore, while the flexibility of the financial regulator is upheld under the prudential carve-out and the balance-of-payment safeguards, the extent of this flexibility is untested. These discussions become increasingly relevant as the financial sector continues to deal with regulation linked to fintech, environmental finance, and Brexit, amongst other things.

The prudential carve-out contained in the GATS and FTAs affords WTO Members and Parties to an FTA a high level of discretion regarding measures implemented for prudential reasons, thus allowing a Member to breach its GATS or FTA obligations provided such a derogation is not used for protectionist purposes to avoid commitments or obligations undertaken. The Prudential carve-out is an exception, however, that is wider than other GATS exceptions or at least not on a par

with other GATS exceptions, e.g. those related to security or environment which require a ‘necessity test’. A prudential measure undertaken under the prudential carve-out is therefore not likely to be challenged on the grounds of ‘necessity’ or being ‘least trade restrictive’.

The seemingly broad definition of the prudential carve-out (with a pro-regulation touch) enables authorities to adopt measures to protect the safety and soundness of the financial system, the integrity of financial markets, and the financial interests of investors and consumers, if they are applied even-handedly. Macro and micro-prudential regulation set out by financial regulators in the wake of the financial crisis are linked to clear prudential reasons, namely protecting the stability of the financial system in response to the 2008 financial crisis, and would therefore fall under the prudential carve-out.

While the general academic view is that the prudential carve-out offers Members a high level of regulatory flexibility with the expectation that WTO Members will act in good faith, the prudential carve-out is still to be fully interpreted by a WTO dispute settlement body. The Argentina – Financial Services dispute, which was the first case to address the prudential carve-out, upheld regulatory flexibility. Some of the key aspects of jurisprudence set out by the Argentina – Financial Services dispute in respect of the prudential carve-out include protection of regulatory flexibility, establishing a kind of criteria for determining a prudential measure being the need to link the cause (i.e., the prudential reason for the effect, i.e. the measure), the need to show risk/injury does not have to be imminent and a decision can be made on a case-by-case basis according to the design, structure, and architecture of the measure. The Panel decision accepted avoidance of or minimising of systemic risk as a prudential measure, while at the same time recognising the protection of investor rights. The natural corollary of the decisions of the Panel and Appellate Body, if applied to post-2008 crisis financial regulation, is that it would on the face of it be covered under the GATS prudential carve-out, unless it was able to be shown that the measures were adopted for protectionist reasons.

Moreover, the Argentina – Financial Services dispute highlights that all WTO Members have an interest in the work of international financial regulatory bodies, such as the BCBS and the FSB, where prudential regulation in the financial sector is being evaluated and standards are being set.

Since prudential carve-outs in FTAs follow the GATS model, they will raise the same issues. However, given variations in the provisions of some US FTAs, there is greater leeway for ISDS given the express reference to it. Furthermore, in some US FTAs the narrow interpretation of ‘prudential measures’, which focuses on

individual financial institutions, may not cover systemic considerations or macroprudential regulation such as capital controls.

Most BITS and several FTAs contain either minimum standard or autonomous FET clauses, which is also the most invoked clause in ISDS dispute settlement. Depending on the circumstances and the provisions of the FTA/BIT under consideration, the FET standard could cover micro and macroprudential regulation under the 'legitimate expectations of the investor' and the 'maintenance of legal and business stability' provisions. Two key case-law-based elements of the FET standard that would offer investors a degree of protection but could potentially jeopardise the position of host state financial regulators are (i) the requirement to fulfill a foreign investor's legitimate expectations and (ii) the onus on the host state to maintain a stable business and legal environment.

However, there are also ICSID cases that have upheld the legitimacy of the host states' regulatory actions both in ISDS and state-to-state (WTO) dispute settlement. This approach of protecting regulatory flexibility in the face of an investor's legitimate expectations is also reflected in some FTAs, e.g. TPP, US-Singapore, and US-Korea agreements, indicating that a breach of investor's 'expectations' will not alone constitute basis to bring a claim of breach of minimum standard of protection. Yet, implicitly, this approach provides that breach of an investor's 'expectations' may be relevant in establishing a violation of FET and minimum standard of protection.

The reflection of autonomous or minimal standard treatment within the FET is potentially relevant to any future dispute settlement case. The difference in the application of the interpretative approaches is significant because if the FET standard is seen as equivalent to the customary international law standard, as in the case of US FTAs, then it will be subject to an objective test requiring a reference to customary international law, meaning that tribunals are less likely to identify a breach of the standard. In the past, tribunals have held that there must be a high level of shock, arbitrariness, unfairness, or discrimination before the host state will be held to have breached the standard. By contrast, in circumstances where the standard is an autonomous FET standard, as is the case for European FTAs/BITS, it is unlikely there will be a reference to customary international law, making the threshold for breach lower and allowing for case-by-case settlement.

An important question in the context of FET would be Does guidelines/standards set by international financial bodies and incorporated into national law, fall within the purview of customary international law, and what would be the source for general/consistent practice of states? As per the UN, the following sources may act as

forms of evidence of customary international law: treaties, decisions of national and international courts, national legislation, opinions of national legal advisors, diplomatic correspondence, and practice of international organisations. This in effect would mean national legislation, IMF Articles of Association, G20 Declarations, policy papers issued by international organisations, FSB policy papers ICSID as well as jurisprudence of national courts, investor-state and WTO tribunals could form customary international law and be used as a defense in future treaty-based disputes.

The above discussion becomes relevant for the financial sector in light of ongoing structural discussions relating to ISDS based on the EU proposal for an ISDS court, but in particular market changes relating to fintech, environment regulation, Brexit, and the rise of financial sector disputes.

III. Post Crisis Macroprudential Regulation: The Case of Capital Flow Measures

A. Introduction

The use of capital flow management measures, including capital controls (‘CFMs’)²³⁵ by governments as a tool for maintaining financial stability prior to the 2007 financial crisis was not encouraged as it was considered a hindrance to trade in services and investment. However, volatile capital movements after the 2007–2008 financial crisis, and more recently following the COVID-19 pandemic, have once more prompted a rethink regarding the use and effectiveness of CFMs.

The international trade architecture as contained in the WTO, FTAs, and BITS require the movement of capital in areas where investment or trade-in-services commitments have been undertaken, which may run contrary to CFM measures. Several of these trade and investment agreements, particularly the more recent ones, contain investor-state dispute settlement provisions, while many BITS and FTAs contain the equivalent of the fair and equitable treatment clause, raising questions around conformity and incompatibility between CFMs and the international trade and investment architecture.

Chapter 3 seeks to examine the use of CFMs in the context of the wider trade and investment architecture, including the FET clause, to understand areas of potential contradiction as well as the importance of regulatory flexibility given contradictions between the usage of CFMs and the trade and investment architecture. Part B provides a conceptual understanding of capital controls/CFMs and the arguments for and against their usage. It outlines the post-2008 financial crisis usage of capital controls by national government and their broader impact.

Part C then outlines the international trade and investment architecture as it relates to capital flows as contained in the GATS, IMF, as well as select bilateral investment and trade treaties. It offers a closer examination of the free transfer of capital and balance-of-payment safeguard provisions contained in these agreements to determine how they can impact the usage of CFMs. It also explores the applicability of elements of the FET standard and related case law to the use of capital controls. After that, Part D provides an overview of the interlinkage and potential

²³⁵ The term ‘capital flow measures’ (or ‘CFMs’) may be used interchangeably with the term ‘capital controls’ in this chapter. A detailed description of both kinds of measures is provided in Part B of this chapter.

incongruencies between the usage of CFMs, capital transfers provisions contained in FTAs/BITS, and the application of the FET standard. It does this by comparing FTAs/BITS provisions relating to investment, trade in services, prudential exception/BoP safeguard provisions, inclusion of the FET standard, and dispute settlement provisions. It then analyses what these provisions would mean for the application of capital control measures/CFMs.

Hypothetical Situation of Capital Control Interface with the Trade and Investment Architecture – US Korea FTA

Korea imposes capital controls, e.g., quotas on capital withdrawals. A US bank operating as a subsidiary in Korea does not anticipate such capital controls, resulting in a loss in its ability to withdraw/move funds to the US or elsewhere. The US-Korea FTA sets out that Korea is within its rights to impose such capital controls up to one year. However, due to a financial-crisis-like situation, Korea has extended the use of capital controls beyond one year. The US investors filed for ISDS under the US-Korea FTA under the grounds of (i) violation of Annex 11-G (usage of capital controls) of the US-Korea FTA (ii) violation of FET-like provisions Article 11.5 read with Chapter 15 (Financial Services), and the government's inability to maintain a stable business and legal environment, resulting in substantial loss to the US investor. The regulators arguments is regulatory flexibility protection under US-Korea FTA provisions and the GATS prudential carve-out, given the wider objective of maintaining systemic stability in the Korean economy.

B. Description of Capital Flow Management Measures, their Economic Rationale and Their Usage post the 2008 Financial Crisis

1. Capital Controls and CFM Measures: What are they?

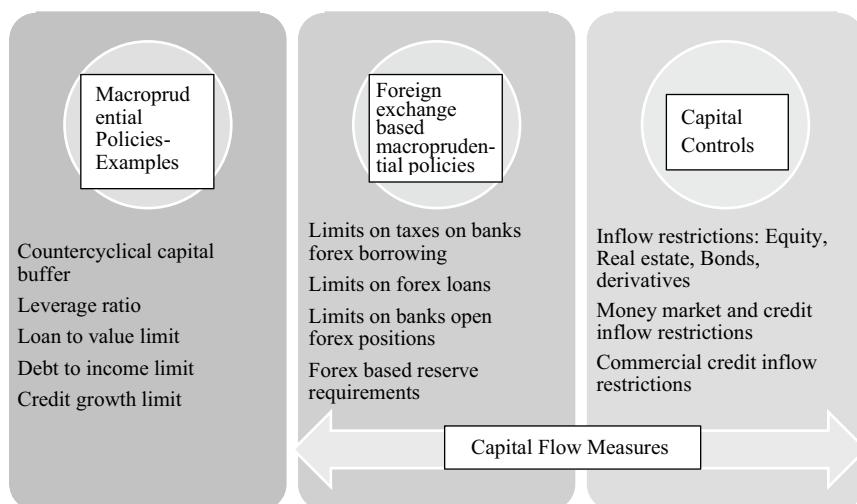
In order to counter the volatility of short-term, generally speculative capital flows, some countries utilise 'capital controls' or regulatory measures to smooth the amount and composition of capital flows. BIS defines capital controls as 'restrictions on cross-border trade in assets'²³⁶. This would more broadly include measures taken by a government or central bank to limit the inflow or outflow of foreign capital into the domestic economy²³⁷.

²³⁶ See Gurnain Kaur Pasricha, 'Policy rules for capital controls', November 2017, Page 2, BIS Working Papers No 670, Monetary and Economic Department.

²³⁷ http://www.investopedia.com/terms/c/capital_control.asp.

There can also be an overlap between macroprudential regulations and capital controls, with some kinds of foreign-exchange-based macroprudential regulation, e.g. limits on forex lending and forex-based reserve requirements, having a similar effect as capital controls, leading to the use of the term ‘capital flow management’ measures by the IMF, which includes capital controls²³⁸.

Figure 4: Capital Controls and Capital Flow Management Measures



Source: Author Construction drawn from Frost Jon, Ito Hiro, Van Stralen Rene, ‘The effectiveness of macroprudential policies and capital controls against volatile capital inflows’, June, 2020, Bank for International Settlements

Groups capital controls as a type of macroprudential regulation based on its ability to alter/limit the behaviour of financial institutions’ contributions to systemic risk²³⁹. Both types of measures, i.e. capital controls and CFM measures, are utilised for the purposes of protecting systemic stability. For the purposes of this

²³⁸ The IMF defines CFMs as measures that are designed to limit capital flows. CFMs comprise two types of measures: (i) residency-based measures, which are measures affecting cross-border financial activity that discriminate based on residency (i.e., between residents and nonresidents); and (ii) other CFMs, which are measures that do not discriminate by residency but are nonetheless designed to limit capital flows. See IMF 2018 Taxonomy of Capital Flow Management Measures.

²³⁹ Xavier Freixas, Luc Laeven, and José-Luis Peydró, ‘Systemic Risk and Macroprudential Regulation’, June 2015, Chapter 9, ‘Systemic Risk, Crises, and Macroprudential Regulation’, MIT Press.

chapter, the terms ‘capital controls’ and ‘capital flow management measures’ will be used interchangeably.²⁴⁰

Governments implement a range of CFM measures depending on their desired objective. As a result, measures may be categorised into economy-wide, sector (financial)-wide, or industry-specific, by type (e.g. debt, equity, direct investment), duration (e.g. short-, medium-, or long-term investment), or direction (inflows versus outflows) of capital flows.

Broadly speaking, capital controls take two forms. (1) They can be ‘administrative’, or direct, controls. Direct controls involve prohibitions on specific types of transactions, quotas, rule-based, or discretionary approval, limits on forex loans, and minimum-stay requirements, e.g., India in 2013 reduced its permitted remittances from \$200,000 per year to \$75,000 per year²⁴¹. (2) They can also be ‘market-based’, or indirect, controls²⁴². Indirect controls rely primarily on explicit or implicit taxation to discourage capital flows²⁴³, e.g. transaction tax on currency exchanges.

2. Volatile Capital Flows and their Systemic Impact

Over the last two decades, the volatility and the pro-cyclicality of private capital flows, particularly in times of financial crisis, have become a reasonably pronounced feature of international capital movements²⁴⁴. Such in-flows come in surges, often bearing little relationship to the economic fundamentals of the coun-

²⁴⁰ See Atish Ghosh, Mahvash Qureshi, and Jonathan Ostry, *Taming the Tide of Capital Flows: A Policy Guide*, 2018 Cambridge: MIT Press.

²⁴¹ Press Release, Reserve Bank of India, ‘RBI Announces Measures to Rationalize Foreign Exchange Outflows by Resident Indians’, August 14, 2013, Last accessed 08/10/2018, at http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=29309

²⁴² Akira Ariyoshi, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Iván Canales-Kriljenko, and Andrei Kirilenko, ‘Capital Controls: Country Experiences with Their Use and Liberalization’, 2000, IMF Occasional Paper No. 190.

²⁴³ Duncan Williams, ‘Policy Perspectives on the Use of Capital Controls in Emerging Market Nations: Lessons from the Asian Financial Crisis and a Look at the International Legal Regime’, 2001 70 *Fordham L. Rev.* 561

²⁴⁴ John Williamson and Zdenek Drabek, ‘Whether and When to Liberalize Capital Account and Financial Services’, 1999, World Trade Organization, Staff Working Paper ERAD-99-03.

try, and leave the country when they are most needed (in a downturn)²⁴⁵. The volatility of capital flows can quickly destabilise an economy, as was the case in the 1997 Asian crisis, when short-term international bank lending quickly dried up²⁴⁶.

Two outcomes can arise from such volatile capital flows. The first is massive capital inflows followed by rapid outflows, which can have devastating economic or financial-sector-wide impacts²⁴⁷. Second, unrestrained capital flows have the potential to cause currency values to rise above their intrinsic value, with potential trade impacts²⁴⁸. For instance, after the 2008 financial crisis, investors looking for a 'safe haven' rushed to purchase Swiss francs on several occasions, a phenomenon which caused the Swiss Central Bank to buy its own government bonds in a bid to prevent over valuation/appreciation of the Swiss franc.

In analysing short-term capital flows (portfolio flows and short-term bank loans), it is necessary to distinguish between capital inflows (being preferable) and capital outflows (non-desirable).

Capital outflows are typically associated with capital flight or financial crises, where residents lose the real value of their savings and non-residents are unable to repatriate their capital. Capital outflows are a greater cause of concern for central banks as sudden reversals in international capital flows have the potential to bring about immediate macroeconomic stability. This is exacerbated by the possibility that international investors, specifically speculative ones, may withdraw funds at the same time, especially in times of crisis²⁴⁹.

Capital inflows, though preferable, can also cause problems such as asset bubbles or exchange rate appreciation. For instance, surges in capital inflows could fuel excess credit expansion in specific sectors, e.g. real estate or stock market, leading

²⁴⁵ For instance, in a country such as Chile, which was deeply integrated with the world financial markets, private foreign capital suddenly withdrew when copper prices fell.

²⁴⁶ Hal Scott and Anna Gelpern, 'Introduction', Chapter One in *International Finance: Transactions, Policy and Regulation*, Page 26, Foundation Press, 21st Edition, 2016.\

²⁴⁷ In emerging economies, capital flows can be particularly volatile as the economy may experience periods of rapid growth and subsequent contraction. Increased capital inflows can lead to credit booms and the inflation of asset prices, which may be offset by losses due to depreciation of the currency based on exchange rates and declines in equity pricing.

²⁴⁸ Andrew Cornford, 'Macprudential Regulation: Potential Implications for Rules for cross-border banking', Page 4, Paper presented at UNCTAD Expert meeting, 2014.

²⁴⁹ Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth, and Instability', 2000, *World Development*, Vol. 28, 1075–1086.

to asset bubbles. Surges in capital inflows may also prompt an unrealistic appreciation of the exchange rate, which in turn could pave the way for a future currency crisis. Laevens, for instance, suggests that macroprudential policies should focus on policies that stem short-term capital inflows prone to quick reversals through the imposition of liquidity requirements²⁵⁰.

While the focus is generally on liberalising or restricting capital outflows, over a period of time inflow and outflow controls have become inextricably linked and governments use both as policy tools.

3. Arguments for and against the use of Capital Controls/Capital Flow Management Measures

The argument for and against the use of capital controls is closely linked to the arguments for and against free transfer of capital or capital account liberalisation, which is an investor or trade protection provision found in the GATS and most FTAs and BITs.

Those in favour of capital account liberalisation argue that it would lead to global economic efficiency and optimal allocation of world savings, thereby enhancing social welfare. Capital account liberalisation could facilitate the diversification of investment and savings portfolios, enabling corporations to raise capital in international markets at a lower cost. For instance, free capital movements could help increase world welfare by transferring resources from ageing populations and lower rates of return in developed countries to younger populations and higher rates of return in newly industrialising countries. The IMF was a key proponent of the capital account liberalisation view; as a result, investor protection provisions on capital transfer are contained in the GATS and most FTA and BITs.

The theoretical case against unfettered capital movements for maximising the gains from trade and world economic welfare has been made by several economists. Stiglitz (2000)²⁵¹, for instance, argues that the concept of free movements of capital is fundamentally different from that of free trade in goods. The theory that financial liberalisation leads to global economic efficiency, based on the analogy

²⁵⁰ Xavier Freixas, Luc Laeven, and José-Luis Peydró, 'New Challenges for Regulatory Policy', June 2015, Chapter 11, 'Systemic Risk, Crises, and Macroprudential Regulation', MIT Press.

²⁵¹ Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth, and Instability', 2000, *World Development*, Volume. 28, issue 6, 1075–1086.

with free trade in goods, is flawed on several counts. Capital flows are subject to asymmetric information, agency problems, adverse selection, and moral hazard. Although such problems may also occur also in trade in goods and services, they are intrinsic to financial flows.

Delhaise (1998) points out that financial markets in general are sensitive, complex, yet indispensable, being the only source of financial intermediation. The impact of vulnerabilities, including those relating to capital flows, can therefore be catastrophic and at times not always reflective of the true market conditions. For instance, during the Asian financial crisis, panic resulted in investment decisions and capital withdrawals, which in turn caused a credit crunch and subsequent contagion to the region starting in Bangkok in July 1997²⁵². Kaminsky and Reinhart (1999), while exploring the links between financial liberalisation, banking, and exchange rate crises, found that banking crises and currency crises are closely related and that banking crises are often preceded by financial liberalisation²⁵³.

As a result of the divergence of opinion on free movement of capital there has been a divergence in the usage of capital controls. Prior to the global financial crisis in 2008, active management of capital inflows was discredited. As a result, countries reduced their usage of CFM measures, as was the case in East Asia prior to the East Asian crisis. After the financial crisis, there has been an acknowledgement of the use of CFMs as an effective macroprudential regulatory tool to limit foreign exchange risk, thereby mitigating systemic risks across the financial system²⁵⁴. An IMF study (2010) showed how capital controls were used to stem large short-term inflows of speculative investment entering economies and causing volatility in exchange rates and asset markets²⁵⁵. The study concluded that ‘capital controls – in addition to both prudential and macroeconomic policy – are justified as part of the policy toolkit to manage inflows.’²⁵⁶

²⁵² Phillippe Delhaise, ‘Asia in crisis: the Implosion of the Banking and Finance Systems’, Chapter 2, pages 11–31, Wiley and Sons (Asia), 1998.

²⁵³ Gracila Kaminsky and Carmen Reinhart, ‘The Twin Crises: The Causes of Banking and Balance-of-Payments Problems’, June 1999, American Economic Review.

²⁵⁴ Kern Alexander, Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges, Accessible at: <http://www.rwi.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

²⁵⁵ Jonathan Ostry, Atish Ghosh, Karl Habermeier, Marcos Chamon, Mahvash Qureshi, and Dennis Reinhardt, ‘Capital Inflows: The Role of Controls’, February 2010, IMF Staff Position Paper.

²⁵⁶ Jonathan Ostry, Atish Ghosh, Karl Habermeier, Marcos Chamon, Mahvash Qureshi, and Dennis Reinhardt, ‘Capital Inflows: The Role of Controls’, February 2010, IMF Staff Position Paper.

A 2011 IMF report further sets out guidelines for when nations should (and should not) deploy such measures and what form they should take²⁵⁷. In 2012, the IMF provided an ‘institutional view’ on the issue of usage of capital controls²⁵⁸. The IMF held that the ‘temporary re-imposition of capital flow management under certain circumstances is consistent with an overall strategy of capital flow liberalization’ and can therefore be used to prevent risks to stability together with macroeconomic adjustment and macroprudential measures.

This reversal of positions on the use of CFMs was reflected in other bodies as well. In 2011, for instance, the G20 recognised the potentially negative impact of volatile capital flows and called for a coherent international approach to international capital flows and necessary measures²⁵⁹, while a UN report advocated the careful use of capital controls on speculative capital²⁶⁰.

4. Post-2008 Financial Crisis Usage of Capital Flow Measures by Countries

A key characteristic of the global financial crisis has been the mass swings of capital flows across the globe. In an attempt to recover, some industrialised nations resorted to loose monetary policy with characteristically low interest rates, e.g. the US quantitative easing programme²⁶¹. With interest rates low in high-income countries, the carry trade brought massive inflows of speculative capital to emerging markets²⁶².

²⁵⁷ IMF, ‘Recent Experiences in Managing Capital Inflows – Crosscutting Themes and Possible Policy Framework’, February 14, 2011, Paper prepared by Strategy, Policy, and Review Department.

²⁵⁸ IMF, ‘The liberalization and management of capital flows: An institutional view’, November 2012, Washington, DC

²⁵⁹ G20, ‘Coherent Conclusions for the management of capital flows drawing on Country Experiences’, October 15, 2011, Last accessed June 2017 at: <http://www.g20.utoronto.ca/2011/2011-finance-capital-flows-111015-en.pdf>.

²⁶⁰ See the Report of the UN Commission of Experts on Reforms of the International Monetary and Financial System, September 21, 2009.

²⁶¹ Quantitative easing is the practice of buying bonds with newly created money.

²⁶² See Nouriel Roubini, ‘Mother of All Carry Trades Faces an Inevitable Bust’, November 9, 2009, Roubini Global Economist, and Garnam, Peter. ‘Fears rise for dollar carry trade future’. Financial Times, February 23, 2010.

Relatively higher interest rates and a stronger recovery triggered surges of capital flows into and out of emerging markets. For instance, in 2010, when the Fed started its second round of quantitative easing, inflows into emerging-market bonds surged and their currencies climbed. Then, in 2012, when emerging markets started to slow, and the Fed hinted that quantitative easing would stop, capital flows reversed directions. In September 2013, when the Fed did not stop its quantitative easing programme, flows changed direction again²⁶³. The result has been an increasing concern as to the manner in which this excess liquidity will lead to rapid credit growth, currency appreciation, and consequently asset bubbles and even inflation.

Emerging and developing countries generally increased their regulations during and after the 2008 global financial crisis. In fact, as the 2008 financial crisis unfolded, several emerging markets – Brazil, Indonesia, Korea, and Thailand – were faced with large capital inflows exceeding pre-crisis levels²⁶⁴. Laeven points out how capital controls as an example of a macroprudential tool were successfully used by Brazil and South Korea to prevent a crisis²⁶⁵. Uruguay (2008) increased reserve requirements for foreign currency deposits of nonresidents including foreign banks to limit risks of sudden stops and bank fragility²⁶⁶.

Table 22: Indicative List of Capital Management Measures used by Countries During the 2007/2008 Financial Crisis provides an overview of CFM measures implemented by several countries after the 2008 financial crisis. The CFM measures implemented by countries relate to prices and quantities, including taxes on certain forms of capital flows and derivative operations, minimum stay periods, ceilings on different types of capital flows, and derivative operations. Most controls target highly short-term capital flows, usually conducted for speculative purposes.

²⁶³ The Economist, ‘Capital: Just in case’, October 12, 2013.

²⁶⁴ IMF, ‘Recent experiences in managing capital inflows – Cross-cutting themes and possible policy framework’, February 2011, Prepared by IMF Strategy, Policy, and Review Department. Washington, DC.

²⁶⁵ Xavier Freixas, Luc Laeven, and José-Lui Peydró, ‘A Primer on Systemic Risk’, Chapter 2, ‘Systemic Risk, Crises, and Macroprudential Regulation’, June 2015, MIT Press.

²⁶⁶ Xavier Freixas, Luc Laeven, and José-Lui Peydró, ‘Systemic Risk and Macroprudential Regulation’, Chapter 9, ‘Systemic Risk, Crises, and Macroprudential Regulation’, June 2015, MIT Press.

Table 22: Indicative List of Capital Management Measures used by Countries During the 2007/2008 Financial Crisis

Country	Year	Capital management measure
Columbia	2007	– Unremunerated reserve requirements on inflows raised to 50% with a 2-year minimum stay on FDI.
Brazil	2009 2010	– Controls took the form of an entrance tax on certain capital transactions, together with other restrictions, mainly on short-term fixed-income securities. – In late 2009, as Brazil raced out of recession and money began to pour in, the authorities switched direction, initially imposing a financial-transactions tax of 2% on foreign purchases of stocks and bonds. In 2010, the tax was then broadened and raised to 6%.
Iceland	2008	– To limit capital flight from domestic banks
India	2013	– Reduced permitted remittances (the amount of money resident Indians can send abroad) from \$200,000 per year to \$75,000 per year. ²⁰ – India also reduced the amount of overseas direct investment in which Indian companies could engage, from 400% to 100% of a firm's net worth.
Indonesia	2010	– Implemented controls include a one-month minimum holding period for certain securities such as central bank papers and a limit on short-term borrowing by banks.
Peru	2009 2010	– Increased its fee on the purchase of central bank papers by non-residents (2010). – Foreign purchases of central bank bills banned (2009). – Capital gains tax on nonresidents' investments in the domestic stock market imposed (2010). – Private pension funds' limit on trading FX imposed for daily and 5-day periods (June 2010).
Korea	2009 2010	– South Korea, where the won has appreciated by 30% since 2008, has direct limits on foreign exchange speculation and has also levied an outflows tax on capital gains of foreign purchases of government bonds. – Reintroduced a withholding tax on foreign purchases of treasury and central bank bonds (mainly in the form of a tax on certain foreign-currency deposits).

(Continued)

Table 22: (Continued)

Country	Year	Capital management measure
Thailand	Around 2010	– Adopted a withholding tax on foreign investors in State bonds, while unremunerated reserve requirements limits have been placed on currency forward positions.
Turkey	2010	– Changed withholding tax rate on bonds issued by Turkish corporations abroad, with lower rates for longer maturities.

Source: *Author Compilation*

Note: *This is not an exhaustive but rather an indicative list. Several measures may have been phased out or altered. For a more exhaustive listing of post-2007/2008 financial crisis usage of capital control measures, see Magud N, Reinhart C and Rogoff K, ‘Capital Controls: Myth and Reality’, 2018, *Annals of Economics and Finance*, 19-1, 1–47.*

Erten and Ocampo’s (2017) analysis of the cross-country averages of capital account regulations across 51 emerging and developing economies from 1995 to 2015 indicates that the most commonly used measures are foreign-exchange-related regulations, followed by capital outflow controls, capital inflow controls, and financial sector regulations.

Based on this analysis of the usage of CFMs, Erten and Ocampo (2017) highlight the importance of CFMs for developing and emerging economies to address the externalities generated by international capital flows and to maintain financial stability²⁶⁷. However, other studies have indicated that while certain CFMs can accomplish specific goals – especially in terms of reducing financial vulnerabilities – most CFMs have limited effectiveness in accomplishing primary goals, namely reducing exchange rate appreciation and net capital inflows²⁶⁸. The Financial Stability Forum raised questions on the effectiveness of CFM measures, pointing out that the costs and benefits of capital controls are not clear. In some circumstances, e.g. crisis capital controls on inflows can serve a prudential purpose, but they should be transitional and cannot be a substitute for sound policy²⁶⁹.

²⁶⁷ Bilge Erten and Jose Antonio Ocampo, ‘Macroeconomic Effects of Capital Account Regulations’, 2017, *IMF Economic Review* 65 (2): 193–240.

²⁶⁸ K Forbes, M Fratzscher, and R Straub, ‘Capital Controls and Macroprudential Measures: What Are They Good For?’, December 1, 2013, *DIW Berlin Discussion Paper* 1343. Analysis of a sample of 60 countries from 2009–2011.

²⁶⁹ Meeting of the Financial Stability Forum, ‘Report of the Working Group on Capital Flows’, 5th April 2000, Page 35, 36.

The COVID-19 pandemic further highlighted the volatility of capital flows. When the COVID-19 shock hit international capital markets in March 2020, emerging market economies experienced the sharpest reversal of portfolio flows on record – more than \$100 billion within a month²⁷⁰. The scale and speed of outflows in the current crisis have been approximately four times larger than during the 2008 financial crisis²⁷¹. While it is too soon to evaluate which countries are applying CFM measures, early indications show that countries that have reduced foreign-currency reserve requirements, or otherwise relaxed regulations related to FX reserve requirements, include Indonesia, Turkey, and Peru²⁷².

While there are differing views on the effectiveness of CFMs vis-à-vis the larger economy, it would be safe to say that their success depends on the specificities of the measure, the situation being addressed, and on financial market conditions and wider economic conditions. Given the specificity and localised nature of CFM application, as well as the need to act swiftly in times of crisis, it can therefore be argued, at the very least, that flexibility of national governments in the usage of CFMs should be maintained.

C. Applicability of the International Trade and Investment Architecture to Capital Control Measures: Capital Transfer and Balance of Payment Safeguard Contained in International Agreements

1. Overview

The greater acceptance of the use of capital controls has once again raised questions around the compatibility of capital control and CFM measures with free transfer of funds provisions found in most international trade and investment agreements. Broadly speaking, transfer of fund provisions provide for outward

²⁷⁰ Tobias Adrian and Fabio Natalucci, ‘COVID-19 Crisis Poses Threat to Financial Stability’, April 14, 2020, IMF Blog Last Accessed 8/11/2020 at: <https://blogs.imf.org/2020/04/14/covid-19-crisis-poses-threat-to-financial-stability/>.

²⁷¹ OECD Policy Responses to Coronavirus (COVID-19), ‘COVID-19 and global capital flows’, 3rd July, 2020, Last visited 11/11/2020 at <http://www.oecd.org/coronavirus/policy-responses/covid-19-and-global-capital-flows-2dc69002/#indicator-d1e937>.

²⁷² OECD Policy Responses to Coronavirus (COVID-19), ‘COVID-19 and global capital flows’, 3rd July, 2020, Last visited 11/11/2020 at <http://www.oecd.org/coronavirus/policy-responses/covid-19-and-global-capital-flows-2dc69002/#indicator-d1e937>.

transfers derived from or associated with investments²⁷³ and/or profits or inward transfers of capital to be invested by a foreign investor for the purposes of making a new investment or developing/maintaining an existing investment²⁷⁴. This situation is complicated further by regulatory flexibility provisions such as the balance-of-payment safeguards and the prudential exception clauses in the same agreements, which also provide for dispute settlement provisions²⁷⁵. (See *Table 23: Overview of Provisions in the GATS and select FTAs Relating to Coverage, Capital Transfers, Prudential Flexibility, Fair and Equitable Treatment and Dispute Settlement Provisions*)

International trade and investment agreements cover capital movements inflows or outflows or both under (i) investment and/or cross-border trade in services or financial services chapters in the case of FTAs; (ii) standalone provisions in the case of BITs; (iii) specific provisions that address capital transfers in the case of multilateral agreements like the GATS and the OECD Codes on Capital Movements and on Current Invisible Operations ('OECD Code on Capital Movements').

As *Table 24: Coverage of Capital Movements and Safeguard Measures in select Trade and Investment Agreements* indicates, each treaty covers the movement of capital only partially and differently. The GATS and FTAs (US FTAs used as an example) cover only capital movements incidental to the scheduled services commitments. This implies a reduced coverage, often limited to the inflow and outflow of capital incidental to mode 1 and the inflow of capital necessary to establish a commercial presence. BITS are more restrictive, covering mostly the outflow of capital in the form of profits and interests incidental to the investment. The OECD Capital Code sets out precise obligations with regards to both inflow and outflow of capital incidental to listed operations.

²⁷³ The term 'investment' can be used to refer to any mechanism used for the purpose of generating future income. In the financial sense, this includes the purchase of bonds, stocks or real estate. See <http://www.investopedia.com/terms/i/investment.asp#ixzz4OKFyHRdq>.

²⁷⁴ UNCTAD and S Hagan, 'Transfer of Funds', 2000, UNCTAD Series on Issues in International Investment Agreements.

²⁷⁵ See Chapter 2 for an outline of the prudential carve-out provisions.

Table 23: Overview of Provisions in the GATS and select FTAS Relating to Coverage, Capital Transfers, Prudential Flexibility, Fair and Equitable Treatment and Dispute Settlement Provisions

FTA/BIT	Investment, financial services chapters	Freedom of capital transfer	Safeguard measures	Kind of FET provision	Kind of dispute settlement provision
GATS	Provisions for investment, financial services and cross-border services	Yes, related to commitments undertaken	Prudential carve-out in financial sector, BoP safeguards	None	State-to-State, WTO's dispute settlement body
TPP	Investment, financial, cross-border services	Yes	Prudential carve-out in financial sector, BoP safeguards	Minimum standard	Provides for ISDS
EU-Singapore	Investment	Yes	Prudential exception, BoP safeguards	Autonomous	Provides for ICSID arbitration
EFTA-Singapore	Investment, trade in services chapters	Yes	Prudential exception, BoP safeguards	Autonomous	provides for ICSID arbitration
US-Korea	Investment, financial, cross-border services	Yes	Prudential carve-out in financial sector	Minimum standard	Provides for ISDS
US-Singapore	Investment, financial, cross-border services	Yes	Prudential carve-out in financial and investment chapter	Minimum standard	Provides for ISDS
India-Singapore	Investment, trade in services chapters	Yes	Prudential exception and BoP safeguard	No obvious FET clause	Provides for ICSID arbitration
ASEAN	Several agreements, the main one being ASEAN Investment Agreement	Yes	Prudential exception and BoP safeguard	Yes	ISDS and ICSID arbitration

Source: *Author Construction*

Table 24: Coverage of Capital Movements and Safeguard Measures in select Trade and Investment Agreements

Agreement	Capital movements		Balance-of-payment safeguards	
	Coverage in agreement	Measure covered		
GATS	Inflow (modes 1–3) Outflow (mode 1)	Capital controls, exchange restrictions	Yes	
OECD	Inflow and outflow	List of operations on capital account incl. FDI and portfolio flows	Yes	
BITs	Mainly outflow	Capital controls, exchange restrictions	Partial	
US FTAS	Inflow (modes 1–3) and outflow (mode 1)	Capital controls, exchange restrictions	None for capital flows, yes for current payments	

Source: *Author Construction*

2. Capital Transfer Provisions and Balance of Payment Safeguards Coverage in the Global Trade and Investment Architecture

a. Transfer of Capital Provisions

Under the GATS, WTO members undertaking market access commitments in the financial services sector are required to permit related cross border movement of capital, essential to the provision of the committed service. GATS Article XVI (1) (8) specifies the following:

'If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I, it is thereby committed to allow related transfers of capital into its territory.'

Thus, under the GATS, if a nation lists Mode 1 or Mode 3 trade-in-services commitments, including those related to financial services, there is an implicit degree of capital account liberalisation, which is warranted. Mode 3 or commercial presence, for instance, necessitate inward flows of capital linked to the investment under consideration²⁷⁶. Mode 1 both inward and outward capital movement, e.g. purchasing securities on stock exchanges outside the host country, and domestic banks making loans or accepting deposits to non-residents.

Mode 1 and 3 transactions, which relate to the creation and transfer of ownership or the liquidation of capital assets and the payment and transfer associated with such transactions, are recorded in the capital account²⁷⁷. For the purposes of the chapter, we will focus on capital account transactions as they relate to cross-border movement of capital in the financial sector in the context of Modes 1 and 3.

The provisions of Article XVI (1) (8), however, do not cover the full extent of cross-border capital flows but do seem to restrict the ambit of application to restrictions on capital inflow for sectors scheduled in Mode 1 and 3, and for restrictions on capital outflow for sectors scheduled in Mode 1²⁷⁸. Furthermore, certain terminology of Article XVI (1) (8) is not defined, including what amounts to ‘cross-border capital’ and ‘an essential part of the service’.

b. Balance of Payments Safeguards

The GATS simultaneously provides for clear regulatory flexibility by way of its balance-of-payments safeguards and the prudential carve-out. The extent of this regulatory flexibility, particularly in relation to capital transfers and the financial sector, has been the subject of much discussion.

The GATS has an in-built BoP safeguard provision. Article XI of the GATS prohibits WTO members from applying restrictions on payments and transfers for current international transactions relating to their specific commitments, except in exceptional circumstances in conformity with GATS Article XII and the IMF Articles of Agreement.

²⁷⁶ M Kono and L Schuknecht, *Financial Services Trade, Capital Flows, and Financial Stability*, WTO, Geneva, 1999.

²⁷⁷ Sydney Key, *The Doha Round and Financial Services Negotiations*, AEI Press, Washington, 2003.

²⁷⁸ Lupo Pasini, F. ‘The International Regulatory Regime on Capital Flows’, 2011, ADBI Working Paper 338. Tokyo: Asian Development Bank Institute.

Article XI of the GATS stipulates:

1. *Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments.*
2. *Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund.*

Article XII in turn sets out that a developing country or transitioning economy WTO member may impose temporary restrictions that suspend its commitments (on all sectors included in its schedule, not only financial services) in the event of serious balance-of-payments and external financial difficulties or threat subject to the fulfilment of certain conditions. In determining the incidence of such restrictions, Members may give priority to the supply of services that are more essential to their economic or development programmes. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular service sector.

GATS Article XII, Restrictions to Safeguard the Balance of Payments sets out:

Paragraph 1:

‘In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, inter alia, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.’

GATS Article XII Paragraph 2:

The restrictions referred to in paragraph 1:

- a) shall not discriminate among Members;
- b) shall be consistent with the Articles of Agreement of the
- c) International Monetary Fund.
- d) shall avoid unnecessary damage to the commercial, economic
- e) and financial interests of any other Member;
- f) shall not exceed those necessary to deal with the circumstances

- g) described in paragraph 1.
- h) shall be temporary and be phased out progressively as the
- i) situation specified in paragraph 1 improves.

Thus, the invocation of the GATS BoP safeguard is temporary and requires the fulfillment of several criteria including being for a developing or transitioning economy suffering from a BoP difficulty. Therefore, the measure should not cause unnecessary damage to the commercial, economic, and financial interests of other WTO members and should be proportionate to the needs of the situation and maintain consistency with IMF articles. Furthermore, WTO Members invoking the BoP safeguard are required to consult with the WTO Committee on Balance-of-Payments Restrictions.

The GATS BoP safeguard does not adequately guarantee that nations can use measures to regulate both the inflow and outflow of capital because while there is clear mention of ‘crisis situations’ there is no reference to derogations to maintain ‘financial stability’. It is therefore unclear as to whether the BoP safeguard can be used for to justify regulatory flexibility in the use of CFM measures.

Moreover, several interpretational issues arise, including whether the capital control measure should be ‘necessary’, ‘temporary’, and ‘avoid unnecessary damage’ to commercial, economic, and financial interests of other members. How are these terms to be defined and evaluated? For instance, XII, 2(c) in the BoP exception states that measures “shall not exceed those necessary” to deal with the circumstances that a measure is trying to prevent or mitigate²⁷⁹.

This amounts to what WTO law refers to as a ‘necessity test’ and could give a dispute panel the authority to rule that an alternative measure, i.e. other than a CFM measure, could have been used.

Procedurally, a WTO member invoking the BoP safeguard will need to notify the WTO’s General Council and consult with the Committee on Balance-of-Payments Restrictions which will assess the BoP situation and restriction undertaken²⁸⁰. The determination of whether the country is under a serious financial threat would be

²⁷⁹ The necessity tests reflect the balance in WTO agreements between preserving the freedom of Members to set and achieve regulatory objectives through measures of their own choosing, and discouraging Members from adopting or maintaining measures that unduly restrict trade. In short, it requires that covered measures that restrict trade do not go beyond what is ‘necessary’ to achieve the Member’s policy objective.

²⁸⁰ GATS Article XII (4), (5).

made in consultation with the IMF²⁸¹ and as per the IMF Articles of Association, which requires procedural compliance.

The GATS BoP safeguard also makes provisions for derogations related to IMF-imposed capital controls, which a WTO member may be asked to undertake. Furthermore, Article VI Section 1 of the Fund's Articles specifically authorises the Fund to request a Member to impose capital controls in order to prevent a large or sustained outflow of capital, where the IMF member is utilising IMF funds.

Thus, the BoP exception clause contained in Article XII of the GATS and similar clauses contained in several FTAs and BITS, could potentially provide governments the basis to impose capital controls for macroprudential reasons, but it is conditional, can be used only in crisis situations, requires procedural compliance, and is subject to interpretation in parts. This would make the application of the BoP Safeguard not conducive to swift action, which would be important in times of crisis and significant systemic risk.

3. Capital Transfer and Balance of Payment Safeguard Provisions in FTAs

Most BITS and FTAs advocate free movement of capital linked to covered investments or trade-in-services commitments undertaken without restriction, with exceptions in the case of balance-of-payment safeguards. For instance, an analysis of FTAs notified to the WTO by the end of 2017 indicated that nearly 60% covered movement of capital, and 51% or 145 of the 284 agreements examined had some commitment to maintain liberalised capital flows for covered transactions. As far as BoP safeguard measures are concerned, the same study found that 82% of all treaties with capital account transfers commitments contain a safeguard protecting countries with balance-of-payments difficulties and/or other macroeconomic difficulties. *Table 25: Coverage of Capital Movements and Safeguard Measures in select Trade and Investment Agreements* provides an overview of capital transfer and BoP safeguard measures in select FTAs.

²⁸¹ GATS Article XII 5 (e).

Table 25: Coverage of Capital Movements and Safeguard Measures Provisions in select Trade and Investment Agreements

FTA/BIT	Freedom of capital transfers
TPP	Free capital transfers linked to covered investments to include contributions to capital, profits, dividends, interest, capital gains, fees, partial/full sale of investment, and payments under contracts, e.g. loan agreements. Exceptions permitted if acting in good faith in the case of bankruptcy, protection of creditor rights, issuing, trading, or dealing in securities, futures, options, financial reporting, judicial proceedings, etc. (Article 9.9). Chile reserved the right to maintain/adopt measures in accordance with specific legislation relating to the Central Bank of Chile, General Banking Act, Securities Market Law in order to ensure currency stability and the normal operation of domestic and foreign payments. Such measures include restrictions or limitations on current payments and transfers (capital movements) to or from Chile and related transactions, e.g. deposits, investments, or credits from or to a foreign country, and be subject to a reserve requirement.
EU-Singapore	In Investment Chapter 9.7. Free transfer related to covered investment, rules that are non-discriminatory/equitable can be made in the case of issuing, trading, or dealing in securities, futures, options, which allows in exceptional circumstances the taking of safeguard measures in case of serious difficulties for monetary/exchange rate policy. Measures should be temporary and not have schedules that exceed 6 months. Article 17.7 Authorisation of payments and transfers of current account as per IMF Article 8. Safeguard measures for balance-of-payment difficulties with regard to trade in goods, services, establishment and/or payments related to investments. Restrictive measure to be temporary and non-discriminatory in accordance with WTO and IMF Agreements. Permitted subject to the nature and extent of BoP or financial difficulties, external economic/trading environment, and existence of alternative corrective measures. IMF information will be final.
EFTA-Singapore	Part III Trade in Services Chapter: GATS-like provisions to avoid the imposition of restrictive measures, reference to GATS Article XI and XII, notification requirement.

(Continued)

Table 25: *(Continued)*

FTA/BIT	Freedom of capital transfers
	Investment Chapter Article 44: Free transfer of payments relating to investment including profits, interests, dividends, capital gains, fees, payments made under a contract including a loan agreement, proceeds from sale/liquidation of all/part of an investment earnings or personnel. Transfer to be made without delay. However, this does not prevent good-faith application of laws relating to insolvency/creditor protection, issuance, trading in securities etc. (Article 44 (4)).
US-Korea	Financial Services Chapter – Prevention/limitation of transfers by financial institutions/cross-border FS suppliers by way of measures that are equitable, non-discriminatory, and applied in good faith to ensure the safety, soundness, integrity, and financial responsibility of financial suppliers (Article 13.10 (3)). Investment Chapter Transfers relating to covered investment to be permitted freely (Article 11.7 (1)). Transfers can be prevented if done in an equitable, non-discriminatory, and good-faith application of laws, relating to bankruptcy, insolvency, or protection of creditor rights, issuing trading or dealing in securities, futures, options, or derivatives (Article 11.7 (4)). Similar provisions are found in the Cross-border Services Chapter (Article 12.10). Annex 11 G Korea has taken an exception based on its Foreign Exchange Transactions Act, imposing limitations on capital transfer provided that measures do not exceed one year (extendable exceptionally), are not confiscatory, create a multiple exchange rate practice, interfere with investors earnings at market rate of return for restricted assets, avoid unnecessary damage to US commercial/financial interests, are phased out, are consistently applied in line with MFN and NT, and are publicly available (para 1). This applies only to capital account transactions and will only apply to current account transactions if there is compliance with IMF articles of agreement.
US-Singapore	Financial Services Chapter: Prevention/limitation of transfers by financial institutions/cross-border FS suppliers by way of measures that are equitable, non-discriminatory, and applied in good faith to ensure the safety, soundness, integrity, and financial responsibility of financial suppliers (Article 10.10 (3)).

(Continued)

Table 25: *(Continued)*

FTA/BIT	Freedom of capital transfers
	Investment Chapter: Transfers relating to covered investment (e.g. capital contribution, profits, capital gains, dividends, interest, etc.) to be permitted freely. Transfers can be prevented if done in an equitable, non-discriminatory, and good-faith application of laws relating to bankruptcy, insolvency, or protection of creditor rights, issuing trading or dealing in securities, futures, options, or derivatives (Article 15.7 (4)). Similar provisions are found in the Cross-border Services Chapter (Article 12.10). Investment Chapter Annex 15 A Singapore has held action for measures taken to prevent transfers that can only be applied one year after the measure is in force and that can only seek damages with respect to the shares of the enterprise (Annex 15A (1)). Such claims cannot be raised in the case of payments/transfers on current transactions, including profits/dividends of FDI of US investors, transfer of proceeds of US FDI excluding those related to financial markets, payments on loans/bonds irrespective of where concluded including inter- and intra-company debt financing. Apart from these three exceptions, Singapore will not be liable for damages incurred by the imposition of restrictive measures for the prevention of outward payments/transfers within one year of imposition. The US will not make claims within one year of imposition of restrictive measures. In determining compensation owed, benefits suspended, and the level of such measures, the aggrieved party and Panel shall consider whether such a request was made at the behest of the IMF.
India-Singapore	Except for safeguards, no restrictions on international transfers/payments of current transactions were linked to specific commitments, as per IMF articles (Article 7.16). Restrictions permitted in case of serious balance of payments/external financial difficulties or in the interest of maintaining financial reserves for economic development purposes. Restrictions must be in keeping with IMF articles of agreement, avoid unnecessary damage to the financial/commercial interests of the other Party, not exceed necessary measures to deal with the specified circumstances, be temporarily adopted on a national treatment basis, and phased out over time (Article 7.17).

(Continued)

Table 25: (Continued)

FTA/BIT	Freedom of capital transfers
ASEAN	Explicit incorporation of GATS prudential carve-out by Singapore in its schedule of commitments which forms part of the AFAS 5th Financial Services Protocol in both insurance and banking head-notes. Furthermore, explicit incorporation of financial regulatory authorities' power to make regulation as under the GATS prudential carve-out. Safeguard measures for serious BoP/financial difficulties. Measures/restrictions on investment permitted in case of economic development/transition/maintenance of financial reserves difficulties (ASEAN framework agreement on AIA 1998, Article 15(1)). Such measures should provide 14 days' notice to AIA Council, not discriminate between member states, be consistent with IMF Article of Agreement, avoid unnecessary damage to the commercial, economic, and financial interests of other member states, be sufficient to deal with specified circumstances, and be progressively phased out (ASEAN framework agreement on AIA 1998, Article 15(3)). Repeated in Article 16 of the ASEAN Comprehensive Agreement.

Source: Author Compilation

In the agreements examined, most BITS/FTAs tend to have some manner of capital transfer provisions, balance-of-payment safeguard, and/or prudential carve-out clauses, which generally tend to be modeled after the GATS provisions on capital transfers and BoP safeguards (see *Table 23: Overview of Provisions in the GATS and select FTAs Relating to Coverage, Capital Transfers, Prudential Flexibility, Fair and Equitable Treatment and Dispute Settlement Provisions*). These provisions therefore raise the same issues identified in the earlier section with GATS capital transfer and BoP provisions, namely lack of clear scope of coverage for capital inflows and outflows and CFM measures, a necessity test, ambiguity in the scope of application, temporariness of measures, procedural considerations, and ambiguity in the terminology.

The transfer of capital provisions in the investment chapters of trade treaties, or in standalone BITs, require that capital be allowed to flow between trading partners 'freely and without delay' (see, for instance, US-Singapore, US-Korea Investment, and Cross-Border Services chapters). This is reinforced in trade treaties' chapters on financial services that often state that nations are not permitted to pose 'limitations on the total value of transactions or assets in the form of numerical quotas' across borders.

The transfer of capital provisions and the safeguard measures contained in FTAs and BITs set out the circumstances under which the provisions can be invoked, e.g. BoP difficulties, the process to be followed, e.g. not damaging to partners, consulting the IMF, and the principles to be applied, e.g. non-discriminatory application (see, for instance, ASEAN, India-Singapore, EU-Singapore, EFTA-Singapore).

As compared to FTAs, BITS provide for stronger disciplines on capital movements, focusing on primarily outflows of capital, while FTAs have a broader scope for capital movements linked to market access provisions and free movement of capital in the pre-establishment phase.

There is a variance in approaches taken by US FTAs as opposed to EU, Japanese or Canadian FTAs. Agreements involving the United States tend to be uniform and have the broadest transfer commitment with limited exceptions; thus, they provide high investor protection, but it can be argued that they limit the government's regulatory flexibility.

US trade and investment treaties deem capital controls to be actionable measures that can trigger investor-state claims. There are a few exceptions to the stringent rules on capital transfer contained in US FTAs. The US-Chile, US-Peru, US-Colombia, and US-Singapore special annexes²⁸² provide for a 'cooling off' provision, which allows countries to violate the terms of the treaty on capital movements. US investors cannot file claims for violations of the free transfers obligation for up to one year on certain capital flows, provided the restrictions do not 'substantially impede transfers'. If the restrictions are lifted within a year, the affected investor will not have recourse to dispute settlement on these restrictions. If the restrictions are in place for more than a year, the investor may take a claim to dispute settlement, and may seek damages caused by the capital controls after their first year in operation. Investors will have the burden to prove the existence and extent of damages caused by the controls. Thus, the US-South Korea FTA allows South Korea to deploy regulations as specified under its law as long as such measures meet a number of limitations specified in the Annex.

This US exception for capital controls is partial in so far as it is limited to the investment chapter and does not apply to restrictions on current transfers and on payment for equity investments, bonds, or loans. The aim of this provision was to provide countries with some policy space during economic crises, without the pressure of investor-state dispute settlement. However, it is interesting to note that

²⁸² See, for example, Annex 10-E of the U.S.-Peru FTA.

the FTA simultaneously expressly provides for the possibility of ISDS if the period of exception is breached.

In contrast, the FTAs and BITs of other major capital-exporting nations tend to follow a comparatively broader approach, allowing for greater flexibility in the usage of capital controls. Most BITs and FTAs involving Japan, the EU, and Canada either have a safeguard measure whereby a nation can pursue its domestic regulations related to capital controls, or regulatory carve-outs or host country capital account legislations to prevent and mitigate financial crises. The Canada-Chile FTA, the EU-Korea FTA, the Japan-Peru BIT, and the Japan-Korea BIT grant greater flexibility for the usage of capital controls²⁸³. For instance, the Canada-Chile FTA grants Chile the flexibility to deploy unremunerated reserve requirements, a form of capital controls, when Chile deems it necessary²⁸⁴.

Specifically in the case of BITs, capital transfer exceptions vary between countries. A more narrow and restrictive approach, as followed by US BITs, does not provide for exceptions to capital transfer provisions or provide for very limited exceptions. This stringent approach has been questioned within the US²⁸⁵.

A broader, more permissible approach explicitly allowing for exceptions to capital transfer provisions in case of BoP crisis or external financial difficulties is followed in several East Asian countries, as is reflected in the Japan-Republic of Korea BIT and the ASEAN agreements. The Republic of Korea-Japan BIT allows for restrictions on both inflows and outflows on two conditions: (a) in the event of serious balance-of-payments and external financial difficulties or threat thereof; or (b) in cases where, in exceptional circumstances, movements of capital cause or

²⁸³ See, for instance, Annex G-09.1 of the Canada-Chile FTA, Article 8.4 of the EU-Korea Free Trade Agreement, Article 20 of the Japan-Peru Bilateral Investment Treaty, Article 17 of the Japan-Korea Bilateral Investment Treaty, Annex 810 of the Canada-Colombia Free Trade.

²⁸⁴ Annex G-09.1 of the Canada-Chile FTA, Unremunerated reserve requirements in this case are essentially a tax or forced loan to Chile's Central Bank.

²⁸⁵ In 2009, for instance, the US Department of State's Advisory Committee on International Economic Policy assembled a subcommittee to review the 2004 Model BIT. Some members on that subcommittee recommended that the administration review the provisions on transfers of capital and consider including temporary derogations. See US Department of State Advisory Committee on International Economic Policy, 'Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment Treaty', 2009, Washington, DC. US Department of State. Available at: <http://www.state.gov/e/eeb/rls/othr/2009/131098.htm>.

threaten to cause serious difficulties for macroeconomic management, particularly monetary or exchange rate policies. Similar language can be found in the ASEAN agreements (*Table 25: Coverage of Capital Movements and Safeguard Measures in select Trade and Investment Agreements*).

Another kind of BIT approach, which is also more flexible in the usage of capital controls, defers to national law relating to capital controls, e.g. the UK-Bangladesh BIT and the China-Germany BIT. For instance, the China-Germany BIT states that transfers must comply with China's laws on exchange controls²⁸⁶.

In the case of BITS relating to the EU, Gallagher (2010) points out that there are variations in approaches adopted by EU member BITS, with some providing for deference to national laws governing capital controls, while others (e.g. Swedish and Austrian BITS) have no exceptions²⁸⁷. The ECJ ruled in 2009 that Austrian and Swedish BITS with developing countries that do not provide for exceptions to free transfer provisions are in violation of their obligations under the EU treaty, which allows members to have exceptions.

While applying the provisions contained in FTAs/BITS to capital control measures, several issues arise. First, since FTAs/BITS tend to reflect the provisions of the GATS, the same issues pertaining to GATS provisions of BoP safeguard and prudential exception apply to FTAs/BITS. Second, in the case of US FTAs in particular, there is the real prospect of capital-control-linked ISDS given the narrow US interpretation of prudential exception limited to individual enterprises and the narrow BoP clause, a clear requirement for the free flow of capital linked to covered investment and services commitments and, in some cases, express provision for ISDS in the case of capital controls.

Third, the differential treatment of capital transfers in the US as opposed to 3rd country FTAs/BITS could lead to a discriminatory application of capital control measures (e.g. applying controls on EU investors but not on US investors). Fourth, the IMF has expressed concerns that restrictions on capital controls in certain FTAs/BITS, even those with special annexes, may conflict with the IMF's authority to recommend capital controls in certain country's programmes, as is the case in Iceland. These agreements lack the adequate safeguards to put in place capital

²⁸⁶ Anderson S, 'Policy Handcuffs in the Financial Crisis. How U.S. Trade and Investment Policies Limit Government Power to Control Capital Flows', 2009, Washington, DC, Institute for Policy Studies.

²⁸⁷ Kevin Gallagher, 'Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements', May 2010, G-24 Discussion Paper Series No. 58.

control measures because ‘[the] limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows’²⁸⁸. Finally, while it can be argued that these agreements provide flexibility for the use of capital control measures, given the broader CFM definition outlined earlier in this chapter, it would be interesting to note whether they would apply to capital control like macroprudential regulation that may not expressly discriminate on a residency basis, such as forex borrowing or lending of a foreign subsidiary.

4. Capital Flow Management Measures and the fair and equitable Treatment Standard

While the previous sections have focused on the use of capital controls and CFM measures as a tool for managing macroprudential risk, capital controls/CFMS can also be used in a manner that adversely impacts the interests of foreign investors or financial service suppliers. As set out earlier, capital controls can be used as part of an effort to sustain an undervalued currency²⁸⁹, which makes exports cheaper. For instance, it has in the past been pointed out that China has used capital controls to keep its exports competitive and to prevent currency speculation²⁹⁰. Countries can also use capital controls to influence world interest rates in a way that would benefit that country. A large creditor country may restrict outflows in an attempt to raise world interest rates, and large debtor countries may attempt to lower world interest rates²⁹¹. These actions have the potential to generate global market distortions and to impact foreign investors negatively.

²⁸⁸ IMF, ‘The Fund’s Role regarding Cross-Border Capital Flows’, November 15, 2010, Prepared by the Strategy, Policy, and Review Department and the Legal Department, Last accessed 25/11/2020 at: <https://www.imf.org/external/np/pp/eng/2010/111510.pdf>.

²⁸⁹ Olivier Blanchard and Jonathan Ostry, ‘The Multilateral Approach to Capital Controls’, December 11, 2012, VOX, Last accessed October 2017 at <http://www.voxeu.org/article/multilateral-approach-capital-controls>.

²⁹⁰ Tom Orlik, China Signals Speedier Moves to Loosen Capital Controls: Bank Official Says Recent Volatility Shouldn’t Hinder Reform, WALL ST. J. (Sept. 5, 2013, 10:29 AM), <http://online.wsj.com/news/articles/SB10001424127887323623304579056741795219748>.

²⁹¹ Jonathan Ostry, Atish Ghosh, and Anton Korineck, ‘Multilateral Aspects of Managing The Capital Account’, September 7, 2012, IMF Staff Discussion Note, SDN/12/10.

As discussed in Chapter 2, the FET standard is contained in most investment and trade agreements in varying forms (*Table 14: Overview of fair and equitable Treatment Provisions in select FTAs*). The key question in relation to CFM measures and FET standards is whether the usage of capital controls conforms with the FET standard elements of transparency, meeting investors' legitimate expectations, and maintaining a stable legal and business environment. Linked to this is whether the FET standard itself provides regulatory flexibility in the usage of capital controls, without applying other provisions such as the BoP safeguard or the prudential carve-out. Finally, what are the implications of differences in the minimum standard FET approach and the autonomous FET standard approach for the usage of capital controls?

In terms of the elements of FET, the key elements relevant to the usage of capital controls are transparency, which includes meeting investors' legitimate expectations, acting in a consistent and non-arbitrary manner, and maintaining a stable business and legal environment.

The transparency element of the FET standard presupposes consistency in the host country's actions as well as for foreign investors the timely availability of relevant laws/regulations and in some cases the possibility to comment on new regulations (see Chapter 2 for a discussion on transparency and FET). The transparency element was a central consideration in *Metalclad Corp v. Mexico* (2000) and *Genin et al. v. Estonia* (2001). It was upheld in *Tecmed v. Mexico* where the tribunal held that a state must 'act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor'²⁹². The tribunal ruled that a NAFTA state should ensure that all relevant legal requirements must be capable of being readily known to foreign investors and that there should be no room for doubt or uncertainty on such matters²⁹³.

For the consistency element, it can be argued that the host state committing to the free transfer of capital in its international agreements while also using capital controls/CFM measures could be considered inconsistent behaviour. Additionally, foreign investors expect the state to act in a transparent manner which includes timely availability of relevant laws/regulations and in some cases the possibility of commenting on new regulations in the host country jurisdiction or prior com-

²⁹² *Tecnicas Medioambientales Tecmed SA v. Mexico*, Award (ICSID Case No. ARB (AF)/00/2, 29 May 2003), para 154.

²⁹³ *Metalclad v. Mexico*, Award, Para 76.

ment²⁹⁴. In the case of capital controls, this would imply that the country imposing the capital control should inform foreign investors of their intention to impose capital controls and perhaps even afford them an opportunity for prior comment²⁹⁵.

Legitimate expectations arise from either specific or general assurances given to an investor, on the basis of which an investment is made. Assurances given by the host state which give rise to 'legitimate expectations' can take the form of (a) specific commitments addressed to the investor personally and (b) more general rules enacted with the specific aim of inducing foreign investment. The common factor in either case is that the investor must have relied on these assurances while making its investment. Freedom of capital transfer provisions contained in the GATS, FTAs, BITs, and other international instruments could therefore be considered general commitments made to investors, especially since they are directly linked to 'covered investments' and 'financial services commitments' undertaken.

Thus, hypothetically, a US financial institutional investor relying on the freedom of capital transfer provisions of the US-Korean FTA may invest in Korean markets. Subsequently, Korea may impose capital control measures that prevent the US financial institutional investor from exiting the market or levying a higher capital gains tax on sale of its investments. The question would be whether these applied capital control measures change the US financial institutional investor legitimate expectations relied on at the point of making its investment.

Similarly, and once more hypothetically, depending on the kind of commitment India has undertaken in its FTA financial services schedules of commitment, capital control measures such as the one India imposed in 2013, which restricted inward remittances as well as outward FDI flows, could be thought of as impacting the legitimate expectations of financial investors wanting to invest in Indian capital markets or a foreign subsidiary wishing to invest outwards from India to a third country.

²⁹⁴ The general obligation of transparency is found in Article III of the GATS, which requires members to publish all relevant laws and regulations and to set forth clear standards so that foreign traders can discern exactly what conditions must be fulfilled in order to conduct trade in the host jurisdiction. Moreover, national authorities must notify the Council for Trade in Services of any changes in regulations that apply to services that are subject to specific commitments. Similar provisions are reflected in several FTAs and BITs.

²⁹⁵ Prior comment is when interested persons are provided a reasonable opportunity to comment on proposed regulatory measures.

However, complying with the transparency and legitimate expectation of investor elements of the FET standard may defeat the purpose of capital control measures. It is important to remember capital control regulation is a tool used by regulators to respond to potentially destabilising domestic and/or global market conditions and rising capital inflows/outflows. Timely application of capital control measures is therefore important. If the FET interpretation of transparency was to be applied, regulators would be required to inform financial markets as to their intention of applying capital control measures, the specific form of such capital control measure, as well as to give the foreign investor sufficient time to plan/adapt their investment. This could in effect defeat the objective of regulatory action, i.e. to act swiftly and maintain financial stability in the markets. At the same time, the possibility that capital controls may be utilised for protectionist measures cannot be ignored.

The onus on the host state to maintain a stable business and legal environment has been upheld in several ICSID cases, such as *Occidental v. Ecuador* (2004) and *CMS Gas Transmission Co v. Argentina* (2005), where government measures were found to violate the FET standard because they altered the legal and business environment under which the investment was made (see Chapter 2's discussion on maintaining a stable business and legal environment). In *Occidental v. Ecuador* (2004) the tribunal held that '[t]he stability of the legal and business framework is ... an essential element of fair and equitable treatment.'²⁹⁶

In *CMS Gas Transmission Co v. Argentina* (2005), the tribunal held that 'fair and equitable treatment is inseparable from stability and predictability' following the monetary crisis in Argentina and the subsequent emergency laws and arrangements, which imposed devaluation of the peso on tariff arrangements. The claimant CMS challenged the emergency laws and arrangements, claiming that at the time it made its investment it was entitled to the calculation of tariffs in US dollars, conversion into pesos at the time of billing, and periodic adjustment of tariffs in accordance with the US Producer Price Index. The tribunal found that the new laws and arrangements introduced by the Argentine government following the monetary crisis in Argentina breached the FET standard as outlined in the US-Argentina BIT²⁹⁷.

In a similar vein, the impact of capital controls on the legal/business environment can be easily identified due to the quantifiable nature of the tools involved, which

²⁹⁶ *Occidental v. Ecuador* (2004), para 183.

²⁹⁷ Article 2(2)(a) of the US-Argentina BIT.

in turn directly impacts an investor's or financial service supplier's operations. The impact of capital controls on the legal/business environment is easily identifiable as (a) the effects of the usage of capital controls are immediate and direct (i.e. exchange rate restrictions or taxes on investments, restrictions on volume of capital repatriation) and (b) the comparison of the pre- and post-capital control legal/business environment is more evident due to the availability of balance sheet data at the firm level.

Anecdotal experience seems to indicate that capital controls can potentially change the legal and business environment, thus impacting investor expectations. The Chilean experience in 1991–2001 is often cited as a successful example of the use of capital controls. In fact, research has indicated that it resulted in harder conditions for small companies looking to raise funds. Companies responded by delaying tax payments, borrowing from suppliers, and sometimes disguising loans as direct investment, giving rise to a cat-and-mouse game with officials²⁹⁸. Similarly, in the case of Brazil, a Brazilian central banker explained how Brazil's ban on currency outflows in the 1980s created a black market in hard currency and 'a culture of transgression'. It has been suggested recent milder controls in Brazil could shift activity offshore and damage transparency and liquidity²⁹⁹.

Capital controls can also create a broader atmosphere of uncertainty, not just amongst investors but also by eroding confidence in the country imposing capital control. For instance, when Malaysia instituted controls on capital outflows during the 1997 Asian Financial Crisis, rating agencies quickly downgraded its sovereign risk and credit ratings. The cost for Malaysia to borrow rose far more steeply than for other affected countries³⁰⁰, thereby impacting borrowing rates domestically too.

Thus, the adoption of capital control measures can directly impact the operations of foreign investors and financial service suppliers by substantially altering the

²⁹⁸ Kristin Forbes, 'One Cost of the Chilean Capital Controls: Increased Financial Constraints for Smaller Traded Firms' December, 2002, Available at SSRN: <https://ssrn.com/abstract=365081> or <http://dx.doi.org/10.2139/ssrn.365081>.

²⁹⁹ Arminio Fraga, a former chief of the Brazil's central bank and now an investment manager quoted in *The Economist*, 'Capital: Just in case', October 12, 2013.

³⁰⁰ Masahiro Kawai and Shinji Takagi, 'Rethinking Capital Controls: The Malaysian Experience', May 2003, PRI Discussion Paper Series, Paper No. 03A-05, available at http://www.mof.go.jp/pri/research/discussion_paper/ron056.pdf (discussing Malaysia's use of capital outflow controls in the late 1990s).

business and legal environment that they relied on at the time of making their investment. This in turn could lead to a contravention of the FET standard.

FTA provisions and FET-related case law and provisions have at the same time protected regulatory flexibility in the face of investors' legitimate expectations, as can be observed from prudential carve-out like provisions contained in FTAs as well as specific provisions that protect regulatory flexibility in the face of an investor's legitimate expectations, such as the US-Singapore agreement³⁰¹, which specifies that whether an investor's investment-backed expectations are reasonable depends in part on the nature and extent of governmental regulation in the relevant sector. The TPP further clarifies this, noting that 'the mere fact that a Party takes or fails to take an action that may be inconsistent with an investor's expectations does not constitute a breach of the Article [on minimum standard of protection] ...'³⁰², indicating that a breach alone will not constitute a basis for an FET claim³⁰³.

While upholding the protection of investors' legitimate expectations, tribunals have also sought to ensure that the host state has a reasonable degree of regulatory flexibility so it can respond to changing circumstances in the public interest. In *Saluka v. Czech Republic* (2006), the tribunal held that a foreign investor's expectations must be weighed against the host State's legitimate right to regulate domestic matters in the public interest³⁰⁴. Meanwhile, in *Duke Energy et al. v. Ecuador* (2008), the tribunal held that the investor's expectation must be assessed against other factors, including political, socioeconomic, cultural, and historical conditions prevailing in the host State³⁰⁵. (See Chapter 2 for a detailed discussion.)

These FTA and tribunal proceedings read with the 'prudential exceptions' and balance-of-payment safeguards contained in international trade and investment agreements, as well as the special case of the financial sector which warrants greater regulatory flexibility, may provide a defense in FET cases linked to the use of capital controls.

Finally, the treaty formulation of the FET standard, i.e. minimum versus autonomous standard is important as it determines the scope of application of the FET

³⁰¹ See Annex 11 B of the US-Singapore agreement.

³⁰² See TPP Article 9.6.4.

³⁰³ See Lise Johnson, Lisa Sachs, "The TPP's Investment Chapter: Entrenching, rather than reforming, a flawed system", November 2015, Columbia Centre on Sustainable Development, CCSI Policy Paper page 4.

³⁰⁴ *Saluka v. Czech Republic*, paragraph 305.

³⁰⁵ *Duke Energy et al. v. Ecuador* (2008), paragraph 320.

standard in respect of post-2008 macroprudential regulation (see Chapter 2 for a discussion on the impact of the minimum versus the autonomous FET standard approach).

The minimum standard approach contained in US FTAs and BITS follows a narrow interpretation of FET linked directly to customary international law ('CIL'). The application of traditional customary international law requires the host state to meet an international standard in its application of the FET standard (*Neer v. Mexico* (1926)) and raises the question as to which international standard or source of CIL would be applied and to what extent³⁰⁶. A second issue is that customary international law is constantly evolving (see Pope and Talbot (2001); *Mondev v. U.S.* (2002)), which is especially true of the financial sector. Hence, there is a strong possibility that what may constitute the international standard may also evolve and therefore traditional sources of CIL may change.

If FET standards that use the minimum standard approach are invoked as a form of defence in ISDS, it raises the question of which CIL should be referred to? (*See Chapter 6 Conclusions for a discussion of CIL application to financial sector disputes.*) This is particularly pertinent to the financial sector given the evolving legislation and policy approach nationally and globally on the use of capital controls and CFM measures.

a. Autonomous FET Approach

In cases where the FTA/BITS do not refer to customary international law or the autonomous approach, the tribunal makes an objective assessment based on the facts of the case, and the underlying rationality of host state regulatory choice is applied³⁰⁷ (*see Chapter 2 for a discussion on the autonomous FET approach*). In a fact-based situational analysis, it is conceivable that a given situation satisfies the FET standard from the perspective of a capital-importing country but fails to do so from the perspective of the foreign investor or the capital-exporting country. This

³⁰⁶ *ADF Group, Inc. v. United States of America*, Award, 9 January 2003, 6 ICSID Reports 470, para. 184. See also *Mondev International Ltd. v. United States of America*, Award, 11 October 2002, 6 ICSID Reports 192, para. 119.

³⁰⁷ This approach has been suggested by Jurgen Kurtz in the context of a state's invocation of scientific justification for measures undertaken. See Kurtz Jurgen, *The WTO and International Investment Law: Converging Systems*, 136–137, Cambridge 2016, page 137.

is especially true in circumstances in which the parties involved have different legal traditions or approach the issue with different assumptions³⁰⁸.

The difference in the application of the interpretative approaches is significant in its application to the usage of capital controls, because if the FET standard is seen as equivalent to the customary international law standard, then it will be subject to an objective test that provides comparatively more predictability³⁰⁹. However this may tie countries wishing to use capital controls to an international standard, which is stringently applied. By contrast, in circumstances where the standard is an autonomous FET standard, the actual situation of individual sectors and the systemic risk posed by the non-use of capital controls mean that the threshold for breach is lower³¹⁰.

Furthermore, in the case of minimum standard FET, the question arises as to which sources of customary international law will apply in the case of usage of capital controls/CFMs. The principles, guidelines, decisions, and even research of international organisations and standards-setting bodies (Basel Committee, IAIS, IOSCO, FSB, IMF) could be considered sources of CIL. However, given the change in policy stances of some international standard-setting bodies on the usage of capital controls and the uncertainty on their effectiveness, the value of such international organisations as sources of CIL either as soft law or by incorporation into national financial regulation, may not be solid (See Chapter 6 for a more detailed discussion). The IMF changed its policy stance on the usage of capital controls to permit capital control on outflows in Iceland, Ukraine, and Latvia as the crisis hit, and recommended that nations such as Brazil, Colombia, and India use controls on inflows to tame the mass influx of capital to emerging markets in 2009–2010. In 2010, the IMF went a step further and recommended that a system of global coordination be put in place for capital controls, an initiative the G-20 took up in 2011. Further evidence on the usage of capital controls at a national level is mixed, raising questions regarding the extent to which national usage of capital control measures act as a source of CIL.

³⁰⁸ Walker, Herman, 'Modern treaties of friendship, commerce and navigation', 1958, Minnesota Law Review, Volume 42 (April), Page 812.

³⁰⁹ Edwin Borchard, 'The "Minimum Standard" of the Treatment of Aliens', 1940, 38 Mich LR 445.

³¹⁰ Coleman Mathew and Innes Thomas, "Investor-State Arbitration and Fair and Equitable Treatment, Investor-State Arbitration Series, May 19, 2015, Steptoe and Johnson, accessible at: <http://www.steptoe.com/publications-10464.html>.

Second, customary international law is inherently evolutionary. The direction of its movements in the case that FET is applied to the financial sector would have to be proved. In the case of capital controls, meanwhile, this would mean establishing a direction of usage of capital controls by several countries, both historically and over a period of time. For instance, a state may invoke the usage of capital controls after the 2008 crisis as well as the IMF's revised position on the usage of capital controls as a defense against alleged FET violations.

D. Establishing Interlinkages Between the Trade and Investment Architecture and Capital Flow Measures: Highlighting Inconsistencies and Contradictions

Several inconsistencies or contradictions arise from bringing together these three strands: (i) CFMs /capital controls imposed by a country; (ii) provisions relating to the free transfer of capital and BoP safeguards contained in international trade and investment agreements as well as the prudential exception also contained in the same agreement; and (iii) FET standard requirements to meet an investor's legitimate expectation and maintain a stable legal and business environment. Each agreement contains investor/trade rights, bolstered at times by the FET standard and weighed up against the government's right to regulate and maintain systemic stability. (*Table 23: Overview of Provisions in the GATS and select FTAS Relating to Coverage, Capital Transfers, Prudential Flexibility, Fair and Equitable Treatment and Dispute Settlement Provisions*)

1. FTA-Related Inconsistencies/Contradictions

Trade and investment commitments are underpinned by the free transfer of capital provisions, which may be compromised by CFMs. FTAs/BITs seek to promote the commercial interests of the parties to the agreement by creating greater certainty for foreign investors and service providers operating in new markets by reducing risks³¹¹. At the same time, financial regulators' ability to regulate is protected by the same FTAs and to a lesser extent in BITs, though this protection is not unconditional. CFMs are primarily a tool of macroprudential policy but can implicate trade and investment policy in that restrictions on the flow of money can impede

³¹¹ D Siegel, Kevin Gallagher, and Rachel Thrasher, 'Movement of Capital', 2020, Chapter 6 in *Handbook of Deep Trade Agreements* (Editors: Mattoo, Aaditya; Rocha, Nadia; Ruta, Michele. 2020), World Bank, Washington DC, 2020.

international trade. Free transfer provisions contained in international trade and investment agreements necessitate movement of capital linked to trade/investment commitments, which can potentially be contravened by the usage of capital controls, especially in the wake of the 2008 financial crisis when the usage of capital controls was more widely accepted.

There are differing approaches to the use of capital controls contained in FTAs/BITS arising from narrow and strict provisions on FTAs/BITS, e.g. US FTAs versus a less restrictive approach contained in EU/Japan/Canada. This disparity in approaches causes a potential overlap of norms and regulatory uncertainty. Korea, for instance, is a member of the OECD and has entered into FTAs with the US and EU. In case Korea experiences severe macroeconomic turbulences, the adoption of capital controls would be allowed under the OECD Code of Capital Movement, the IMF rules, and by the EU-Korea FTA, but it would be conditionally permitted by the US-Korea FTA. Since it is difficult to selectively apply capital controls based on the origin or destination of the capital flow, the country adopting the measure would be in a regulatory dilemma that could ultimately result in having to make a choice between macroeconomic stability versus violation of the US FTA³¹².

2. FET-Related Inconsistencies/Contradictions

With specific reference to BITs and the applicability of the FET standard, the question arises as to whether the usage of CFMs as a macroprudential tool should be given higher weightage than investor protection under the FET standard. As set out earlier in this chapter, the economic literature on the effectiveness of capital controls is mixed; however, national usage of capital controls, especially in developing countries, is very much part of the regulator's policy toolkit. Thus, in the context of macroprudential policy, capital controls may be necessary not only in classical balance-of-payments crises but also for handling difficulties caused by excessive upwards pressure on exchange rates due to capital inflows³¹³, which is in essence the macroprudential objective of preventing systemic risk build-up. The question then arises as to which one should and can be given greater weightage:

³¹² Federico Lupo-Pasini, 'International Regulatory Regime on Capital Flows and Trade in Services', January 4, 2012, ADBI Working Paper 338.

³¹³ Andrew Cornford, 'Macroprudential Regulation: Potential Implications for Rules for cross-border banking', 2014, Page 4, Paper presented at UNCTAD Expert meeting.

investor protection through the FET standard or regulatory flexibility to use capital controls for maintaining systemic stability?

There is a likely contradiction between the FET standards of protection of investors' legitimate expectations including that of maintaining a stable business and legal environment on the one hand and the usage of capital controls as a macroprudential tool on the other. For instance, some capital control measures, such as taxes on certain forms of capital flows, unremunerated reserve requirements, ceilings on different types of capital flows and derivative operations, and minimum stay periods, can be considered to have changed the business landscape and the legitimate expectations of financial operators.

The minimum standard FET approach may link to customary international law. In the case of capital controls, this raises the issue of what the applicable customary international law is. For the financial sector, the definition of international customary law can be sourced from IMF Article of Agreements, G20 declarations on the use of capital controls, ICSID cases, established practice in FTAs/BITS, and national usage of capital controls, amongst others. Furthermore, given the evolving nature of customary international law and current financial regulation, including the changed policy stance on the usage of capital controls, the question arises as to how a reference point can be established.

Trend towards greater usage of dispute settlement: there is a strong possibility for dispute settlement, given that many FTAs and BITS contain dispute settlement provisions including ISDS provisions, particularly the recent (post-2005) FTAs, which have extensive investment or trade in services chapters (*see Table 23 Overview of Provisions In The GATS And Select FTAs Relating To Coverage, Capital Transfers, Prudential Flexibility, Fair And Equitable Treatment And Dispute Settlement Provisions*). There has also been a rise in ISDS cases in general, but specifically in the financial services sector (*see Chapters 5 and 6 for an in-depth discussion of financial-service-linked disputes*). Disputes arising from capital control measures are possible as FTAs/BITs that reflect GATS provisions suffer from the same problems, namely self-cancelling language, e.g. disallowing the usage of capital controls but providing for the freedom of monetary policy and narrow interpretation of terminology, e.g. prudential exception, provisions for the free flow of capital linked to covered investment and services commitments, and some agreements that explicitly provide for ISDS in the case of capital controls. For instance, US trade and investment treaties deem capital controls to be actionable measures that can trigger investor-state claims. Later, however, US FTAs do contain some flexibility by providing a 'cooling off' period before filing ISDS claims.

E. Conclusions

Since the 2008 financial crisis, the use of capital controls has reemerged as a macroprudential tool that may be necessary to maintain the stability of the financial sector and the economy at large. While the economic jury is divided on the effectiveness of CFMs, their success is situation-, time-, and target-specific.

Massive capital inflows followed by rapid outflows can have devastating economic or financial-sector-wide impacts, especially in countries with underdeveloped financial systems. If capital liberalisation can lead to banking and currency crises or even instability within financial markets and the wider economy, it can be argued that CFMs, provided they are not used for protectionist purposes, would be necessary regulatory tools at the disposal of regulators to prevent systemic risk build-up and act swiftly in times of crisis. It would therefore be important to maintain policy flexibility for governments to decide what is best for their markets.

While applying the provisions contained in FTAs/BITs to capital control measures, several issues arise. First is the inconsistency within trade and investment agreements. Trade and investment agreements contain provisions relating to the free transfer of funds linked to covered investments and trade in services (investment or cross-border commitments)³¹⁴. These trade and investment provisions are instituted for the purpose of investor/financial service supplier protection. The same agreements provide for regulatory flexibility by way of prudential exceptions and balance-of-payment safeguard measures, providing for regulatory flexibility. It can be argued that CFMs help meet an important macroprudential objective of maintaining systemic stability as well as being a crucial tool in times of BoP crisis.

Thus, depending on the kind of CFMs under consideration and the trade and investment commitments a member state makes internationally or bilaterally, a specific kind of capital control measure may not conform to a WTO member's commitment. For instance, in the case of US FTAs, there exists the real prospect of capital-control-linked ISDS given a clear requirement for the free flow of capital linked to covered investment and services commitments and a narrow US interpretation of prudential exception limited to individual enterprises. The IMF too has expressed concerns that restrictions on capital controls in certain FTAs/BITs, even those with special annexes, may conflict with the IMF's authority to recommend capital controls in certain country programmes, as is the case in Iceland.

³¹⁴ Investment definitions include intangible assets such as mortgages, liens, and pledges, as well as portfolio investment in the form of shares, stocks, debts, or interests in the property of local companies.

Second, would the usage of CFM measures be covered under the GATS-like prudential carve-out contained in FTAs? Given the direct link between the usage of CFM measures to maintain systemic stability, there is every likelihood of its coverage as a 'prudential exception'. Chapters 2, 5, and 6 discuss in detail the application of the prudential exception. There is, however, the possibility of the legitimacy of such CFM measures being questioned, specifically in the case of ISDS, on the grounds of being 'protectionist' and given the divided economic literature on the effectiveness of CFMs.

Third, the BoP safeguard measure contained in the GATS and FTA/BITS may not be effective in the case of CFMs. The BoP safeguard measure is envisaged for use in 'crisis-like' situations and not necessarily to maintain financial stability, and it is also required to be temporary. The application of the BoP safeguard clause necessitates the prior fulfillment of certain procedural requirements such as the procedures of the IMF Articles of Agreement and consultations with the WTO's balance of payment committee. This may delay or render ineffective a swift macroprudential regulatory imposition of capital controls. Furthermore, in the case of both the prudential exception and the BoP safeguard, several interpretational issues relating to terms such as 'necessary', 'temporary', 'unnecessary damage', and 'essential part of services', as contained in the applicable GATS, FTA/BITS provisions may arise.

Fourth, BITs through the FET standard contain provisions requiring the host state to meet the legitimate expectations of investors and to maintain a stable legal and business environment. Several CFMs, such as taxes on certain forms of capital flows, ceilings on different types of capital flows and derivative operations, and minimum stay periods, potentially contravene free capital transfer provisions contained in trade and investment agreements. It can therefore be argued that CFMs can change the legitimate expectations of investors and financial service suppliers as well as the FET requirement to maintain a stable legal and business environment. At the same time, given the ambiguity of the FET standard, several at times contradictory case law interpretations as well as case law that upholds the host state's right to regulate the success of dispute settlement in applying the FET standard to usage of CFMs is unclear.

Fifth, given the inconsistencies in trade and investment agreements, there is a strong probability of disputes, whether investor-state or state-to-state. The two kinds of disputes are handled very differently in their respective fora. State-to-state dispute settlement at the WTO or regional bodies takes into account larger considerations, including regulatory flexibility and economic considerations, and are more likely to be sympathetic to the usage of CFM measures. ISDS dispute

settlement, on the other hand, tends to focus on the facts of the case and rights and obligations under a given trade and investment agreement, thereby following a legalistic approach.

An important theme that emerges from the review of GATS, FTA, and BITS is the tension between capital transfer provisions and the market access goals of FTAs as well as the absence of a coherent multilateral regime to oversee the international effects of these provisions³¹⁵. Given the current reaffirmation of the use of capital controls, there is a need to rationalise the potentially conflictual provisions relating to investor and financial service provider protection on the one hand and regulatory flexibility on the other hand.

While developing a coherent multilateral regime to address volatile capital flows, CFMs and the trade and investment architecture can be a longer-term objective. A few elements to consider at the global level include:

- The need for global surveillance and preferably coordination on cross-border flows. This should also be linked to an understanding of the trade effects of cross-border flows as well as capital control measures. To some extent, this is happening through various bodies including the IMF, BCBS, and FSB, but there is a need to bring this together within a central consolidated forum. The same forum could also monitor developments surrounding capital transfer provisions in FTAs, issues that arise bilaterally, regionally, or globally, including through mediation and dispute settlement, when tensions arise between provisions of trade and investment agreements, cross-border capital flows, and the usage of capital controls.
- Developing a global regime to handle CFMs would give it a ‘public good’ status, taking it out of the hands of investors. Carney suggests that the creation of a Global Financial Safety Net, which would be more efficient than individual countries’ insurance against capital flows at risk. Instead, resources would be pooled with the IMF at lower levels and lower costs to achieve the same objective, i.e. reserve adequacy in the face of future risky external balance sheets³¹⁶. This would also have the added effect of taking the potential challenge on the use of capital controls out of the hands of investors by effectively making ‘sustainable capital flows’ a kind of global public good.

³¹⁵ See also D Siegel, Kevin Gallagher, and Rachel Thrasher, ‘Movement of Capital’, 2020, Chapter 6 in *Handbook of Deep Trade Agreements* (Editors: Mattoo, Aaditya; Rocha, Nadia; Ruta, Michele. 2020), World Bank, Washington DC, 2020.

³¹⁶ Mark Carney, ‘Pull, Push, Pipes: Sustainable Capital Flows for a New World Order’, 6th June 2019, Speech given at the institute of International Finance, spring Membership Meeting, Tokyo.

IV. Post Crisis Microprudential Regulation: The Case of Legal Form and Separation of risky Trading Activities

A. Introduction

Two key areas of microprudential regulation that were impacted during the crisis relate to ‘legal form’, i.e. the requirement to incorporate as a subsidiary as opposed to a branch, and ‘restrictions on risky trading activities’ by way of the segregation of banking and investment activities, i.e. proprietary trading and ringfencing³¹⁷. While both kinds of measures were implemented for systemic stability, bank reorganisations following their implementation have business and economic implications for investors and financial service suppliers, testing the interface between regulatory and trade/investment interests.

The purpose of this chapter is to examine select post-crisis micro financial regulation in terms of its consistency with (a) the GATS and select trade/investment agreements; (b) its implications for investors through the application of the FET clause; and (c) the flexibility of regulators. To achieve this, the thesis considers two examples of post-crisis microprudential regulation relating to legal form and restrictions on risky trading activity, i.e. proprietary trading and ringfencing (‘separation of risky activities’). The chapter is structured as follows. Part B outlines post-financial-crisis microprudential measures relating to the legal form of financial service providers focusing on the requirement to incorporate as a subsidiary as opposed to branching and proprietary trading and/or ringfencing. It outlines the kind of regulation being undertaken and the rationale behind such regulation.

Part C of this chapter then outlines the international trade and investment architecture as it relates to select microprudential measures. It focuses on market access, national treatment, and prudential exception provisions of the GATS and select bilateral investment and trade treaties and how they relate to the post-financial-crisis microprudential regulation. It also explores the application of the FET standard to select microprudential regulation. After that, Part D provides an overview of the interlinkages between post-crisis microprudential regulation, provisions contained in FTAs/BITS, and the application of the FET standard in terms of its implications for regulatory flexibility and investment/trade.

³¹⁷ Please note for the rest of this paper the reference to post-2008 financial crisis regulation relating to legal form, proprietary trading, and ringfencing may be collectively referred to as ‘select microprudential regulations’ or ‘microprudential regulation’.

Hypothetical Situation of Micropurdenial Regulation relating Legal Form and Separation of risky Trading Activities Interface with the Trade and Investment Architecture

Country B enacts microprudential regulation relating to proprietary trading and ring-fencing as well as the requirement for foreign financial services suppliers to incorporate as a subsidiary. Financial operator from Country A has global banking operations including a network of branches in Country B. In 2005, at the time of structuring its global financial operations including in Country B, Country A financial operator relied on the existing trade and investment architecture within the GATS and a bilateral FTA which permitted branching and proprietary trading. After the 2008 financial crisis, Country A's financial service operator is now faced with a situation in which it must restructure its financial operations in Country B as well as globally, owing to microprudential regulation enacted by Country B.

This has involved economic costs to Country A's financial operator in creating a subsidiary company, separating its investment and deposit-taking activities and complying with the new monitoring and reporting requirements as well as opportunity costs of pulling out of a third country due to expenses.

Country A's financial operator is contemplating filing an ISDS case on the grounds that the enactment of select microprudential regulation amounts to a breach of Country B's trade and investment obligations as well as a potential breach of the FET requirements to maintain a stable business and legal environment and meet investors' legitimate expectations. The situation is further complicated by ongoing discussions in the context of Brexit (Country B was used as an entry point into regional financial markets) as well as the possibility that proprietary trading regulation can result in the creation of a new type of financial service under the GATS/FTA.

Country B's financial regulators argue that the regulation was necessary after the 2008 financial crisis to bring stability to the market and protect consumer deposits, i.e. through reducing the possibility of systemic risk. Country B's financial regulators argue that they are protected under the GATS/FTAs prudential carve-out as well as case law relating to FET, which recognises legitimate regulatory actions.

B. Description of select Microprudential Regulation, their Economic Rationale and Usage post the 2008 Financial Crisis

The past two decades have witnessed ever-greater globalisation and integration of financial services. Foreign banks have become important in domestic financial intermediation. For example, in terms of loans, deposits, and profits, market shares of foreign banks average 20% in OECD countries and close to 50% in

emerging markets/developing countries³¹⁸. Van Horen and Claessens point out that this financial globalisation is a continuing trend even in the wake of the financial crisis³¹⁹.

The liberalised financial sector approach prior to the 2008 financial crisis preferred less as opposed to more regulation, displaying a preference for the branch-based approach to financial expansion and permissive norms on proprietary trading. As a result, in the run-up to the 2008 financial crisis, microprudential regulation focused on individual institutions, ignoring the impact of financial institutions' risk-taking on the broader financial system such as a bank's size, leverage, and interconnectedness³²⁰. After the 2008 financial crisis, however, this trend appears to have reversed, with a greater preference among regulators for subsidiaries as opposed to branches and reenactment of provisions that had once been repealed, e.g. Glass-Steagall and a move towards greater host country regulation in general, contrasting with the pre-2008 crisis home country regulation approach advocated in BASEL II³²¹.

1. Microprudential Regulation related to Legal Form: Subsidiary versus Branches

a. General Overview of Branch versus subsidiary Choice

Foreign banks opt for international expansion by physical presence in the host country in the form of a branch or subsidiary. An investor's choice of legal form,

³¹⁸ Stijn Claessens and Neeltje van Horen, 'Foreign Banks: Trends, Impact and Financial Stability', January 2012, IMF Working Paper WP/12/10, Pg. 5. The paper bases its findings on a comprehensive database on bank ownership, including the home country of foreign banks, covering 137 countries from 1995 to 2009. It provides salient facts on trends in foreign ownership, compares foreign and domestic bank characteristics, and analyses the relationship between foreign bank presence and financial development and the impact of foreign banks on lending stability during the recent crisis.

³¹⁹ Stijn Claessens and Neeltje van Horen, 'Foreign Banks: Trends, Impact and Financial Stability', January 2012, IMF Working Paper WP/12/10.

³²⁰ Kern Alexander, 'Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges', 2010, Page 6, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-fffffa42d6c8/micro.pdf>.

³²¹ Basel II is the second of the Basel Accords issued by the BCBS in June 2004 for implementation in early 2008. Owing to the financial crisis in 2008, it was partially superseded by Basel III.

i.e. branch or subsidiary, depends on several factors, including business strategy/penetration in the host country, tax on profits, country risk, and new technologies, with regulation being a primary factor.

Prior to the 2008 financial crisis, the preference was for financial expansion through operation of branches. This pre-2008 crisis model of ‘branchification’ enabled foreign banks to operate freely across borders, entailed less regulatory requirements, with a single point of supervision being home country supervision and fewer costs. The regulatory emphasis was also on the operation of branches as opposed to subsidiaries. Basel II, for instance, required branches and subsidiaries of foreign banks to defer to home country supervision³²². For subsidiaries too the trend was to defer to host country supervision³²³.

Operations of a branch as opposed to a subsidiary have several regulatory, structural, business, and risk implications of importance to both investors/financial services suppliers and regulators. *Table 26: Differences in Legal Status, Business Model and Risk Impact of a Branch versus a Subsidiary* sets out some of the differences between operating as a branch as opposed to operating as a subsidiary as well as the potential impacts for investor and regulator.

³²² The Basel Committee’s position on home and host authorities’ responsibilities relating to the supervision of branches of cross-border banks is described in the Basel Concordat and summarised in the Basel Core Principles for Effective Banking Supervision. Section VI of the Basel Core Principles describes the obligations of home and host supervisors as follows: ‘Home supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries’ (Core principle 23). With regard to host country responsibilities, there is an expectation that host supervisors will ensure that the business conduct of local affiliates of foreign banks is of the same high standard expected and enforced for domestic institutions, and that they have the ability to share information with relevant home authorities in order for the latter to carry out satisfactory consolidated supervision (Core principle 25).

³²³ See Basel II, Basel Core Principles for Effective Banking Supervision. With regard to host country responsibilities, there is an expectation that host supervisors will ensure that the business conduct of local affiliates of foreign banks is of the same high standard expected and enforced for domestic institutions, and that they have the ability to share information with relevant home authorities in order for the latter to carry out satisfactory consolidated supervision (Core principle 25).

Table 26: Differences in Legal Status, Business Model and Risk Impact of a Branch versus a Subsidiary

Issue	Branch	Subsidiary	Trade and investment impacts
Legal status	– No legal personality – Directly owned by parent bank, which coordinates management of assets, capital, and liquidity within the banking group. – Subject to home country supervision	– Legal person with limited liability – Greater autonomy, normally funded locally – Subject to host country supervision	– Legal action against a branch is not possible as it has no legal personality. – The regulatory requirement for subsidiarisation can invalidate existing trade and investment commitments which permit operations as a branch, providing grounds for a dispute. – Subsidiaries are subject to host country supervision.
Kind of business model	– Centralised business model, focus on wholesale and investment banking. Less costly owing to economies of scale arising from centralised operations.	– Decentralised business model, with financial, legal, operational independence with higher costs.	– Business model changes and subsequent conversion from a branch to a subsidiary are costlier.
Macro-prudential Impact	– Branches have a large number of interconnections within the banking group. This has systemic risk implications for the group.	– Subsidiaries can be a better safeguard for financial stability as they avoid contagion to other parts of the group.	– Risk of contagion in the case of a branch is borne by the parent company, whereas in the case of a subsidiary it is contained domestically. – Branches have a higher potential macro-prudential impact.

Source: Adapted by Author from BBVA Research Papers on Financial System and Regulation, Global Economic Watch

Branches, as compared to subsidiaries, have a higher macroprudential impact given their interconnectedness across a corporate group and limited regulatory control caused by their lack of legal personality. They are also subject to home as opposed to host country regulation. For investors, branches enable greater control and the cost of administering a branch is lower.

b. Post-2008 Crisis Regulation Relating to Legal Form

The 2008 financial crisis has also impacted the legal structure of financial operations. Between 2008 and 2013 there was a fall in the number of foreign subsidiaries and a marginal increase in the number of foreign branch operations.³²⁴

This has two implications. First, it could mean that after the crisis the number of subsidiaries has fallen as a result of home country consolidation arising from the economic costs of implementing more stringent regulatory requirements in host countries and resulting in firms pulling out of foreign markets. Second, the EU has shown a rise in foreign branches and a fall in foreign subsidiaries, possibly owing to the EU's consolidated post-crisis regulatory regime, which harmonises financial services regulation and creates regional institutions³²⁵.

Since the 2008 financial crisis, several countries required or encouraged a change in financial operators' mode of operation with requirements linked to the legal form of their operations, i.e. as a branch or subsidiary. In general, several host country authorities exhibited a preference for a subsidiary-based approach as it provides a greater degree of control and avoids repatriation of resources to the parent or the transfer of toxic assets to the branch, especially in times of crisis. The inadequate level of capital at some major banks in the run-up to the 2008 financial crisis was a key factor that led to financial regulators' encouragement of subsidiaries versus branches as well as host country versus home country regulation (*Table 27: Overview of select Countries Enactment of Legal Form related microprudential Regulation post the 2008 Crisis*).

³²⁴ See Alvarez Jose Maria, Garcia Javier Pablo, Gouvela Olga, 'The Globalisation of banking: How is regulation affecting global banks?', 8th August 2016, Page 8, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

³²⁵ Commentators have pointed out that the 'branchification' in Europe has been marked in comparison to the fall in the number of subsidiaries and is due to the existence of the European Common Market and the subsequent creation of the European Banking Union. See Alvarez Jose Maria, Garcia Javier Pablo, Gouvela Olga, 'The Globalisation of banking: How is regulation affecting global banks?', 8th August 2016, Page 8, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

Table 27: Overview of select Countries Enactment of Legal Form related microprudential Regulation post the 2008 Crisis

Country	Broad measure and year of implementation	Regulatory change in legal form/permitted activity
India	Preference for subsidiary	– Foreign banks with ‘complex structures’ and systemically important banks must incorporate as subsidiaries. Existing foreign banks encouraged to incorporate locally.
Spain	Subsidiary versus branch incorporation	– Home country legal form requirement where Banco de Espana prefers expansion in Latin America through subsidiaries to avoid risk of contagion to Spain.
EU	Subsidiary versus branch incorporation	– Since the financial crisis, differences in the supervision of branches and subsidiaries has lessened as host countries have tightened control of financial institutions operating in their territory, e.g. EU supervisory mechanism has extended ECB’s supervision to branches of banks whose parents are based outside the EU.
UK	Legal form	– All non-EU banks to operate as subsidiaries if (a) home country supervision is not equivalent; (b) resolution assurances are insufficient; and (c) the foreign bank intends to carry out critical economic functions in the UK.
US	Legal Form	– Federal Reserve requirement for systemically important banks to incorporate in the US.

Source: Author Compilation

The post-crisis preference for subsidiarisation is based on the regulatory objective of preventing contagion from spreading. It can be the result of direct regulation, i.e. express requirements or encouragement by the host country regulator³²⁶, or an indirect business outcome in response to new post-crisis regulations, e.g., to benefit from lower capital reserve requirements (‘CRR’) or deposit guarantee coverage.

³²⁶ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, ‘The globalisation of banking: How is regulation affecting global banks?’, 8th August 2016, Page 9, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

The UK Prudential Regulation Authority, for instance, requires all non-EU banks to operate as subsidiaries if (a) home country supervision is not equivalent; (b) resolution assurances are insufficient; and (c) if the foreign bank intends to carry out critical economic functions in the UK.

In November 2013, The Reserve Bank of India ('RBI') decided that foreign banks with 'complex structures' and banks that do not provide 'adequate disclosure' in their home jurisdiction would have to compulsorily convert themselves into wholly owned subsidiaries. In addition, large banks on account of their balance-sheet size, are also required to convert themselves into wholly owned subsidiaries³²⁷. Further commercial banks are incentivised to avail of 'near national treatment' on the condition of local incorporation. Existing foreign banks, especially those that are systemically important, were encouraged to adopt local incorporation³²⁸.

The US Federal Reserve Board announced in December 2012 that systemically important firms ('SIFIs') with both USD 50 billion or more in global consolidated assets and US subsidiaries with at least USD 10 billion in total assets would be required to organise in US subsidiaries under a single US Intermediate Holding Company. This would facilitate consistent regulation and supervision of US operations as well as resolution of operations in the event of failure. Subsidiarisation would entail a range of requirements including those relating to formation, structure, reporting, supervision, and enhanced prudential regulation, amongst others³²⁹.

Finally, Spanish regulators continued their preference for subsidiarisation, especially in relation to Latin American operations, based on the rationale that it prevented contagion and contributed to greater financial system resilience. In fact, a comparative study of Latin American and Caribbean countries based on BIS data found that countries were least exposed to the financial crisis as foreign bank lending was conducted by local subsidiaries, denominated in domestic currency, and broadly funded from a domestic deposit base³³⁰.

³²⁷ Tamal Bandhopadhyay, 'Global banks' local woes in India', 22nd December, 2014, The Livemint, Last Accessed on 9/12/2020 at <https://www.livemint.com/Opinion/5XcJE56bh1b4r4KLDJRjibO/Global-banks-local-woes-in-India.html>

³²⁸ Tamal Bandyopadhyay, 'New Regime for Foreign Banks', 7th November 2013, The Livemint.

³²⁹ See US Code of Federal Regulations Chapter 12, C.F.R. § 252.152(a) and (b) (2) and C.F.R § 252.153 (a) and (b).

³³⁰ Herman Kamil and Kulwant Rai, 'On the Eve of Retrenchment? The Effect of the Global Credit Crunch and Foreign Banks' Lending to Emerging Markets, why did Latin America Fare Better?', April 2010, IMF Working Paper WP/10/102. See also José De

Within the EU, the creation of a single banking union with a common framework for supervision and resolution has encouraged banking operations within a single jurisdiction and enabled branch-based operations³³¹.

Thus, regulatory preference for subsidiarisation as opposed to branches is linked to better control (i.e. subsidiaries being more attuned to local economic conditions), better supervision (i.e. greater oversight, such as over capital reserves owing to clearer delineation of capital from parent and domestic banks and therefore better protection of domestic deposits), prevention of systemic risk (i.e. through contagion given branches' interconnectedness), and finally greater control in case of banking failure (e.g. an effective bank resolution process).

2. Segregation of risky Trading Activities through microprudential Regulation on Proprietary Trading and Ringfencing, post the 2008 Crisis

Whether banks are trading for proprietary reasons, or to facilitate client business, they will be exposed to some form of market and counterparty risks³³². Ultimately, as with any risk, if losses are sufficiently large, this could lead to a bank's insolvency. Banks are therefore required to hold capital to protect against such risks.

To protect against market and counterparty risks, several countries in the wake of the 2008 financial crisis implemented regulation related to proprietary trading (e.g. the US), ringfencing (e.g., the UK), or a mix of both (e.g. the EU). Both proprietary trading and ringfencing regulation have similar objectives, i.e. to restrict the use of insured deposits by banks, thereby preserving systemic stability.

Gregorio, 'Resilience in Latin America: Lessons from Macroeconomic Management and Financial Policies', IMF Working Paper WP/13/259, Page 10, 2013. Available at: <https://www.imf.org/external/pubs/ft/wp/2013/wp13259.pdf>. Gregorio points out that in Latin American countries most foreign commercial banks are constituted as subsidiaries, operating like a domestic bank, with its own capital, its own board of directors, and strict rules for deposits of the subsidiary in the parent bank. This subsidiarisation also induces more local funding, thereby contributing to a resilient financial system.

³³¹ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The Globalisation of banking: How is regulation affecting global banks?', 8th August 2016, Page 9, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

³³² Whenever banks engage in trading activities, they take on risks – particularly the risk that their investments will fall in value (market risk) and the risk that the counterparties to their investments will fail to pay them (counterparty credit risk). Losses caused by these counterparty risks erode a bank's capital base.

Table 28: Overview of select Countries Enactment of Legal Form related microprudential Regulation post the 2008 Crisis

Country	Broad measure	Description of regulatory change
US	Proprietary trading	– The Volcker Rule does not allow banks to invest more than 3% of their Tier 1 capital in private equity and hedge funds and trade for hedging purposes. The Volcker Rule was implemented into the Dodd-Frank Act in 2010.
Germany	Proprietary trading	– The German Banking Act (Kreditwesengesetz – KWG) was amended by the Act on the Ringfencing of Risks and the Planning of the Recovery and Resolution of Credit Institutions and Financial Groups.
EU	Mixed approach, proprietary trading, and ringfencing	– The Liikanen report proposed walling off trading operations of banks (proprietary and market making) in separately capitalised subsidiaries if they exceeded specified thresholds. This was incorporated into parts of the EU’s regional acquis, but portions have been withdrawn since 2018.
UK	Ringfencing	– The UK Independent Banking Commission proposal for ringfencing retail banking from other activities was incorporated into the UKs Banking Reform Act 2013 which requires ringfencing of certain retail businesses in separate legal entities within the same group by January 1, 2019.
Eastern Europe	Ringfencing	– In 2015, some Eastern European bank imposed ringfencing measures, e.g. additional controls and limits on transactions in order to avoid an outflow of funds from branches of Greek banks to their parent company in Greece. This was implemented more as a crisis measure.

Source: Author Compilation

The current microprudential regulation relating to proprietary trading and ringfencing is a result of several reports undertaken after the 2008 financial crisis

in the US (Volcker Committee), EU (Liikanen report)³³³, and UK³³⁴ (*Table 27: Overview of select Countries Enactment of Legal Form related microprudential Regulation post the 2008 Crisis*). The underlying rationale for regulation relating to the separation of risky trading activities was to reduce systemic risk build-up using capital (deposit taking) and funding (investment banking). Some banks have already begun implementing these measures, such as UBS, Deutsche Bank, and Credit Suisse.

a. Restrictions on risky Trading Activities through Proprietary Trading

Proprietary trading is defined as ‘When a bank, brokerage or other financial institution trades on its own account rather than on behalf of a customer.’³³⁵ It has been out of favour amongst regulators since the financial crisis, when banks took heavy losses after betting some of their own capital on future market moves³³⁶.

– United States:

The antecedents of proprietary trading in the US can be found in the Glass-Steagall Act 1933, which prohibited commercial banks with privileged deposit insurance coverage from engaging in securities activities while simultaneously excluding investment banks from accepting deposits. It was introduced as part of the ‘New Deal’ in 1933 as a response to the Great Depression, in which banks suffered major losses through securities dealings. The most important restrictions of the Glass-Steagall Act were lifted in 1999 by the Gramm-Leach-Bliley Act.

³³³ Report by the High-Level Group chaired by the Governor of the Bank of Finland, Erkki Liikanen, 2 October 2012, (IP/12/1048), Available at http://europa.eu/rapid/press-release_IP-12-1048_en.htm.

³³⁴ UK’s Independent Commission on Banking Report, also known as the Vickers report.

³³⁵ See Financial Times Lexicon. Proprietary trading is where a trading desk, using the bank’s own capital and balance sheet, carries out trades in various instruments, often for speculative purposes.

³³⁶ Proprietary trading occurs when a trader trades stocks, bonds, currencies, commodities, their derivatives, or other financial instruments with the firm’s own money, as opposed to depositors’ money, to make a profit for itself. The challenge arises because banks are still able to act as ‘market makers’, maintaining an inventory so that they can buy and sell from clients who cannot find other investors who want to take opposite positions. The area between market making and proprietary trading can become blurry – for market making, banks must be able to demonstrate that their positions are to satisfy ‘the reasonably expected near-term demand of clients, customers, or counterparties’, which is not an exact science.

After the financial crisis, in 2009 the US adopted the Volcker Rule, which, beyond a few exceptions, prohibits banks from trading on their own account. The Volcker Rule prohibits two types of activities: (i) bank entities are not allowed to engage in proprietary trading (i.e. they cannot buy or sell securities for their own account); and (ii) banks may not acquire or retain an interest in hedge funds or private equity funds. In the opinion of Paul Volcker, these two types of activities are too risky and at the same time not essential for deposit-taking institutions³³⁷.

In 2010, the Volcker rule became part of the Dodd-Frank Act adopted as a response to the 2008 financial crisis³³⁸. Banks were given until 22 July 2014 to comply with the new measures of the Dodd-Frank Act. The prohibitions are applied to individual banks, as well as to banking groups, therefore extending to depository institutions, their parent companies, and subsidiaries. On a technical level, this was achieved by inserting the Volcker Rule into the Bank Holding Companies Act³³⁹.

Problems relate to a definition or description of the excluded activities under proprietary trading. The determination of what amounts to ‘proprietary trading’ was left up to competent government authorities³⁴⁰, creating a problem in terms of scope and application. For instance, securities dealings by banking entities are not excluded; they are only prohibited to the extent that they constitute ‘proprietary trading’, for which there is no definition. There are, however, some key features as to what could constitute ‘proprietary trading’³⁴¹. Ultimately, it requires determining whether the securities were acquired to realise short-term profits³⁴².

³³⁷ Paul Volcker, ‘How to Reform Our Financial System’, New York Times, 31 January 2010, p. 11.

³³⁸ See sec. 619 (12 U.S.C. § 1851) Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. 111–203, 124 Stat. 1376.

³³⁹ Sec. 13 Bank Companies Holding Act = 12 U.S.C. § 1851.

³⁴⁰ The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). The first four of these agencies have submitted a common rule on 10 December 2013,²³ while the CFTC has published its own final rule on 31 January 2014.

³⁴¹ See 12 U.S.C. § 1851(h)(4).

³⁴² See 12 U.S.C. § 1851(h)(4) and (6).

– European Union:

The EU has followed a mixed approach involving elements of proprietary trading and ringfencing. The European Commission proposed prohibiting the largest retail banks from undertaking proprietary trading, whilst also conferring new powers on bank supervisors to require further activity restrictions³⁴³.

The proposed reforms aim to ban the 30 largest European deposit-taking banks from proprietary trading in financial instruments and commodities, to grant supervisors the power to require the transfer of other high-risk trading activities to separate legal trading entities within the group, and to provide rules on the economic, legal, governance, and operational links between the separated trading entity and the rest of the banking group. In July 2018, the Commission decided to withdraw the proposed reform because its objective to a large extent had already been achieved by other measures³⁴⁴.

– Germany:

The German Banking Act (Kreditwesengesetz – KWG) has been amended by the Act on the Ringfencing of Risks and the Planning of the Recovery and Resolution of Credit Institutions and Financial Groups. As a result of the amendment, subject to thresholds, certain entities are not permitted to conduct specified banking activities as set out below³⁴⁵:

- a) proprietary business (Eigengeschäft), i.e. the purchase or sale of financial instruments on an own-account basis which does not constitute a service for others;

³⁴³ EU Press Release, Structural reform of the EU banking sector, 29th January 2014, can be accessed at: http://europa.eu/rapid/press-release_IP-14-85_en.htm?locale=en.

³⁴⁴ Official Journal of European Union, ‘Withdrawal of Commission Proposals’, 2018/C 233/05, Last accessed 13/12/2020 at <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52018XC0704%2803%29> and European Commission, “Structural Reform of the EU Banking Sector”, Last accessed 13/12/2020 at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/structural-reform-eu-banking-sector_en#documents.

³⁴⁵ The scope of the prohibitions is limited to credit institutions within the meaning of Article 4 para. 1 No. 1 of the Capital Requirements Regulation or CRR Credit Institutions and to entities that are members of a group of institutions, a financial holding group, a mixed financial holding group, or a financial conglomerate, provided that such a group or conglomerate comprises at least one CRR Credit Institution.

- b) loan and guarantee business with hedge funds and non-German alternative investment funds (or their management companies, respectively), in the latter case provided that the alternative investment fund employs leverage on a substantial basis;³⁴⁶
- c) high frequency trading, except for market making within the meaning of Art. 2 para. 1 lit. k) of the regulation on short selling and certain aspects of credit default swaps.

b. Restriction of Risky Trading Activities through ringfencing Requirements

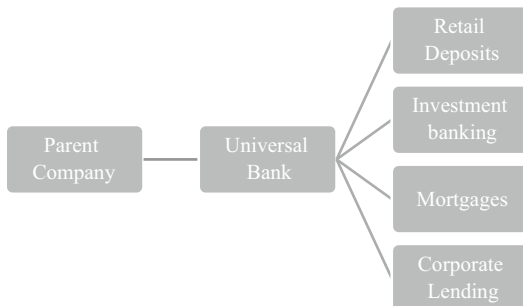
The key principle behind the requirement for banks to ‘ringfence’ core activities is to isolate basic banking businesses from riskier trading or investment banking units. Ringfencing rules in the UK were implemented formally through the 2013 Financial Services (Banking Reform) Act, which required the ringfencing of certain retail businesses in separate legal entities within the same group by January 1, 2019.

One of the key requirements of ringfencing is that the legal entity within a banking group that provides core retail activities cannot provide other activities such as investment and international banking. Such activities are referred to as ‘prohibited’ or ‘excluded’ activities. A bank in the scope of the reform that undertakes these activities will either need to stop doing so, divest them to a third party, or place them within separate legal entities outside the ringfence in its banking group (see *Figure 5: United Kingdom Pre 2008 Financial Crisis Universal Bank Structure* and *Figure 6: UK Ringfenced Structure Post 2008 Financial Crisis*)³⁴⁷.

³⁴⁶ Within the meaning of Article 111 para. 1 Regulation (EU) No. 231/2013 (a delegated Regulation supplementing the Alternative Investment Fund Managers Directive).

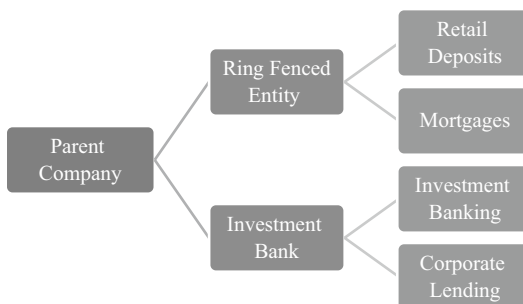
³⁴⁷ Katie Britton, Lindsey Dawkes, Simon Debbage, and Talib Idris, ‘Ring-fencing: what is it and how will it affect banks and their customers?’, 2016, Bank of England Quarterly Bulletin 4, Page 164, Bank of England’s Major UK Deposit Takers Supervision Directorate, Accessible at: <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2016/ring-fencing-what-is-it-and-how-will-it-affect-banks-and-their-customers>.

Figure 5: United Kingdom Pre 2008 Financial Crisis Universal Bank Structure



(Source: Author Construction drawn from Katie Britton, Lindsey Dawkes, Simon Debbage, and Talib Idris, 'Ring-fencing: what is it and how will it affect banks and their customers?', 2016, Bank of England Quarterly Bulletin)

Figure 6: UK Ringfenced Structure Post 2008 Financial Crisis



(Source: Author Construction based on 'Ring-fencing: what is it and how will it affect banks and their customers?', 2016, Bank of England Quarterly Bulletin)

Some of the key ringfence-related issues are as follows³⁴⁸:

- a) Ringfenced bodies would focus on accepting deposits from retail and small business customers in the UK or the European Economic Area.
- b) They would not undertake proprietary trading, i.e. deal in investments as principal.

³⁴⁸ Katie Britton, Lindsey Dawkes, Simon Debbage, and Talib Idris, 'Ring-fencing: what is it and how will it affect banks and their customers?', 2016, Bank of England Quarterly Bulletin 4, Page 164, Bank of England's Major UK Deposit Takers Supervision Directorate, Accessible at: <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2016/ring-fencing-what-is-it-and-how-will-it-affect-banks-and-their-customers>.

- c) The Prudential Regulation Authority and the Financial Conduct Authority would develop rules for implementing ringfencing. The PRA also has the power to require further restructuring of banking groups if they fail to deliver the essential elements of ringfencing.
- d) Banks with more than £25 billion of core retail deposits should be ringfenced³⁴⁹.

While the regulation relating to separation of risky banking activities, i.e. both proprietary trading and ringfencing, have the common objective of restricting risky activities involving insured deposits, there are differences in regulatory approaches in terms of how and when the regulation comes into play. The UK's ringfence approach is to define the activities that banks may fund with insured deposits. The underlying rationale is that a strong ringfence will help insulate the provision of core financial services from losses that could arise from proprietary trading³⁵⁰. By contrast, the US's Volcker rule and Dodd-Frank legislation aim to define the activities that banks may not fund with insured deposits.

The definition and scope of application in both cases can be ambiguous and regulation can vary between jurisdiction raising issues and costs for cross-border banking.

C. Microprudential Regulation relating to Legal Form and Segregation of risky Trading Activities in Relation to the International Trade and Investment Architecture

1. Overview

The legal frameworks as set out in the trade and investment architecture touch upon aspects of microprudential regulation relating to legal form and the separation of risky banking activities at two levels: the GATS and FTAs.

The GATS and FTAs cover financial services and linked investments through general and specific obligations, thereby covering microprudential regulation relating to legal form and the separation of risky activities. FTAs too contain GATS-like

³⁴⁹ The Government argued that applying ringfencing to smaller banks may result in disproportionate costs and hinder competition. See HM Treasury/Department for Business, Innovation and Skills, 'Banking reform: delivering stability and supporting a sustainable economy', June 2012.

³⁵⁰ Banking Standards, Written Evidence by the Financial Services Authority to the UK Parliament, 15th January 2013, Available at: <https://publications.parliament.uk/pa/jt201314/jtselect/jtpebs/27/27vi44.htm> .Last visited 25 January 2019.

Table 29: Overview of GATS and select FTA Provisions of Relevance to microprudential Regulation relating to Legal Form and Segregation of risky Activities

Agreement	Coverage of FS and thereby provisions relating to legal form, proprietary trading, and ringfencing	Prudential carve-out
GATS	– Provision relating to market access and national treatment, specifically Modes 1, 3, Annex on Financial Services, and Understanding on Financial Services Commitments	Yes
TPP	– General provisions and those relating to market access and national treatment contained in the Investment, Cross border Services, Financial Services (Chapters 9, 10, 11)	Yes, GATS-like
EU-Singapore	– General provisions and those relating to market access and national treatment contained in Trade in Services, Investment (Chapter 9)	Yes, GATS-like
EFTA-Singapore	– General provisions and those relating to market access and national treatment contained in Trade in Services, Investment Chapter (part III and Article 39 onwards)	Yes, GATS-like
US-Korea	– General provisions and those relating to market access and national treatment contained in Financial Services, Investment (Chapter 13)	Yes, GATS-like
US-Singapore	– General provisions and those relating to market access and national treatment contained in Financial Services, Cross Border services, Investment (Chapters 10, 8, 15)	Yes, GATS-like
India-Singapore	– General provisions and those relating to market access and national treatment contained in Investment and Trade in Services (Chapters 6, 7)	Yes, GATS-like
<i>ASEAN</i>	– General provisions and those relating to market access and national treatment contained in Trade in Services Agreement, Investment Agreement, Financial Services Protocol	Yes, GATS-like

Source: Author's compilation based on analysis of the respective agreements

provisions relating to financial services and investment including specific chapters on financial services, trade in services, cross-border services, and/or investment, along with corresponding market access, national treatment, and regulatory flexibility provisions. For an overview of the kinds of obligations in the GATS and

FTAs that touch upon microprudential regulation relating to legal form and the segregation of risky activities, see *Table 28: Overview of GATS and select FTA Provisions of Relevance to microprudential Regulation relating to Legal Form and Segregation of risky Activities*. Many BITs include coverage of portfolio investments which could be impacted by microprudential regulation relating to proprietary trading and ringfencing.

Microprudential regulations' interface with the trade and investment architecture raises several questions, some of which have been set out in *Table 29: Implication of Trade and Investment Architecture for select microprudential Regulation*.

Table 30: Implication of Trade and Investment Architecture for select microprudential Regulation

General provision	Implication for legal form	Implication for proprietary trading/ringfencing
Coverage of financial services measures	Is the microprudential regulation covered under the GATS, FTAs, BITS? If yes, under which chapter/provision?	
New financial product	Does the microprudential regulation amount to a new financial service? If yes, is it permitted under the trade agreement?	
Market access	– Implications under Modes 1, 3, and schedules of commitments	– Implications under Modes 1, 3, and schedules of commitments
National treatment	Are the new regulations discriminatory?	
Prudential carve-out	Is the new microprudential regulation justified under the prudential carve-out?	
Understanding on FS	Has the Understanding on FS been recorded or adopted? Are the new microprudential regulations in contravention of obligations under the Understanding on FS?	

Source: Author Construction

2. Microprudential Regulation and GATS and FTA Obligations

a. Coverage of Financial Services and linked Investment

Select microprudential regulation relating to legal form and segregation of risky activities is covered by the GATS and most FTAs, as well as BITS. The GATS covers 'measures relating to the financial sector', whilst also covering financial

services as one of the sectors in the GATS W120 classifications. The WTO Annex on Financial Services specifies the kinds of financial services that are covered. These include several sub-sectors which are of relevance to select microprudential regulation³⁵¹. For instance, of direct relevance to microprudential regulation relating to proprietary trading are the subsectors ‘Asset management’ and ‘Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise’. Furthermore, as far as legal form is concerned, microprudential regulation requiring change of legal form, i.e. incorporation as a branch or subsidiary in any of the financial services set out in the Annex on Financial Services fall within the scope of the GATS. Thus, a WTO or FTA party that has made a commitment in the sub-sectors specified in the Annex on FS could potentially have a conflictual situation between post-2008 microprudential regulation enacted at a national level and their trade obligations, depending on the kind of commitment undertaken in their schedules of commitments³⁵².

b. Market Access and National Treatment Considerations

Post-2008 crisis microprudential regulation, as it relates to legal form and segregation of risky activity, impacts market access and national treatment commitments

³⁵¹ WTO Annex on Financial Services, Section 5 A goes onto specify that financial services for the banking sector include the following activities: acceptance of deposits; lending of all types; financial leasing; all payment and money transmission services; guarantees and commitments; money broking; asset management, such as cash or portfolio management; pension fund management; custodial, depository, and trust services; settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments; provision and transfer of financial information, and financial data processing and related software; advisory, intermediation, and other auxiliary financial services including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy; participation in issues of all kinds of securities, and provision of services related to such issues; trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following: (a) money market instruments (including cheques, bills, certificates of deposits); (b) foreign exchange; (c) derivative products including, but not limited to, futures and options; (d) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements; (e) transferable securities; (f) other negotiable instruments.

³⁵² GATS Article XX sets out the format of the schedules of commitments namely the terms, conditions, limitations, and qualifications under which WTO members may schedule their commitments.

undertaken within the context of the WTO and FTAs³⁵³. GATS Article XVI (2) sets out permissible market access limitations that a member may maintain in their schedules of commitments. Notable provisions relate to:

- limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test³⁵⁴;
- measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and
- limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.

Under GATS Article XVI (2) on market access, once commitments have been entered into, it is no longer possible to set limits on aspects such as the size of the service, number of branches, types of products offered, and legal character. It can be argued that requirements for separation of risky activities either through ring-fencing or proprietary trading could amount to limitations in the context of GATS Article XVI (2)(c), i.e. the total number of service operations or service output, by requiring universal banks to separate into investment and retail operations or not permitting a bank to trade for its own account as regulation on proprietary trading indicates.

Similarly, it could be argued that microprudential regulation relating to legal form requirements to incorporate as a branch or subsidiary is in contravention of GATS Article XVI (2)(e) and (f). Thus, if WTO member A does not require a foreign bank to incorporate as a subsidiary as per its schedule of commitments, but since the 2008 financial crisis now requires incorporation as a subsidiary, then it would be a contravention of its GATS obligations.

In terms of modal coverage, select microprudential measures impact binding commitments countries may have undertaken specifically in Mode 1 (cross-border trade) and Mode 3 (commercial presence). An additional issue to consider in the context of the GATS is whether branches are juridical persons and therefore sub-

³⁵³ GATS Article XVI outlines market access provisions and GATS Article XVII outlines national treatment provisions. See Chapter 2 on the International Trade and Investment Architecture for a detailed outline of the GATS provisions relating to market access and national treatment.

³⁵⁴ Footnote 9 of Article XVI (2) (c) specifies that ‘Subparagraph 2(c) does not cover measures of a Member which limit inputs for the supply of services.’

ject to the same financial regulatory compliance requirements as juridical persons or subsidiaries with an independent legal existence.

GATS Article XVII provides for national treatment for services suppliers where a commitment has been undertaken. WTO members are expected to accord to services and service suppliers of any other Member treatment no less favourable than that it accords to its own like services and service suppliers. WTO members are, however, able to inscribe exceptions or qualifications in their schedules of commitments.

In the case of national treatment commitments, the post-2008 crisis microprudential regulations may constitute different provisions for foreign suppliers than domestic suppliers, impacting one or the other differently. For both legal form and separation of risky activity regulations, a potential national treatment problem arises only if (a) a commitment has been made to treat foreign financial service suppliers on a par with domestic suppliers, or (b) the foreign financial services provider is required to comply with a different microprudential regime to domestic financial service suppliers in respect of the commitment undertaken.

Thus, in the case of the separation of risky activities, post 2008, a foreign firm may be required to meet stricter proprietary trading or ringfencing criteria or requirements as compared to domestic financial service suppliers in a sector where the government made binding commitments to provide national treatment to foreign financial service suppliers.

In terms of microprudential regulation relating to legal form, there is the possibility that the foreign financial firm may suffer worse terms of operation if it were to operate as a subsidiary (i.e. as a domestic service supplier). For instance, if CRR requirements are higher in the host country as than in the home country, then incorporating as a subsidiary as opposed to a branch will require compliance with higher domestic CRR requirements. Domestic services suppliers may receive preferential treatment or be subject to lighter CRR requirements than a branch that is supervised by a foreign entity while providing a similar service, which could be argued to be discriminatory. The converse may also hold true, e.g. where domestic services suppliers are subject to more stringent regulation than foreign services suppliers, enabling them to benefit from regulatory arbitrage. In such a case, the domestic services suppliers may mount a domestic legal challenge to this.

c. Specific Obligations: Schedules of Commitments in Financial Services

Trade-in-services schedules of commitments under the GATS or in FTAs are an indicator of the degree of financial sector liberalisation a country has undertaken by way of binding commitments.

The exact impact of the post-2008 crisis microprudential regulation vis-à-vis GATS and FTA commitments vary and must be read with countries actual schedules of commitment³⁵⁵. An assessment of financial services commitments undertaken during the Uruguay round in 1997 indicate that a substantial number of WTO members made commitments in the financial services sector, with 95 commitments in the banking sector alone including market access limitations for subsidiaries and branches (*Table 30: WTO Member Commitments on Foreign Bank Entry and Activities*). The financial services commitments for both market access and national treatment in FTAs tends to be deeper than those undertaken under the GATS.

Most developed countries allowed for the operation of foreign branches and did not require establishment as subsidiaries for operation in the domestic market. Furthermore, substantial cross-border provision of financial services (Mode 1) was made. The question now is whether post-2008 crisis microprudential regulation requires incorporation as a subsidiary or prevents cross-border trading or asset management activities owing to new rules on proprietary trading. This can be considered a roll back on trade-in-services commitments (*Table 30: WTO Member Commitments on Foreign Bank Entry and Activities*). It is, however, important to remember that WTO commitments were undertaken in 1997 over two decades ago.

Moreover, WTO commitments frequently do not reflect what takes place in practice in many countries. For instance, on the issue of whether foreign banks can enter via branching, 85.7% of the countries that said they restricted/prohibited foreign branch entry, did in fact allow it according to their supervisory authorities' responses in the World Bank survey³⁵⁶. Hence, once more, the regulatory picture would be unclear.

³⁵⁵ For the purposes of this paper, it would be a lengthy process to go into individual member schedules of commitments.

³⁵⁶ James Barth, Juan Marchetti, Daniel Nolle, and Wanvimol Sawangngoenyung, 'WTO Commitments versus Reported Practices on Foreign Bank Entry and Regulation: A Cross Country Analysis', *Oxford Handbook of Banking* (Editors: Berger, Molyneux and Wilson), Chapter 17, Page 445.

Table 31: WTO Member Commitments on Foreign Bank Entry and Activities

Measure	Number of commitments undertaken
Commitments made in banking	95
Market access restrictions for foreign banks	– Limitation on number of foreign banks allowed to operate in the territory – Total 38, 37 DCs – Foreign equity limitations – 41 all DCs – Foreign bank entry not permitted through: (i) acquisitions – 33 (DCs 32); (ii) subsidiaries-44(DCs 42); (iii) branching – 42, all DCs – Limitation on value of banking system assets that foreign banks can hold – 34, all DCs
Cross-border supply of financial services permitted	– Acceptance of deposits – 24 – Lending – 25 – Financial leasing – 21 – Payment and transmission services – 18 – Guarantees and commitments – 24 – Participation in issuance of securities – 15 – Asset management – 12 – Money broking – 11 – Settlement and clearing services – 8 – Provision/transfer of financial information – 52 – Advisory intermediation, auxiliary financial services – 53
Minimum capital requirements being higher for foreign banks	Total 37, DCs – 36

Source: Barth James, Marchetti Juan, Nolle Daniel, Sawangngoenyuan Wanvimol, WTO Commitments versus Reported Practices on Foreign Bank Entry and Regulation: A Cross Country Analysis, Chapter 17, *Oxford Handbook of Banking* (Editors: Berger, Molyneux and Wilson), 2010. Data on Cross-Border Supply of Financial Services drawn from Barth James, Marchetti Juan, Nolle Daniel, Sawangngoenyuan Wanvimol, Foreign Banking: Do Countries' WTO Commitments Match Actual Practices? WTO Staff Working Paper ESRD-2006-11, October 2006. The study was based on responses of 123 countries to a World Bank questionnaire on given activities/restrictions.

Note: DC – developing country, IC – industrialised country

d. Understanding on Financial Services Commitments

Several Countries³⁵⁷ desirous of faster liberalisation of their financial sectors decided to use the Understanding on Commitments in Financial Services, which offers an alternative mechanism for deeper commitments³⁵⁸ (*see Chapter 2 on the Trade and Investment Architecture for a discussion on the Understanding on Financial Services Commitments*). Paragraph A of the Understanding on FS provides for a kind of ‘standstill provision’, specifying that *‘[a]ny conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures’*. The Understanding on FS’s ‘standstill provision’ effectively requires the non-creation of new regulations (or reverse liberalisation).

The enactment of new microprudential regulation relating to legal form and segregation of risky activities can amount to a roll back on existing commitments undertaken under the Understanding on FS. For instance, Korea, in its schedule of commitments, undertakes standstill provisions in its financial services commitments in Modes (1), (2), and (3) for both market access and national treatment commitments, with effect on 31 August 1997. Microprudential regulation relating to legal form and segregation of risky activities, if undertaken, could in effect amount to a roll back of its commitments.

Another interesting feature of the Understanding on FS relates to its coverage of new financial services. Paragraph B.7 of the Understanding on FS obliges the governments concerned to permit foreign financial service suppliers established in their territory to offer any new financial service. This raises two questions. First, as businesses are being restructured and remodeled as a result of regulation relating to legal form and segregation of risky activities, would the services supplied by the new entities be considered a new financial service? For instance, would the separation of commercial and deposit-taking activities of banks from trading and riskier activities amount to the provision of a new financial product or a new financial service?

The WTO’s Understanding on Financial Services defines new financial services in the following way: ‘A new financial service is a service of a financial nature,

³⁵⁷ It is estimated that some 30 Members (counting the then EC 15 as one) have scheduled financial services commitments as per the Understanding on Commitments in Financial Services.

³⁵⁸ By providing details on the sectoral/modal scope/nature of commitments and by containing additional obligations (standstill, government-procurement, new financial services, transfer/processing of information, and non-discriminatory measures).

including services related to existing and new products or the manner in which a product is delivered, that is not supplied by any financial service supplier in the territory of a particular Member but which is supplied in the territory of another Member.³⁵⁹ Based on this definition, it can be argued that a new microprudential regulation requirement requiring a company to incorporate as a subsidiary or to segregate the provision of financial services could potentially amount to a new financial service as it would relate to existing products as well as a change in the way in which a produce is delivered.

Similar provisions permitting new financial services and products are contained in several FTAs (see *Chapter 2 on the Trade and Investment Architecture*), but these are subject to certain authorisation and qualification requirements.

e. Prudential Carve-Out -Annex on Financial Services

It can be argued that the select post-2008 crisis microprudential regulation is permitted under the Annex on FS's prudential carve-out contained in the GATS and most FTAs (see Chapter 2 on the Trade and Investment Architecture for a discussion on the prudential carve-out). The purpose of microprudential regulation after the financial crisis is linked to clear prudential reasons, namely protecting the stability of the financial system as set out below:

- Regulators' preference for a certain kind of legal form such as a subsidiary as opposed to a branch: prudential rationale is to prevent branch-based contagion from branches to parents as in the Argentine crisis of 2001 and vice versa from parents to branches, given that business structures can be vectors of contagion.
- Separation of trading activities through proprietary trading and ringfencing: Prudential rationale is to ringfence or separate deposit taking activity from more risky investment like activities, to enable greater supervision and safeguard deposits.
- Ad hoc crisis regulatory measures: Financial regulators may demand a degree of control in times of crisis to avoid repatriation of resources to the parent or the transfer of toxic assets to the branch, e.g. some Eastern European banks imposed ringfencing measures (additional controls and limits on transactions) in the summer of 2015 in order to avoid flight of funds from branches of Greek banks to their parents in Greece³⁶⁰.

³⁵⁹ WTO Understanding on Commitments in Financial Services, Part D, paragraph 3.

³⁶⁰ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The globalisation of banking: How is regulation affecting global banks?', 8th August 2016, Page 8, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

The prudential carve-out is fairly wide and can easily accommodate the new generation of microprudential regulations post the 2008 crisis. However, as noted in Chapter 2, there are several inherent problems with the prudential carve-out, which leaves it open to interpretation and potential challenge. On the one hand, the prudential carve-out is a specific exception for measures taken for prudential reasons permitting their inconsistency with a Member's MFN obligations, or specific commitments on financial services³⁶¹. On the other hand, the measure has to be shown to have been taken for 'prudential reasons' for which a definition does not exist in the GATS, FTAs (with the exception of some US FTAs), and can evolve over time³⁶². Furthermore, the microprudential regulation undertaken must not be undertaken to avoid a member's trade-in-services obligation.

3. Select Microprudential Regulation and the Fair and Equitable Treatment Standard

As discussed in Chapter 2 on the Trade and Investment Architecture, the FET standard is contained in varying forms in most investment and trade agreements (*see Tables 14 and 15*). The key question in relation to select microprudential regulation and the FET standards is whether their usage conforms with the FET standard elements of transparency, meeting investors legitimate expectations and maintaining a stable legal and business environment. Linked to these questions is whether the FET standard itself provides for regulatory flexibility. Finally, what are the implications of differences in the minimum standard FET approach and the autonomous FET standard approach for the usage of select microprudential regulation?

The transparency element of the FET standard presupposes consistency in the host country's actions as well as for foreign investors the timely availability of relevant laws/regulations and in some cases the possibility to comment on new regulations (*see Chapter 2 on the Trade and Investment Architecture for a discussion on transparency and FET*). The transparency element was a central consideration in *Metalclad Corp v. Mexico* (2000) and *Genin et al. v. Estonia* (2001). Moreover, it was upheld in *Tecmed v. Mexico*, in which the tribunal held that a state must

³⁶¹ WTO Secretariat, 'Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services', 3 February 2010, S/C/W/312 S/FIN/W/73.

³⁶² WTO Secretariat, Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services, S/C/W/312 S/FIN/W/73 3 February 2010.

‘act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor’³⁶³, while another tribunal ruled that a NAFTA state should ensure that all relevant legal requirements must be capable of being readily known to foreign investors and that there should be no room for doubt or uncertainty on such matters³⁶⁴.

For the consistency element it can be argued that the host state committing to liberalise financial services through market access, national treatment, and investment in its international agreements, while imposing regulatory measures that roll back on existing trade and investment commitments, could be considered to be engaging in inconsistent behaviour. Furthermore, foreign investors expect the state to act in a transparent manner, which includes the timely availability of relevant laws/regulations and in some cases the possibility to comment on new regulations in the host country jurisdiction or prior comment³⁶⁵.

In the case of microprudential regulation, this could imply that the regulation-imposing country should inform foreign investors of their intention to impose microprudential regulation relating to legal form and segregation of risky trading activities and afford them an opportunity for prior comment³⁶⁶. However, at the same time, if the FET interpretation of transparency were to be applied, regulators would be required to inform financial markets of their intention to apply microprudential measures prior to doing so, specify the form of such measures, as well as give the foreign investor sufficient time to plan/adapt their investment. This could in effect impede swift regulatory action at points of financial market instability.

Legitimate expectations arise from either specific or general assurances given to an investor, based on which an investment is made. Assurances given by the host state which give rise to ‘legitimate expectations’ can take the form of (a) specific

³⁶³ *Tecnicas Medioambientales Tecmed SA v. Mexico*, Award (ICSID Case No. ARB (AF)/00/2, 29 May 2003), paragraph 154.

³⁶⁴ *Metalcad v. Mexico* Award, paragraph 76.

³⁶⁵ The general obligation of transparency is found in Article III of the GATS, which requires members to publish all relevant laws and regulations and set forth clear standards so that foreign traders can determine exactly which conditions must be fulfilled in order to conduct trade in the host jurisdiction. Moreover, national authorities must notify the Council for Trade in Services of any changes in regulations that apply to services that are subject to specific commitments. Similar provisions are reflected in several FTAs and some BITS.

³⁶⁶ Prior comment is when interested persons are provided a reasonable opportunity to comment on proposed regulatory measures.

commitments addressed to the investor personally and (b) more general rules enacted with the specific aim of inducing foreign investment. The common factor in either case is that the investor must have relied on these assurances while making its investment. Market access, national treatment, and binding obligations made in individual countries' trade-in-services schedules of commitments as well as investment commitments contained in BITS and other international instruments could be considered general commitments made to investors, especially since they are directly linked to 'covered investments' and 'financial services commitments' undertaken.

Thus, hypothetically, a European firm relying on GATS/FTA commitments or investment provisions contained in BITS may make investments within the US or UK, for example. Following the 2008 financial crisis and the imposition of measures, such as those related to proprietary trading or ringfencing, the European firm may be faced with an entirely new regulatory landscape requiring substantial changes in business structure and incurring economic costs. The question would be whether the applied microprudential measure changed the European financial institutional investor's legitimate expectations relied on at the point of making its investment.

The onus on the host state to maintain a stable business and legal environment has been upheld by way of several ICSID cases, such as *Occidental v. Ecuador* (2004) and *CMS Gas Transmission Co v. Argentina* (2005), in which government measures were found to violate the FET standard because they altered the legal and business environment under which the investment was made (*see Chapter 2 on the Trade and Investment Architecture discussion on maintaining a stable business and legal environment*).

In *Occidental v. Ecuador* (2004), the tribunal held that '[t]he stability of the legal and business framework is ... an essential element of fair and equitable treatment'³⁶⁷. In *CMS Gas Transmission Co v. Argentina* (2005), the tribunal held that 'fair and equitable treatment is inseparable from stability and predictability' and that the new laws and arrangements introduced by the Argentine government following the monetary crisis in Argentina breached the FET standard as contained in the US-Argentina BIT³⁶⁸.

The adoption of microprudential measures can directly impact the operations of foreign investors and financial service suppliers by substantially altering the busi-

³⁶⁷ *Occidental v. Ecuador* (2004), Paragraph 183.

³⁶⁸ Article 2(2)(a) of the US-Argentina BIT.

ness and legal environment that they relied on at the time of making their investment. This in turn could lead to a contravention of the FET standard. However, at the same time, the FET standard requirements of maintaining a stable legal and business environment and meeting investors' legitimate expectations can ensure the host state's ability to regulate, which in the case of the financial sector is crucial for financial market stability. FTA provisions and FET-related case law and provisions have at the same time protected regulatory flexibility in the face of investors' legitimate expectations, as can be observed from prudential carve-out, such as provisions contained in FTAs.

Some FTAs also contain specific provisions to protect regulatory flexibility in the face of an investor's legitimate expectations, such as the US-Singapore agreement³⁶⁹, which specifies that whether an investor's investment-backed expectations are reasonable depends in part on the nature and extent of governmental regulation in the relevant sector. For example, an investor's expectations that regulations will not change are less likely to be reasonable in a heavily regulated sector than in a less heavily regulated sector. Considerations include whether the sacrifice expected by the investor exceeds what is considered important in the public interest. Given that microprudential regulation relates to the financial sector, which is indeed one of the most heavily regulated sectors in the economy, and linked to systemic stability, which is in the public interest, there is the strong possibility that regulatory flexibility will be upheld.

The TPP also clarifies that 'the mere fact that a Party takes or fails to take an action that may be inconsistent with an investor's expectations does not constitute a breach of the Article [on minimum standard of protection] ...'³⁷⁰ This indicates that a breach of an investor's 'expectations alone will not constitute a basis to bring a claim of breach of minimum standard of protection. Yet, implicitly, this approach provides that breach of an investor's 'expectations' may be relevant in establishing a violation of FET and minimum standard of protection³⁷¹.

In terms of ICSID case law, while upholding the protection of investors' legitimate expectations, tribunals have sought to ensure that the host state has a reasonable degree of regulatory flexibility so that it can respond to changing circumstances

³⁶⁹ See Annex 11 B of the US-Singapore agreement.

³⁷⁰ See TPP Article 9.6.4.

³⁷¹ See: Lise Johnson and Lisa Sachs, 'TPPs Investment Chapter: Entrenching rather than resolving a Flawed System', 21 November 2015, Policy Paper Columbia Centre for Sustainable Investment, page 4.

in the public interest. In *Saluka v. Czech Republic* (2006), the tribunal held that foreign investors' expectations must be weighed against the host State's legitimate right to regulate domestic matters in the public interest well³⁷² (*see Chapter 2 on the Trade and Investment Architecture for a detailed discussion of regulatory flexibility in case law*).

These BITS and tribunal proceedings taken alongside the 'prudential exceptions' contained in the GATS and FTAs, as well as the special case of the financial sector which warrants greater regulatory flexibility, may provide a defense in FET cases linked to the use of microprudential regulation related to legal form and separation of risky activities.

Finally, the treaty formulation of the FET standard, i.e. minimum versus autonomous standard, is important as it determines the scope of application of the FET standard in respect of post-2008 microprudential regulation (*see Chapter 2 on the Trade and Investment Architecture for a discussion on the impact of minimum versus autonomous FET standard approach*).

The minimum standard approach contained in US FTAs and BITS follows a narrow interpretation of FET linked directly to customary international law. The application of traditional customary international law requires the host state to meet an international standard in its application of the FET standard and raises the question as to which international standard or sources of customary international law would be applied and to what extent. In the autonomous approach, the FTA/BITS do not refer to customary international law and the tribunal makes an objective assessment based on the facts of the case and the underlying rationality of host state regulatory choice (*see Chapter 2 for a discussion on the autonomous FET approach*).

A key question in the application of the minimum standard FET is which sources of customary international law will apply in the case of microprudential regulation relating to legal form and separation of risky trading activities such as regulation relating to proprietary trade and ringfencing. The principles, guidelines, decisions, and even research of international organisations and standards-setting bodies (Basel Committee, IAIS, IOSCO, FSB, IMF) could be considered sources of CIL.

However, given the change in policy stances of some international standard-setting bodies on aspects of microprudential regulation, the value of such international organisations as a source of CIL may not be reconsidered. For instance,

³⁷² *Saluka v. Czech Republic*, paragraph 305.

prior to the 2008 financial crisis, a key policy stance at trade negotiations at the WTO and elsewhere was to encourage operation through branches as opposed to subsidiaries. After the 2008 financial crisis, we have seen the reverse in some countries, i.e. preference by regulators for subsidiaries as opposed to branches. Furthermore, operation as a universal bank was permitted, but after the 2008 financial crisis there is an emphasis in several countries on the separation of risky activities through regulation relating to proprietary trading and ringfencing. These shifts in regulatory approaches in select microprudential regulation question the extent to which national regulation relating to legal form and separation of risky activities can act as a source of CIL.

Second, customary international law is inherently evolutionary. The direction of its movements if FET is applied to the financial sector would have to be proved. In the case of specific microprudential regulation, this would mean establishing a direction of usage of the select microprudential regulation by several countries, both historically and over a period of time.

D. Select Post-Crisis microprudential Regulation and Contradictions/Inconsistencies with the Trade and Investment Architecture

Changes in select 2008 financial crisis microprudential regulation have directly or indirectly³⁷³ resulted in inconsistencies with or contradictions to the existing trade and investment architecture. The trade and investment architecture covers measures affecting the financial sector, including select post-crisis microprudential regulation. The same agreements protect investor rights and regulatory flexibility in the financial sector, as well as provide for some manner of dispute settlement, including investor-state dispute settlement (*see Table 31: Overview of Provisions contained in select Trade Agreements Relating to Coverage of the Financial Sector, Investor Protection, Regulatory Flexibility, and Dispute Settlement*).

³⁷³ For instance, changes in microprudential regulation in other areas, such as capital reserve requirements or resolution requirements, may impact the choice of legal form.

Table 32: Overview of Provisions contained in select Trade Agreements Relating to Coverage of the Financial Sector, Investor Protection, Regulatory Flexibility, and Dispute Settlement

FTA/BIT	Kind of coverage	Coverage of select microprudential regulation	Regulatory flexibility	Kind of FET provision	Provision for investor-state dispute settlement
GATS	Investment, financial services	Yes*	Yes	FET like	Yes, on financial services
TPP	Investment, financial, cross-border services	Yes*	Prudential carve-out in the financial sector, BoP safeguards	Minimum standard	Yes
EU-Singapore	Investment	Yes	Prudential exception, BoP safeguards	Autonomous	No, but provision for ICSID arbitration
EFTA-Singapore	Investment, trade in services chapters	Yes*	Prudential exception, BoP safeguards	Autonomous	No, but provision for ICSID arbitration
US-Korea	Investment, financial, cross-border services	Yes*	Prudential carve-out in financial sector	Minimum standard	Yes
US-Singapore	Investment, financial, cross-border services	Yes*	Prudential carve-out in financial and investment chapter	Minimum standard	Yes
India-Singapore	Investment, trade in services chapters	Yes*	Prudential exception and BoP safeguard	No obvious FET clause	Provides for ICSID arbitration
ASEAN	Several agreements, the main one being ASEAN Investment Agreement	Yes*	Prudential exception and BoP safeguard	Yes	Investor-state dispute settlement and ICSID arbitration

Source: Author compilation based on select trade and investment agreements

Note: Yes indicates that the exact commitment will depend on specific obligations undertaken by parties to the agreement*

This in theory creates a situation where a bank with global or cross-border operations is faced with new post-crisis microprudential regulation that is (a) substantially different or contradictory to the WTO/FTA commitments it relied on to initiate cross-border operations or is (b) contradictory to its legitimate expectations under the FET clause of BITs, which (c) results in economic costs from regulatory compliance or economic loss from closing existing operations due to regulatory burden.

Depending on the FTA and the jurisdiction, the investor could potentially file for an investor-state dispute settlement. At the same time, the financial regulator would have coverage of regulatory exception clauses such as the prudential carve-out, but the extent of regulatory protection is still to be tested. Furthermore, the outcome of the dispute may vary depending on the forum in which the dispute settlement is sought, i.e. WTO, ICSID etc., and potentially the political climate.

1. Trade and Investment related Contradictions and Inconsistencies

On the trade and investment front, the post-2008 microprudential regulation has three results: (a) contravention or incompatibility with the existing trade and investment architecture, which would make strict adherence to key trade and investment principles of market access, national treatment, fair and equitable treatment, and the ensuing trade and investment commitments made in this regard difficult to maintain; (b) trade-barrier-like effects in the form of direct and indirect impacts on investors and financial services suppliers through business restructuring and economic costs; and (c) implications for regulatory flexibility (*Table 32: Direct/Indirect Impact on Financial Services Providers, Investors, Investors and Financial Regulators of select Post-Crisis microprudential Regulation relating to Legal Form, Ringfencing, and Proprietary Trading*).

Table 33: Direct/Indirect Impact on Financial Services Providers, Investors, Investors and Financial Regulators of select Post-Crisis microprudential Regulation relating to Legal Form, Ringfencing, and Proprietary Trading

Measure	Direct or indirect effect on whom	Conformity with trade and investment architecture	FET implications	Potential tension between regulatory prerogative and investor rights
Legal form	– Direct effect on investor and financial service supplier from business restructuring, regulatory compliance, unclear regulatory landscape, – Impact on regulator as implementor and supervisor	– Market access, national treatment provisions, Mode 3, new financial product, understanding on FS commitments, Annex on FS and prudential carve-out	– Legitimate expectations, economic costs	– Potential challenge under WTO/ BITS provisions balanced against prudential carve-out exception and dispute settlement clauses – Will also depend on political will, implementation costs, and regulators maintaining systemic stability
Ringfencing	Same as above	Same as above	Same as above	Same as above
Proprietary trading	Same as above	Same as above	Same as above	Same as above

Source: Author Construction

Specific contraventions of the trade and investment architecture arising from the implementation of select microprudential regulations are set out in *Table 33: Possible Contraventions of Trade Agreements by select Post-Crisis Microprudential Regulation Relating to Legal Form, Ringfencing, and Proprietary Trading*. In general, select post-2008 microprudential regulation imposed by regulators on financial service suppliers and investors can act as market access and national treatment barriers by going back on or contravening commitments made in trade agreements, e.g. in Modes 3 and 1 or requiring additional conditions to be met.

Table 34: Possible Contraventions of Trade Agreements by select Post-Crisis Microprudential Regulation Relating to Legal Form, Ringfencing, and Proprietary Trading

Measure	Potential contravention	Trade agreement likely to be contravened
Legal form	– MA: Requirement to incorporate as a subsidiary, with own capital – MA: Branch required to provide guarantee by parent company – MA: Permission for supply of cross-border services (Mode 1) may be changed to require a commercial presence, i.e. either branch or subsidiary – MA: Higher CRR for foreign branches or existing subsidiaries	– FS commitments in Mode 3 and 1, Understanding on FS standstill provision, FTAs, BITs commitments
Ringfencing	– MA: Separation of existing investment activity from retail banking, incurring business restructuring and economic costs	– FS commitments in Mode 3, Understanding on FS commitments standstill provision, FTAs, BITs commitments
Proprietary trading	– MA: Ban on proprietary trading in jurisdictions where it was permitted in the past – MA: Proprietary trading from jurisdiction in which permitted to one where it is not as a result of new regulation. Particularly impacted are group holding companies	– Mode 1, Understanding on FS commitments standstill provision, FTAs, BITs commitments
All three	– Business restructuring and economic costs for regulatory compliance, regulatory arbitrage impacts – NT: Discrimination against foreign banks, e.g. lighter CRR requirements for domestic suppliers, proprietary trading for foreign banks cross jurisdictional operations	

Source: Author Construction

Note: For the column on trade agreement contraventions, actual contraventions will depend on individual countries' trade-in-services commitments at the WTO or under FTAs. MA: market access. NT: national treatment

Under GATS Article XVI (2) and XVII on market access and national treatment, respectively, once commitments have been entered, it is no longer possible to set limits on aspects such as the size of the service, number of branches, types of products offered, legal character, and foreign capital participation or to indicate a preference for domestic service suppliers. These provisions can potentially be contravened by select post-2008 microprudential regulation. For instance, the requirement for a financial operator to incorporate locally, rather than operate as a branch of a foreign institution, or the requirement to incorporate locally when in the past the provision of cross-border supply of financial services was permitted can contravene existing trade and investment obligations.

In the case of national treatment commitments, the new regulations may constitute different provisions for foreign suppliers than domestic suppliers, impacting one or the other differently. Thus, if domestic services suppliers receive preferential treatment or are subject to lighter CRR requirements than a branch that is supervised by a foreign entity while providing a similar service, such behaviour can potentially be considered discriminatory. The converse may also hold true, such as when domestic services suppliers are subject to more stringent regulation than foreign services suppliers, enabling them to benefit from regulatory arbitrage, to which the domestic services suppliers may mount a domestic legal challenge.

However, from a regulatory perspective, the rationale behind post-2008 microprudential regulation is strong. First, in the case of legal form requirements, cross-border credit (Mode 1) tends to be less stable than the supply of credit by local subsidiaries (Mode 3), particularly in times of crisis³⁷⁴. Second, a foreign bank may become systemically important in the host country market or there may be a concentration of assets in the hands of banks originating in the same home country³⁷⁵. Similarly, if proprietary trading requirements for restructuring and ringfencing are undertaken with the regulatory objective of protecting depository accounts, then for both kinds of microprudential regulation the larger objective is maintaining systemic stability.

Other issues are the conceptual differences between provisions in trade agreements and microprudential regulation. For instance, under the GATS, branches

³⁷⁴ Ralph De Haas and Iman van Lelyveld, 'Foreign bank penetration and private sector credit in Central and Eastern Europe', 2004, *Journal of Emerging Market Finance*, Volume 3, Pages 125-151.

³⁷⁵ See also WTO Secretariat, 'Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services', 3 February 2010, S/C/W/312 S/FIN/W/73.

and representative offices are recognised as Mode 3 ‘commercial presence’ to be treated on a par with domestic service suppliers, even though a branch is not a juridical person³⁷⁶. By default, this treatment could extend to the parent company too. However, in the case of a subsidiary, the right to such treatment does not extend to other parts of the juridical person that exist outside the jurisdiction of the host country, i.e. other group members³⁷⁷. This would mean that Bank X operating through its branch in country A can benefit from the same beneficial treatment as a subsidiary of Bank Y also incorporated in Country A³⁷⁸. Incorporation as a subsidiary therefore is not required. This creates complications in the context of implementing the post-crisis microprudential regulation for legal form and proprietary trading, both of which have differential treatment of a branch as opposed to a subsidiary as well as the extended group holding company.

2. Trade-Barrier-Like Effect

Differing post-crisis microprudential regulations can act as a trade barrier by hampering cross-border and investment banking operations. All three microprudential regulations set out in *Table 33: Possible Contraventions of Trade Agreements by select Post-Crisis Microprudential Regulation Relating to Legal Form, Ring-fencing, and Proprietary Trading* will entail business restructuring and economic costs and to that extent may be considered indirect barriers to trade. Proprietary trading requires the restructuring of operations into separate business lines, e.g. universal banks may need to set up two different entities or in the case of the UK be ringfenced. Furthermore, microprudential regulatory compliance applies to the

³⁷⁶ Article XXVIII(g) was introduced in order to clarify the status of branches in the GATS. Footnote 12 states the following: ‘Where the service is not supplied directly by a juridical person but through other forms of commercial presence such as a branch or a representative office, the service supplier (i.e. the juridical person) shall, nonetheless, through such presence be accorded the treatment provided for service suppliers under the Agreement. Such treatment shall be extended to the presence through which the service is supplied and need not be extended to any other parts of the supplier located outside the territory where the service is supplied.’

³⁷⁷ WTO Secretariat, ‘Note on Financial Services to the Council on Trade in Services and the Committee on Trade in Financial Services’, 3 February 2010, S/C/W/312 S/ FIN/W/73.

³⁷⁸ However, the branch can be subject to differential requirements in areas such as taxation and deposit taking, given that it is not a legal entity in itself. See WTO Secretariat Note on Status of Branches as Services Suppliers, document MTN.GNS/W/176, 23 October 1993.

single entity and, in the case of the US and Germany, group entities as well. In the case of legal form, barriers and costs may arise from changes in the conditions of existing operations, e.g. higher CRR requirements for foreign branch operators or subsidiaries, enhanced reporting, and supervisory requirements, e.g. reporting/supervisory requirements to the host country regulator or parent companies may be required to provide guarantees for their branches.

Business restructuring and economic costs become even more acute issues for firms operating in several jurisdictions, as they may be faced by conflicting or incompatible microprudential regulation. For instance, US regulation on proprietary trading extends to depository institutions, their parent companies, and subsidiaries³⁷⁹. However, the reverse is true of the UK's ringfencing regulation, which does not prevent the ringfenced entity from being owned by a parent company that also owns a bank that undertakes prohibited or excluded activities. Such entities can sit within the same banking group as a ringfenced bank so long as this is consistent with the objectives of ringfencing. For a cross-border banking company with operations in both the US and the UK, this effectively means dealing with two banking systems with the same objective but different and potentially contradictory means of implementing them.

Within the EU the issue of conflicting regulation, which impacts cross-border operations, has been negated for intra-EU banking operations as a result of the harmonised European Banking Union. Thus, in the case of regulation related to legal form, the need for incorporating as a subsidiary is not necessary for intra-EU operations, but, for a non-EU bank, incorporation as a subsidiary could be important. Additionally, Brexit (if it does occur) gives the issue of legal form another dimension for existing or future British banks operating in the EU.

Linked to the trade impact of differing regulation is the potential for regulatory arbitrage, particularly in the case of ringfencing and proprietary trading regulation. Several potential scenarios arise, e.g. if proprietary trading or ringfencing is permitted in country A but not permitted in country B, then a financial services supplier established in Country A may have to rethink or readapt its operations in country B. Again, this scenario will differ depending on whether the FS operator is incorporated as a branch or a subsidiary, as well as the definition and the kinds of activities permitted under ringfencing and the proprietor trading regime in both jurisdictions.

³⁷⁹ See 12 U.S.C. § 1851(h)(1).

The exact impact of the microprudential measures on cross-border flows will depend on the willingness and ability of financial entities to arbitrage between countries. After the 2008 financial crisis, for instance, the introduction of government guarantees for banks' debt or changes in retail deposit insurance mechanisms, significantly raised the potential for regulatory arbitrage when the measures were initially introduced in an uncoordinated manner³⁸⁰.

3. Investor Impact and the Fair and Equitable Treatment Standard

From an investor's perspective, the post-2008 financial crisis regulatory changes relating to microprudential requirements (e.g. segregation of risky trading activities, ringfencing, legal form requirements occurring at differing levels and speeds

³⁸⁰ In Asia, for example, four economies (Chinese Taipei; Hong Kong, China; Malaysia; and Singapore) introduced unlimited guarantees of all deposits on a temporary basis. That a trade rationale has influenced some of these decisions was made apparent in Singapore's statement, in which both the Ministry of Finance and the Monetary Authority of Singapore stated that 'the announcement by a few jurisdictions in the region of Government guarantees for bank deposits has set off a dynamic that puts pressure on other jurisdictions to respond or else risk disadvantaging and potentially weakening their own financial institutions and financial sectors. This is why although Singapore's banking system continues to be sound and resilient, the Government has decided to take precautionary action to avoid an erosion of banks' deposit base and ensure a level international playing field for banks in Singapore.' Indonesia and the Philippines also increased their protection, within limits. Australia's and New Zealand's unlimited deposit guarantees (for three years, respectively) have been motivated by similar considerations. As expressed by Kevin Rudd, Australian Prime Minister, in a press conference, 'I don't want a first-class Australian bank discriminated against because some other foreign bank, which has a bad balance sheet, is being propped up by a guarantee by a foreign government.' In Europe, 'level-playing-field' considerations have prompted common action regarding deposit guarantees. At a meeting on 7 October 2008, EU finance ministers decided to raise minimum bank deposit guarantees across all 27 Member States and to take coordinated action to save financial institutions. Following that meeting, on 15 October 2008, the European Commission put forward a revision of EU rules on deposit guarantee schemes, making it mandatory for Members States to increase the coverage level to at least 50,000 euros and within a further year to at least 100,000 euros. In its opinion of 18 November 2008, the European Central Bank emphasised 'that any increase in the coverage exceeding the latter of the above-mentioned amounts should be preceded by close coordination at the EU level, as substantial differences between national measures may have a counter-productive effect and create distortions in the single market.' See Report on the Financial and Economic Crisis and Trade Related Developments by the WTO Director General to the Trade Policy Review Body, 15th July, 2009, WT/TPR/OV/W/2.

of regulatory reform) have raised challenges related to the cost and scope of financial investor operations³⁸¹.

From an FET perspective, a key question is whether investors have sufficient cause to invoke the FET standard. As set out in Chapter 2 on the International Trade and Investment Architecture, the key elements of the FET standard are (i) whether the legitimate expectations of investors have been met and a stable business environment has been maintained and (ii) whether investors are faced with heavy economic costs arising out of a breach of the FET standard.

a. Legitimate Expectations of Investors

From an investor's perspective, it can be argued that the new microprudential regulation has changed the business and legal environment that investors relied on at the time of making their investment, thereby failing to meet investors' 'legitimate expectations'. First, the regulatory landscape and the very direction of regulation has changed drastically in several ways, moving from a *laissez-faire* to a more regulated approach and from micro to macroprudential and home to host country regulatory focus. At the time of making their investments, investors relied on the existing trade and investment architecture, parts of which the post-2008 microprudential regulation appears to be contravening.

Second, regulations have directly and indirectly made it less attractive for banks to maintain large foreign operations³⁸². Banks in advanced countries are not only faced with large losses and capital shortfalls, but also the cost of regulatory compliance, arising from major restructurings of their business operations. The structural reforms necessitated by regulation coupled with other regulation relating to higher liquidity requirements changes the incentives and business models of how banks structure their cross-jurisdictional activities and recovery and resolution planning³⁸³.

³⁸¹ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The globalisation of banking: How is regulation affecting global banks?', 8th August, 2016, Page 8, BBVA Research Papers on Financial System and Regulation, Page 6, Global Economic Watch.

³⁸² For further discussion, see Kristin Forbes, Dennis Reinhardt, and Tomasz Wieladek, 'The spillovers, interactions, and (un)intended consequences of monetary and regulatory policy', June 2016, National Bureau of Economic Research Working paper number 22307.

³⁸³ Ernst and Young, 'Financial Regulatory Reform: What it means for bank business models', 2012, Page 8.

Regulators' preference for certain kinds of legal forms or regulatory structures may influence a bank's entry or continued operation into a market owing to costs and changes required for changing their existing business structures. In fact, an analysis of banks from the US, Canada, the UK, Sweden, Germany, Austria, Netherlands, France, Italy, Spain, and China shows that half of the banks surveyed pulled out of certain countries due to regulatory reasons³⁸⁴.

Third, national regulatory divergences have further necessitated changes in business operations. For instance, the application of proprietary trading rules and ring-fencing regulation to a banking company with cross-border operations in the US and UK would require a reassessment of the bank's global operations. The costs of regulatory divergence are expected to be even higher post Brexit. In the absence of a regulatory roadmap and conciliation of regulations with each other, the sum of reforms presents banks with issues of redundancy, duplication, and rules working at cross purposes³⁸⁵.

Fourth, because post-2008 financial crisis microprudential regulation is still developing and, at times, there is ambiguity in coverage, wording, and implementation, investors must face a degree of ambiguity in terms of regulatory application, differential implementation, and varying timelines as the regulation gets clarified. For instance, in US regulation there is no definition of proprietary trading, although there are some key features as to what could constitute 'proprietary trading'³⁸⁶. This could make it a subjective and complicated criterion, potentially proving the implementation of the Volcker rule to be costly. In the case of the UK's ringfencing regulation, an important issue is defining where the ringfence should fall given several grey areas, e.g. placement of large corporate loans and syndicated lending.

Finally, the uncertainty in the financial markets, coupled with broader downturns including those brought about by COVID-19, creates an uncertain environment, as banks respond to changing global economic patterns arising out of and beyond the 2008 crisis³⁸⁷. While it can be argued that global market uncertainty is out of

³⁸⁴ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The globalisation of banking: How is regulation affecting global banks?', 8th August 2016, Page 6, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

³⁸⁵ Ernst and Young, 'Financial Regulatory Reform: What it means for bank business models', 2012, Page 10.

³⁸⁶ See 12 U.S.C. § 1851(h)(4).

³⁸⁷ Stijn Claessens and Neeltje van Horen, "Foreign Banks: Trends, Impact and Financial Stability", January 2012, IMF Working Paper WP/12/10, Pg. 6. The paper bases its findings on a comprehensive database on bank ownership, including the home country of foreign banks, covering 137 countries from 1995 to 2009. It provides salient facts

the hands of the regulator, the enactment, implementation, and supervision of regulation is very much in the hands of the financial regulator.

The factors above, namely the changing and changed business and legal environment, the arising economic costs and requirements for business restructuring, the ambiguity in evolving regulation, national regulatory divergences and the broader economic uncertainty, worsened by developments such as Brexit, fintech, COVID-19, and the emerging climate change regime, together create an uncertain business and legal environment that is very different from the environment and investment terms that financial investors relied on at the time of making their investments.

b. Economic Costs to Investor of Implementing new Regulation

Economic costs accrue to financial service suppliers from implementing post-2008 crisis microprudential regulation. These economic costs include changes in business structure to adapt to new regulation – e.g. separation of businesses, establishing different entities, compliance with varying regulations, and ensuring internal operational coherence – and meeting new reporting and monitoring requirements (see Chapter 5 for a detailed discussion of economic costs accruing to investors, financial services suppliers, and taxpayers). In 2015, Oliver Wyman estimates that between 2.5% and 3.5% of North American, European, and Australian financial institutions' total costs come from meeting new regulatory guidelines³⁸⁸.

A good example of the economic costs is conformity with ringfencing requirements for which banks must implement separate management strategies³⁸⁹ as well as undertake large and complicated programmes with significant changes to their organisational and operational structures prior to 1 January 2019³⁹⁰. The changes

on trends in foreign ownership, compares foreign and domestic bank characteristics, and analyses the relationship between foreign bank presence and financial development and the impact of foreign banks on lending stability during the recent crisis.

³⁸⁸ Oliver Wyman, '18th State of Financial Services Industry Report, 2015', Available at: <http://www.oliverwyman.com/our-expertise/insights/2015/jan/state-of-the-financial-services-2015-managing-complexity.html>.

³⁸⁹ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The globalisation of banking: How is regulation affecting global banks?', 8th August 2016, Page 11, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

³⁹⁰ See Financial Services (Banking Reform) Act 2013, www.legislation.gov.uk/ukpga/2013/33/contents/enacted. In October 2016, the Deputy Governor for Prudential Regulation and Chief Executive of the PRA reiterated that the PRA would continue to implement ringfencing in accordance with the legislative requirements and timetable set out by the Government. See Woods (2016).

that banks will need to make will also affect their customers, counterparties, and suppliers.

There is also the opportunity cost of pulling out of markets and the inability to enter potentially newer markets, owing to a lack of capital to do so. Regulators' preference for certain kinds of legal forms or regulatory structures may influence a bank's entry into the market owing to costs and changes associated with a new legal entity, e.g. incorporation as a subsidiary is more expensive than operating as a branch. Another example is ringfenced banks, which are required to have higher levels of capital. Once implemented, approximately 75% of UK retail deposits will be held within banking groups subject to ringfencing³⁹¹.

It can also be argued that the differences in regulatory approaches on segregation of risky trading activities (e.g. between EU, UK, US, and German regulation) impact a banking group's business model and increase the economic costs of cross-country operations. In a recent study OECD-IFAC found that regulatory divergence costs financial institutions between 5% and 10% of annual revenue turnover. Moreover, smaller institutions are twice as likely as their larger counterparts to experience very material costs³⁹².

For financial service suppliers, non-compliance with post-crisis microprudential regulation is not an option, as failure to do so can result in substantial penalties and/or cancellation of their operating license. For instance, all European banks operating in the US must prove they have adequate systems and controls in place to ensure that market making meets the Volcker definitions guidelines. Deutsche Bank became the first institution to fall foul of that requirement in 2016, resulting in a \$157m penalty from the Federal Reserve³⁹³.

³⁹¹ McKinsey Global Institute, 'The New Dynamics of Financial Globalization', August 2017, Page 2.

³⁹² Report 'Regulatory Divergence: Costs, Risk, Impact: An International Financial Sector Study', International Federation of Accountants and Business at OECD (BIAC), February, 2018. The survey was conducted on 250 regulatory and compliance professionals from major global financial institutions. Smaller institutions were defined as institutions having an annual turnover of less than \$100m. Report accessible at: http://biac.org/wp-content/uploads/2018/04/IFAC-OECD_Regulatory-Divergence_V9_singles.pdf. The factors behind this cost included increased the number of staff to deal with cross-jurisdictional regulatory matters, training costs for personnel, systems costs required for multiple systems, restructuring of compliance departments, and costs of external consultants.

³⁹³ Laura Noonan, UK-based banks still active in proprietary trading, Financial Times, October 8, 2017, Last accessed 15th August, 2021 at: <https://www.ft.com/content/>

In all the above situations, the foreign investor or financial service supplier can potentially mount a challenge against specific financial regulation, arguing that the change in the regulatory landscape has resulted in economic costs and impacted the investor's legitimate expectations.

4. Microprudential Regulation and Regulatory Flexibility

The goal of all prudential regulation, including microprudential regulation, is to safeguard the financial system by creating a more disciplined, less pro-cyclical financial system³⁹⁴. In short, it protects against systemic risk. Systemic risk is 'the risk of threats to financial stability that impair the functioning of a large part of the financial system with significant adverse effects on the broader economy.'³⁹⁵ It can originate in any part of the financial system and typically builds up over time.

Channels of transmission of systemic risk can be shocks caused by excessive risk taking or wholesale depositors'/investors' expectations that cause rational revisions and/or pure panic unrelated to fundamentals³⁹⁶. A good example of systemic risk build-up during the 2008 financial crisis was when some bank branches became a source of instability, acting as transmitters of the international crisis³⁹⁷.

Financial crisis is the cost of regulatory failure and its inability to prevent systemic risk build-up. A compilation of banking crises around the world (147 countries) from 1970–2011 found that the average fiscal costs of resolving a banking crisis is approximately 7% of GDP and that cumulative output loss average is 23% of GDP (Laeven and Valencia, 2013).

c1704966-9f81-11e7-8cd4-932067fbf946?desktop=true&conceptId=71a5efa5-e6e0-3ce1-9190-a7eac8bef325&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft.notification:daily-email:content:headline:html.

³⁹⁴ WTO Secretariat, Note on Regulatory Issues on Sectors and Modes of Supply, Working Party on Domestic Regulation, S/WPDR/W/48, 13 June 2012.

³⁹⁵ See IMF, Bank for International Settlements, Financial Stability Board, 'Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations', October 2009, Report to G20 Finance Ministers and Governors and European Central Bank, Financial Stability Review, December 2009.

³⁹⁶ Xavier Freixas, Luc Laeven, and José-Luis Peydró, 'Systemic Risk, Crises, and Macroprudential Regulation', June 2015, MIT Press.

³⁹⁷ Stijn Claessens and Neeltje van Horen, 'Foreign Banks: Trends, Impact and Financial Stability', January 2012, International Monetary Fund Working Paper WP/12/10.

Systemic risk itself is an elusive and volatile concept, making regulatory flexibility including through the continuous review of regulatory choices indispensable for consumer protection and financial integrity³⁹⁸. Microprudential regulation protects small depositors by limiting the frequency and cost of individual bank failures³⁹⁹. Regulatory flexibility to enact microprudential regulation is therefore of great importance.

The interlinkages between financial regulation and the trade and investment architecture pose a challenge for the regulator, specifically in terms of the scope of regulatory flexibility vis-à-vis trade and investment commitments⁴⁰⁰. As compared to macroprudential regulation, microprudential regulation, with its focus on individual institutions, engages more comprehensively with the trade and investment architecture.

The interlinkage between select 2008 microprudential regulation and the trade and investment architecture has created three key areas of potential incongruity, namely change of regulatory approaches, change in regulatory responsibilities (i.e. home versus host country), and finally the extent of regulatory flexibility weighing prudential objectives against trade and investment commitments. A key question here is how far the provisions to protect regulatory flexibility, such as the prudential carve-out contained in the trade and investment architecture, can be extended to select microprudential regulation, especially considering WTO and ICSID case law, an area dealt with more in Chapter 2⁴⁰¹.

a. Changes in Regulatory Rationale and Regulatory Approaches

The economic rationale for financial sector regulation has shifted from the pre-2008 crisis ‘laissez faire’ deregulation approach to the post-crisis new regulation or reregulation approach. From the microprudential perspective, the pre-2008 cri-

³⁹⁸ Panagiotis Delimatsis, *International Trade in Services and Domestic Regulation – Necessity, Transparency and Regulatory Diversity*, 2007, Oxford University Press.

³⁹⁹ See Sudipto Bhattacharya and Anjan V Thakor, ‘Contemporary Banking Theory’, 1993, *Journal of Financial Intermediation* 3 and Xavier Freixas, Luc Laeven, and José-Luis Peydró, ‘Systemic Risk, Crises, and Macroprudential Regulation’, June 2015, MIT Press.

⁴⁰⁰ Wendy Dobson and Pierre Jacquet, *Financial services Liberalization in the WTO*, June 1, 1998, Peterson Institute for International Economics; Illustrated Edition.

⁴⁰¹ Chapter 2 on the International Trade and Investment Architecture outlines case law under ICSID and the WTO, which deals with situations in which regulatory flexibility was protected.

sis trend towards deregulation of the financial sector led to the encouragement of branch operations as opposed to the incorporation of subsidiaries. Proprietary trading and the separation of banking activities were permitted or tolerated. After the financial crisis, however, there has been a move towards the incorporation of subsidiaries and ringfencing, effectively rolling back or reregulating these areas.

Another change in regulatory approaches has been the change in focus from micro to macroprudential regulation. The focus of financial regulation in the decade leading up to the financial crisis was on the operations of financial firms, i.e. microprudential regulation premised on the notion that if bank supervisors could ensure that banks and other financial firms were managing their risks well on an individual basis they would be stable while systemic risks across the financial system would be negligible⁴⁰². As a result, in the run-up to the 2008 financial crisis, microprudential regulation focused on individual institutions, ignoring the impact of financial institutions' risk-taking on the broader financial system⁴⁰³. However, after the 2008 crisis, the focus shifted to macroprudential regulation with the objective of preserving systemic stability at all costs. For instance, in the case of proprietary trading rules, the aim is to prevent potential misuse by banks by investing in risky trading activities, which could create systemic risk. An example of such conflict could be a bank's interest in recommending shares or bonds to its customers after having added them to its own investment portfolio.

The new focus of microprudential regulation could raise questions around the classification of prudential regulation. Given that the goal of microprudential regulation since the 2008 crisis has been the same as macroprudential regulation, i.e. preventing systemic risk build-up, the basis of the criteria used for the classification of macro versus microprudential can be raised.

Some scholars have observed that micro and macroprudential regulation are complementary to each other, both aiming to maintain the overall stability of the

⁴⁰² Kern Alexander, 'Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges', Page 6, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

⁴⁰³ Kern Alexander, 'Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges', Page 6, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

financial system⁴⁰⁴. Information gathered through microprudential supervision, for instance, can facilitate macroprudential supervision⁴⁰⁵. However, the complementary approach can have unintended spillover effects in the trade context⁴⁰⁶. The lines between micro and macroprudential regulation are not clear, and therefore the justification for the application of ‘exceptions’ under the trade and investment architecture including the ‘prudential carve-out’ can be unclear. Furthermore, as domestic activation of macroprudential instruments increases, the scope for international spillovers to microprudential regulation may also increase⁴⁰⁷. For example, national regulators demand that international banks satisfy capital and liquidity requirements locally, resulting in many US and European firms winding up their subscale foreign operations to concentrate on domestic markets.

Changes in the post-2008 financial crisis microprudential regulatory approach, including the blurring of lines between macro and microprudential regulation, therefore introduce incongruities between the existing trade and investment architecture.

b. Regulatory Burden: Home versus Host Country Regulation

The second consideration of importance for microprudential regulation is the change of focus from home country regulation to host country regulation. Microprudential regulation impacts the home and host country regulator in terms of who can and should bear the regulatory and supervisory burden. Prior to the financial crisis, the general view in the BCBS and amongst many developed countries was that home country regulation was sufficient (BCBS 1997, BCBS 2006)⁴⁰⁸. In the

⁴⁰⁴ Freixas, Laeven, Peydro, ‘Macro prudential Regulation’, Systemic Risk, Crises, Chapter 8: Systemic Risk and Micro Prudential Regulation, MIT Press, June 2015.

⁴⁰⁵ WTO Committee on Trade in Financial Services, Report of the Meeting held on 20th March 2013, S/FIN/M/70, 19 April 2013. Norway and Australia both pointed out the close complementary role between macro and microprudential regulation and supervision.

⁴⁰⁶ WTO Committee on Trade in Financial Services, Report of the Meeting held on 20th March 2013, S/FIN/M/70, 19 April, 2013. Norway and Australia both pointed out the close complementary role between macro and microprudential regulation and supervision.

⁴⁰⁷ Claudia Buch and Claudia Goldberg, ‘Cross-Border Prudential Policy Spillovers: How Much? How Important? Evidence from the International Banking Research Network’, March 2017, International Journal of Central Banking.

⁴⁰⁸ The Basel Committee’s position on home and host authorities’ responsibilities relating to the supervision of branches of cross-border banks is described in the Basel Concor-

case of microprudential regulation, the pre-crisis model for foreign banks relied on home country jurisdiction, allowing banks to operate freely across borders, providing for and encouraging incorporation as a branch, which entailed fewer regulatory requirements and generally a single point of supervision being the home country supervision. These provisions are reflected in several trade agreements, most notably the WTO's Understanding on FS commitments.

After the financial crisis, however, the focus has been on host-country supervision⁴⁰⁹, which has been manifested by financial authorities in several ways:

- Supervisors sought greater assurances on the financial soundness of branches and subsidiaries from parent institutions.
- Evaluation of the adequacy of liquidity being held locally by the branch or subsidiary.
- Evaluation of standards of regulation and supervision in the home country.
- Local regulatory requirements in the case of the US proprietary trading and the UK's ringfencing regulation.

Within the EU, the issue of home and host country regulation has been minimised as a result of the common market, in which financial providers have a 'passporting privilege' which enables them to operate throughout the European Banking Union while relying on home country regulatory and supervisory regimes⁴¹⁰. In the Brexit context, the issue of home and host country regulation is an acute consideration for

dat and summarised in the Basel Core Principles for Effective Banking Supervision. Section VI of the Basel Core Principles describes the obligations of home and host supervisors as follows: 'Home supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries' (Core principle 23). With regard to host country responsibilities, there is an expectation that host supervisors will ensure that the business conduct of local affiliates of foreign banks is of the same high standard expected and enforced for domestic institutions, and that they have the ability to share information with relevant home authorities in order for the latter to carry out satisfactory consolidated supervision (Core principle 25).

⁴⁰⁹ Lord Adair Turner, Avinash Persaud, amongst others.

⁴¹⁰ Under the EU's passporting regime, a firm authorised and/or regulated in an EU/EEA member state may (i) establish a branch in another EU member state with reliance on the home country authorisation and/or (ii) provide services on a cross-border basis without the need for further authorisation in the State in which they have established a branch or provide services.

existing or future British banks operating in the EU and vice versa, as they may lose their passporting privileges.

From the investor and financial services supplier perspective the home and host country regulation is important as it would determine the point of regulatory compliance and, in the case of disputes, determine the point of cause of action and jurisdiction.

c. The Importance of Regulatory Flexibility for Minimising Systemic Risk versus Regulatory Burden on Investors and Financial Service Suppliers

Microprudential regulation is premised on the notion that if bank supervisors can ensure that banks and other financial firms manage their risks effectively on an individual basis, they would be profitable and stable, thus ensuring systemic risks across the financial system are negligible⁴¹¹. Developments after the 2008 financial crisis resulted in regulators implementing select microprudential regulation with the aim of protecting systemic stability, but the same microprudential regulations could also contravene trade and investment commitments.

To take the example of legal form, in the wake of the 2008 financial crisis, regulators in some countries preferred incorporation as a subsidiary as opposed to operations as a branch. While this choice has the potential impact of rolling back on any trade commitments made, developments during the 2008 financial crisis explain the economic rationale behind such a preference. Eastern European banks followed a ‘branch-based’ approach, while Latin American banks opted for a ‘subsidiary-based’ approach. When the financial crisis set in, banks in Eastern Europe were badly hit, as local currencies depreciated, and a sizeable proportion of loans were granted in foreign currencies. Moreover, since global bank’s function based on intra-group financing, when the interbank market dried up, banks started to suffer from liquidity problems, which led to a massive withdrawal of funds from branches back to the parents. As a result, there was an abrupt contraction in lending, negatively affecting the real economy and the financial stability of the country.

Spanish and Latin American regulators, on the other hand, have always preferred foreign banks to operate through subsidiaries with a degree of autonomy vis-à-vis

⁴¹¹ Kern Alexander, ‘Redesigning Financial Regulation to Achieve Macroprudential Objectives: A commentary on some of the regulatory challenges’, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

their parent bank⁴¹². It has been observed that the subsidiary-based decentralised models adopted in Latin America resulted in a degree of protection during the financial crisis as subsidiaries had a high degree of autonomy in respect of capital and liquidity management⁴¹³. The systemic risk and contagion impact was therefore lower for banks operating as subsidiaries in Latin America as compared to banks following the branch-based approach adopted in Eastern Europe prior to the financial crisis of 2008.

Similarly, in the case of proprietary trading, whether banks are trading for proprietary reasons or to facilitate client business, they are exposed to certain market and counterparty risks. Ultimately, as with any risk, if losses are sufficiently large, this could lead to a bank's insolvency and, depending on the size and interconnections of the bank in question, have wider systemic risk implications.

Regulatory flexibility in the design, implementation, and enforcement of microprudential regulation is therefore important for protection against the buildup of systemic risk. Recognising the importance of regulatory flexibility in the financial sector, most trade and investment agreements contain provisions protecting regulatory flexibility to act in a prudential manner (*see Chapter 2 on the Trade and Investment Architecture for a discussion on prudential regulation exceptions in trade agreements*).

However, the post-2008 crisis prudential regulation tests the interface between regulatory flexibility and protection afforded to investors and financial services providers by the trade and investment architecture. On the one hand, post-2008 financial crisis microprudential regulation on proprietary trading, ringfencing, and legal form can play an important role in checking the buildup of systemic risk, emphasising the importance of regulatory flexibility. On the other hand, the same post-2008 financial crisis microprudential regulation can inhibit competition, act as a trade barrier, and contravene existing trade and investment commitments.

For instance, in the case of legal form and as can be observed from *Table 32: Direct/Indirect Impact on Financial Services Providers, Investors, Investors and Financial Regulators of select Post-Crisis microprudential Regulation relating to Legal Form, Ringfencing, and Proprietary Trading*, a regulatory requirement to

⁴¹² Santiago Fernandez de Lis and Antonio Cortina, *El modelo de negocio de los bancos españoles en America Latina*, ICE, 2015.

⁴¹³ Jose Maria Alvarez, Javier Pablo Garcia, and Olga Gouvela, 'The globalisation of banking: How is regulation affecting global banks?', 8th August 2016, Page 5, BBVA Research Papers on Financial System and Regulation, Global Economic Watch.

incorporate as a subsidiary means higher costs and a business model change for investors. It could also mean a roll back of existing trade and investment commitments that may allow operations as a branch. For the host country regulator, however, it could mean better oversight and control over the subsidiary's asset and the containment of the threat of contagion in the subsidiary.

A dichotomy therefore exists between microprudential regulation that is emerging in different countries and the trade and investment architecture as it stands. An essential element of the trade and investment architecture is the protection of investor and financial service providers' rights, which can be compromised. Regulatory flexibility must therefore be balanced against loss in efficiency of financial services provision as it could curtail credit availability, result in regulatory arbitrage, or risk shifting to unregulated parts of the financial system⁴¹⁴. This in turn will negate the prudential objective of the regulators. Arguments have thus been made for a reconceptualisation of international economic law to bring it in line with developments on financial regulation⁴¹⁵.

E. Conclusions

After the 2008 financial crisis, the microprudential regulatory landscape has changed considerably in the areas of legal form, proprietary trading, and ring-fencing, resulting in substantial economic and business costs for investors and financial service suppliers.

The regulatory rationale for both changes in legal form and separation of risky banking activities was the prevention of systemic risk build-up through greater control and oversight over bank operations. Regulation relating to proprietary trading and ringfencing was implemented in several countries after the 2008 financial crisis as a means to protect against market and counterparty risks, while legal form regulatory changes focused on a preference for a subsidiary-based approach as opposed to 'branchification'.

⁴¹⁴ Xavier Freixas, Luc Laeven, and José-Luis Peydró, 'Systemic Risk, Crises, and Macro-prudential Regulation', June 2015, MIT Press.

⁴¹⁵ Kern Alexander, *Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges*, Page 14, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-fffffa42d6c8/micro.pdf>.

Such changes in microprudential regulation have implications for the trade and investment architecture, which covers measures affecting the financial sector. The trade and investment architecture simultaneously protects investor/financial services supplier operations, regulatory flexibility, and provides for some manner of dispute settlement. The interlinkages between the trade and investment architecture and select microprudential regulation has resulted in (a) contraventions or incompatibility with the existing trade and investment architecture, (b) trade-barrier-like effects arising out of business restructuring and economic costs, and (c) implications for regulatory flexibility.

1. Inconsistences between select Post-2008 Financial Crisis Microprudential Regulation and the Trade and Investment Architecture

Select microprudential regulation can be inconsistent with or run contrary to existing trade and investment commitments undertaken by countries. The legal framework of general and specific obligations set out in the trade and investment architecture (GATS, FTAs, and BITs) touches upon aspects of microprudential regulation relating to legal form and separation of banking.

In terms of scope, select microprudential regulation relating to legal form and segregation of risky trading activities is covered under the GATS, FTAs, and BITS in the form of commitments made in specific financial subsectors such as asset management, portfolio investment, trading on one's own account or on the account of customers, and over-the-counter market or otherwise, amongst others.

Once market access and national treatment commitments are undertaken, limitations on the size of the service, number of branches, types of products offered, legal character, foreign capital participation, or indication of a preference for domestic service suppliers are not permitted. Select post-2008 microprudential regulation can create these limitations, effectively rolling back on commitments made. For instance, requirements for the separation of risky activities either through ring-fencing or proprietary trading could amount to market access limitations on the total number of service operations or service output, by requiring universal banks to separate into investment and retail operations or not permitting a bank to trade for its own account. Similarly, microprudential regulation requiring incorporation as a subsidiary could contravene limitations on legal form, where such commitments are undertaken.

In terms of modal coverage, despite a clear prudential rationale, select microprudential measures impact binding Mode 1 (cross-border trade) and Mode 3 (com-

mercial presence) commitments. For instance, in the case of legal form requirements, cross-border credit (Mode 1) tends to be less stable than the supply of credit by local subsidiaries (Mode 3), particularly in times of crisis.

The enactment of new microprudential regulation relating to legal form and segregation of risky trading activities can amount to a roll back on existing commitments scheduled as per the Understanding on FS, which includes a 'standstill provision' requiring non-creation of new regulation or reverse liberalisation. Furthermore, the Understanding on FS may raise questions of inconsistency in regard to the select microprudential regulation being considered a 'new financial service'.

The extent of contraventions or inconsistencies of select microprudential regulation with the trade and investment architecture will depend on the exact nature of commitments undertaken by individual countries in their trade-in-services schedules of commitments as well as specific BITS commitments. If post-2008 crisis microprudential regulation requires incorporation as a subsidiary or prevents cross-border trading or asset management activities owing to new rules on proprietary trading, this can be considered a roll back on trade-in-services commitments. The likelihood of incompatibility is higher for FTAs where financial services commitments tend to be deeper than those undertaken under the GATS.

It can be argued that the select post-2008 crisis microprudential regulation is permitted under the prudential carve-out contained in the GATS and FTAs. However, there are several inherent problems with the prudential carve-out which leave it open to interpretation and potential challenge including the need to demonstrate that the measure was undertaken for 'prudential reasons' and not to avoid trade obligations. Other issues relate to the conceptual ambiguity of terminology including the term 'prudential'.

The potential for non-conformity of select microprudential regulation to the FET standard contained in BITS, including elements established in ICSID case law relating to consistency in host states' actions, investors' legitimate expectations, and maintaining a stable business and legal environment, can form the basis for a dispute settlement challenge. The transparency element of the FET standard presupposes consistency in the host country's actions. The host state committing to liberalise financial services through market access, national treatment, and investment provisions, while imposing regulatory measures that roll back on existing trade and investment commitments, can be considered to be inconsistent behaviour.

Legitimate expectations arise from specific or general assurances given to an investor, based on which an investment is made. Market access, national treat-

ment, and scheduled trade-in-services and investment commitments can be considered general commitments made to investors, which may be contravened by select microprudential regulation. Additionally, the adoption of microprudential measures can substantially alter the business and legal environment that foreign investors and financial services suppliers relied on at the time of making their investment. This in turn could lead to a contravention of the FET standard element of maintaining a stable business and legal environment.

However, it is important to note that FTA provisions, e.g. the TPP and FET case law have protected regulatory flexibility in the face of investors' legitimate expectations. Given that microprudential regulation relates to the financial sector, and is linked to systemic stability, there is the strong but not guaranteed possibility that regulatory flexibility will be upheld.

For minimum standard FET, the source of customary international law applicable to microprudential regulation relating to legal form and separation of risky activities is problematic as the policy stance of international organisations and national governments has changed. For instance, prior to the 2008 financial crisis, a key policy stance at trade negotiations of the BCBS and other fora was to encourage home versus host country regulation and operation through branches as opposed to subsidiaries, which has since been reversed. These shifts in regulatory approaches question the extent to which international bodies and national regulators can act as a source of CIL.

2. Trade-Barrier-Like Effect

Differing post-crisis microprudential regulations, e.g. segregation of activities, ring fencing, legal form requirements occurring at differing levels and speeds of regulatory reform can act as indirect barriers to trade by requiring substantial business restructuring and incurring economic costs. The structural reform necessitated by regulatory change coupled with other regulation relating to higher liquidity requirements changes the incentives and business models of how banks' structure their cross-jurisdictional activities.

Business restructuring and economic costs become even more acute issues for firms operating in several jurisdictions which may be faced by differing microprudential regulation for provision of the same financial services. As a result, national regulatory divergences have driven business model changes, as suggested by evidence in the US, Canada, the UK, Sweden, Germany, Austria, Netherlands, France, Italy, Spain, and China.

Finally, the post-2008 financial crisis microprudential regulation is still evolving and at times there is ambiguity in coverage, wording, and implementation, creating a degree of uncertainty for the investor in regulatory application.

3. Regulatory Flexibility for minimising systemic Risk versus Regulatory Burden on Investors and Financial Service Suppliers: Interlinkages with the Trade and Investment Architecture

The goal of prudential regulation is to safeguard the financial system and protect against systemic risk build-up and financial crisis. Microprudential regulation protects small depositors by limiting the frequency and cost of individual bank failures. Systemic risk is a volatile and elusive concept, making regulatory flexibility in the design, implementation, and enforcement of microprudential regulation indispensable for consumer protection and financial integrity.

Select microprudential regulation after the 2008 financial crisis may have been implemented with the aim of protecting systemic stability but can contravene existing trade and investment commitments. At the same time, the trade and investment architecture recognises the importance of regulatory flexibility in the financial sector, with provisions to protect regulatory flexibility.

The interlinkage between select 2008 microprudential regulation and the trade and investment architecture has created two key areas of potential incongruity, namely changes in regulatory approaches and finally regulatory flexibility, i.e. weighing prudential objectives against trade and investment commitments.

In terms of the regulatory approach, after the 2008 financial crisis, financial sector regulation has shifted from the pre-crisis 'laissez faire' deregulation approach to the post-crisis new regulation or reregulation approach, from micro to macroprudential regulation, and from home country regulation to host country regulation. Changes in regulatory approaches have implications for the investor and financial services supplier in terms of the business costs, point of regulatory compliance, and in case of disputes around the cause of action and jurisdiction.

At the interface of the trade and investment architecture and emerging financial architecture is the question of regulatory flexibility versus investor/trade protection, which is tested by post-2008 microprudential regulation. On the one hand, post-2008 financial crisis microprudential regulation on proprietary trading, ring-fencing, and legal form can play an important role in checking the build-up of systemic risk, emphasising the importance of regulatory flexibility. On the other hand, the same post-2008 financial crisis microprudential regulation can inhibit

competition, act as a trade barrier, and contravene existing trade and investment commitments.

Regulatory flexibility must therefore be balanced against loss in efficiency of financial services provision as it could curtail credit availability and result in regulatory arbitrage or risk shifting to unregulated parts of the financial system. This in turn will defeat the prudential objective of the regulators.

There is also a need to create a regulatory roadmap and conciliation of regulations in specific areas such as proprietary trading, legal form, etc., including through the work of international standard-setting bodies. This would enable financial service providers/investors and regulators to deal with issues of redundancy of regulation, duplication, and rules working at cross purposes.

4. Dispute Settlement Considerations

The contradictions and inconsistencies between microprudential regulation and the trade and investment architecture are further complicated by the dispute settlement provisions that exist in all trade agreements and BITs providing either for state-to-state or investor-state dispute settlement. In the case of a regulatory challenge, the weighing of investor/trade rights versus regulatory flexibility will be a moot issue and it appears from current WTO cases and to a lesser extent in ISDS cases that regulatory flexibility will be given substantial weightage. However, the WTO cases also emphasise the importance of case-by-case evaluation and the need to demonstrate that no significant attempt to escape trade commitments has been made. Furthermore, the outcome of a dispute settlement decision is likely to differ based on the fora, i.e. investor-state format or state-to-state, as well as the state of the national and global economy when the dispute settlement decision occurs.

It is also necessary to understand and rationalise the impacts for dispute settlement in the financial sector, especially ISDS dispute settlement, given the range of fora, including the emerging discussions of a dispute settlement forum by the European Union. For instance, the absence of the BITs FET principle equivalent in EU law⁴¹⁶ poses a problem for BITs with regards to the EU member states, especially the newly acceding member states. The recent EU plurilateral agreement for the

⁴¹⁶ PL Holdings S.à.r.l. versus. Republic of Poland, Partial Award of 28 June 2017, Paragraph 312, Stockholm Chamber of Commerce, Arbitration No. V 2014/163.

termination of all 190 intra-EU BITs⁴¹⁷, following the Achmea Judgement⁴¹⁸ and the question of third-party rights in this case.

5. Interplay of Broader Factors

The interplay of larger economic and institutional factors, such as the growth of fintech, the setting up of ISDS fora, structural financial market changes arising from the emerging green finance regime, COVID-19, and Brexit, are likely to further deepen issues surrounding the interface of the trade and investment architecture and regulatory flexibility in light of emerging microprudential regulation. Hence, there is a need for a reconceptualisation of international economic law to bring it in line with developments on financial regulation. Within or outside the WTO it may be useful to discuss further amongst member states the extent of what they would consider ‘prudential’⁴¹⁹, as this would give member states an opportunity to share views rather than be foisted with a decision of the WTO’s DSB.

⁴¹⁷ On 24 October 2019, the European Commission announced the plurilateral treaty for the termination of all intra-EU BITs.

⁴¹⁸ On 6 March 2018, the European Court of Justice ruled in the Achmea case that the investment arbitration clause contained in intra-EU BITs is incompatible with EU law, effectively putting an end to the intra-EU BITs.

⁴¹⁹ A suggestion along these lines was made by the Swiss Government to the WTO Committee on Trade in Financial Services in 2001. Communication by Switzerland to the CTFS, 2001, S/CSS/W/71.

V. Dispute Settlement and Economic Cost Considerations of Post-2008 Financial Regulation

A. Introduction

The contradictions of post-2008 financial crisis regulation vis-à-vis the trade and investment architecture are relevant, as they open the dispute settlement option for investors/financial service suppliers and governments. Since 2008, there has been growth in financial-sector-linked disputes. Two factors in particular have led to a greater willingness on the part of investors and financial services suppliers to challenge post-2008 financial crisis regulation: (a) developments in the financial (e.g. increasing regulatory impacts, fintech) and trade (e.g. Brexit) sectors as well as the dispute settlement architecture, all of which accentuate the complex and multijurisdictional nature of financial transactions; and (b) the number and scope of dispute settlement clauses encapsulated in the network of FTAs and BITs.

Dispute settlement in the context of post-2008 financial crisis regulation also raises questions around the kind of economic costs accruing to investors and financial service suppliers, for which they can seek compensation from dispute settlement tribunals. However, these economic costs must be weighed against the costs of the non-implementation of appropriate financial regulation, which in turn could lead to systemic instability and the possibility of financial crisis costs to taxpayers.

Part B of this chapter sets out the factors that have and will continue to contribute to an increasing trend in financial disputes. It also looks at the coverage of dispute settlement provisions within the international trade and investment architecture. Part C then evaluates the principal considerations or grounds based on which investors and financial service suppliers may file dispute settlement cases in the financial services sector. This includes consideration of whether there has been a breach of the existing trade and investment architecture, i.e. GATS, WTO, FET standard, whether the investment or financial services qualify as such under the treaty/agreement under consideration, and where the investment lies in terms of jurisdiction. Finally, Part D evaluates the economic costs of post-2008 crisis financial regulation in an attempt to understand specific impacts both direct and indirect on investors and financial service suppliers in terms of damage and economic costs and weighs them against the costs that could accrue to taxpayers.

B. The Financial Sector and International Dispute Settlement

1. Increasing Trend in Financial Sector linked Disputes

Given the highlighted areas of contradictions/inconsistencies between emerging post-2008 financial crisis regulation and the trade and investment architecture, the likelihood of disputes is high⁴²⁰. Dispute settlement can be of two kinds: state-to-state, in which disputes are settled through dispute settlement processes set up under bilateral or regional tribunals (e.g., NAFTA, FTAs, BITS, or the WTO's dispute settlement body)⁴²¹; or investor-state dispute settlement, which is seen primarily in fora such as the ICSID Tribunal⁴²² as well as in the Permanent Court of Arbitration, Stockholm Chamber of Commerce, London Chamber of International Arbitration, and Singapore Chamber of International Arbitration, amongst others. A State party's choice of the kind of dispute settlement, i.e. state-to-state or ISDS as well as the process and fora for dispute settlement, is contained in FTAs, BITS, and the WTO Agreements they are party to.

On the whole, there has been an increasing trend in ISDS, with a marked increase since the 2008 financial crisis in dispute settlement in the financial sector. The preference for international dispute settlement, arbitration, WTO, or otherwise is because they provide an international and neutral platform, with the ability to require bank regulators to account for perceived 'discriminatory treatment of the regulated investor bank' by asserting the claim that the bank was denied agreed protections under FTAs/BITS, e.g. the right to FET⁴²³.

⁴²⁰ See Chapters 3 and 4 for an outline of areas of inconsistency and contradiction between post-2008 crisis financial regulation and the trade and investment architecture.

⁴²¹ Each of these dispute settlement mechanisms are governed by a set of rules either as part of the agreement under which they are constituted or standalone annexes, letters, etc. The WTO's dispute settlement mechanism, for instance, is governed by the Understanding on Rules and Procedures Governing the Settlement of Disputes.

⁴²² Arbitration and conciliation under the ICSID Convention and Additional Facility Rules are voluntary, and parties provide consent to ICSID jurisdiction through a variety of investment laws, contracts, and bilateral or multilateral investment and trade treaties.

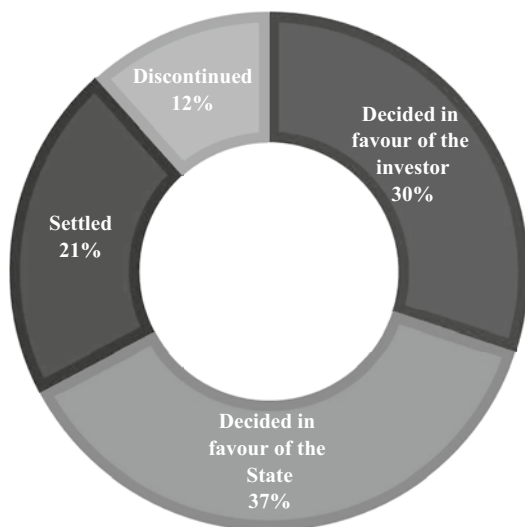
⁴²³ International Chamber of Commerce Commission on Arbitration and ADR Task Force, Report on Financial Institutions and International Arbitration, 2016, Last accessed 23/03/2020 at https://www.icc-portugal.com/images/documentos/comissao_de_arbitragem/Financial_Institutions_and_International_Arbitration.pdf.

See *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka* (ICSID Case ARB/09/2), Award (31 October 2012) [*Deutsche Bank*]; *Antoine Goetz v. République*

An evaluation of ISDS cases indicates that as of the end of 2019 there were a total of 1,023 dispute settlement cases, 343 pending, 674 concluded. Decisions were made in favour of both investor and state. Of the concluded ISDS arbitration proceedings, nearly 29% were decided in favour of the investor, 37% in favour of the state, and 21% were settled (*see Figure 7: Decisions on concluded arbitration proceedings*).

BITS are a primary basis for filing ICSID cases, although parties are increasingly resorting to trade treaties⁴²⁴. In 60% of the cases, BITS formed the basis of consent invoked to establish ICSID jurisdiction in cases registered under the ICSID convention and additional facility rules⁴²⁵.

Figure 7: Decisions on concluded arbitration proceedings



(Source: Autor Recreation from UNCTAD ISDS Navigator)

du Burundi (ICSID Case ARB/95/3), Award (10 February 1999). For a case where the ICSID tribunal upheld its jurisdiction *ratione materiae* over a claim against a national bank regulator but did not award damages, see *Levy de Levi v. Republic of Peru* (ICSID Case ARB/10/17), Award (26 February 2014).

⁴²⁴ In 2019, for instance, cases were also instituted under the Dominican Republic-Central America Free Trade Agreement; the North American Free Trade Agreement; the Central America-Panama Free Trade Agreement; the Canada-Colombia Free Trade Agreement; and the US-Colombia Trade Promotion Agreement. For the first time, a case was brought on the basis of the Peru-Singapore Free Trade Agreement and another on the basis of the US-Morocco Free Trade Agreement. See ICSID Annual Report 2019.

⁴²⁵ ICSID Caselaw Statistics, Edition 2021.

ICSID cases relating to the finance sector have increased from 1966–2021. In fact, the global financial crisis of 2008 brought an unprecedented wave of financial market litigation⁴²⁶. As of 2020, 9% of new cases filed under the ICSID Convention and Additional Facility Rules related to finance⁴²⁷ and in 2017 the distribution of new cases by economic sector showed that 15% of cases are related to the finance sector⁴²⁸. It therefore appears that financial institutions, which traditionally resolved disputes nationally or by litigation in jurisdictions hosting recognised financial centres, are increasingly turning their attention to ISDS⁴²⁹.

The rising trend of dispute settlement in the financial sector is the result of a combination of several existing and emerging factors. First is the importance of the financial services sector to the economy. While it is difficult to obtain specific figures on the size of the global financial services sector, it can be reasonably asserted that the sector is a large part of any nation's economy. The BIS estimates that banks' global cross-border claims reached USD 31 trillion at the end of September, 2019⁴³⁰. The gross market value of OTC derivatives alone, summing positive and negative values, stood at \$12.1 trillion⁴³¹. Given the value of the financial sector, it is often the case that the amount of money at risk in cases of financial disputes is substantial.

⁴²⁶ Jeffrey Golden, 'Judges and Systemic Risk in the Financial Markets', 2012, *Fordham Journal of Corporate & Financial Law*, XVIII, Page 330, highlights that 'a "tsunami" of financial markets litigation from the financial crisis are pouring in.' The 2012 Eurozone crisis is also regarded in the financial services sector as being likely to have an impact on litigation activity. In the ICC Survey 'Corporate Choices in International Arbitration' (2013), the plurality of financial services industry respondents (46%) indicated that they foresaw a rise in disputes as a result of the 2012 crisis (p. 11).

⁴²⁷ ICSID Caselaw Statistics, Edition 2021.

⁴²⁸ ICSID Press Release on ICSID Caseload Statistics, February 2, 2018, Last visited 24th February 2021 at <https://icsid.worldbank.org/news-and-events/news-releases/new-issue-icsid-caseload-statistics-published-issue-2018-1>.

⁴²⁹ ICC Commission report, 'Investment Arbitration and Financial Institutions', 2016, Last accessed on 24/02/2020 at : <https://iccwbo.org/content/uploads/sites/3/2016/11/icc-financial-institutions-and-international-arbitration-icc-arbitration-adr-commission-report.pdf>.

⁴³⁰ BIS international banking statistics at end-September 2019, Press Release 22nd January 2020, Last accessed on 25/03/2020 at <https://www.bis.org/statistics/rppb2001.htm>.

⁴³¹ OTC derivatives statistics at end-June 2019 8th November 2019, Last accessed on 25/03/2020 at https://www.bis.org/publ/otc_hy1911.htm.

Second, because of the sheer size of their balance sheets, their deposit-taking activity, and the important role they play in the economy, financial entities are subject to substantial domestic regulation in virtually all countries. They often bear the brunt of regulations intended not specifically for them but for the economy in general. This is the case, for instance, for foreign exchange controls that impact financial entities, although the larger regulatory benefit of systemic stability accrues to the larger economy.

Third, the large volume of modern financial transactions has inevitably resulted in a 'complex world of increasingly connected markets and jurisdictions'⁴³², often involving multi-party, multi-contract, and multiple modes of delivery. The growth in cross-border disputes therefore is not surprising given the complex-structured financial products, implicating several legal relationships that interact in complicated ways and across jurisdictions⁴³³.

Fourth, emerging factors including technological and political developments such as fintech⁴³⁴, greater usage of cryptocurrencies, and Brexit are likely to complicate the interactions between prudential regulation and the trade and investment architecture. Brexit and the consequent negotiations on financial services will impact financial entities operating in the EU and EU entities operating in the UK, including those from third-party jurisdictions, e.g. the US, East Asia, Canada, etc., which prior to Brexit were operating out of the UK or the EU. Fintech is a growing market, with almost 80% of financial institutions having entered into fintech partnerships⁴³⁵. In addition to cross-border and financial regulatory elements, fintech

⁴³² Golden Jeffrey, Werner Peter, *The Modern Role of Arbitration in Banking and Finance*, in *International Financial Disputes: Arbitration and Mediation*, Edited by Jeffrey Golden, Carolyn Lamm, March 2015, <https://olrl.ouplaw.com/view/10.1093/law/9780199687862.001.0001/law-9780199687862-chapter-1#law-9780199687862-chapter-1-note-5>.

⁴³³ See Jeffrey Golden, 'Judges and Systemic Risk in the Financial Markets', 2013, *Fordham Journal of Corporate & Financial Law*, XVIII, Pages 327–37.

⁴³⁴ The Bank of International Settlements defines Fintech as follows: 'Fintech refers to technology-enabled innovation in financial services'. McKinsey and Co. McKinsey & Company characterises fintech companies as 'start-ups and other companies that use technology to conduct the fundamental functions provided by financial services, impacting how consumers store, save, borrow, invest, move, pay, and protect money.' See Dietz Miklos, Khanna Somesh, Olanrewaju Tunde and Rajgopal Kaushik, 'Cutting through the noise around financial technology', February 2016.

⁴³⁵ McKinsey and Company, 'Synergy and Disruption: 10 Trends Shaping Fintech', December 2018.

regulatory considerations also relate to issues of data, privacy, and security, which may not have been provided for either in the existing regulatory frameworks or the trade and investment architecture.

Fifth, COVID-19 is expected to impact the functioning of the financial sector, but exactly how this will play out is difficult to assess at this point in time. UNCTAD notes that the usage of BITS/FTA dispute settlement by foreign investors is likely to increase as countries respond to the COVID-19 pandemic by taking measures in support of investment protection for ‘critical’ domestic industries⁴³⁶. Other areas likely to be impacted are financial products, the creation and settlement of debt, and the digitalisation of financial services.

Sixth, despite the complex, cross-border and decentralised nature of financial transactions, the financial marketplace does not have access to a global or centralised dispute settlement mechanism⁴³⁷. However, financial institutions, which have traditionally resolved disputes by litigation in jurisdictions hosting recognised financial centres, are turning their attention to international commercial arbitration, and, in appropriate cases, to ISDS⁴³⁸.

Seventh, on the trade and investment dispute settlement front there have been several developments related to the WTO and the EU. The WTO’s Appellate Body has not been able to function since December 11, 2019, owing to past US administrations’ blockage of the appointment of new judges. The US expressed several concerns related to the WTO’s Appellate Body, including issues of judicial activism and substantive interpretations, amongst others⁴³⁹. In regard to judicial activism, the US observed that the purpose of the dispute settlement system is

⁴³⁶ UNCTAD Investment Policy Monitor, “Investment Policy Responses to the COVID-19 Pandemic, 4th May 2020
https://unctad.org/en/PublicationsLibrary/diaepcbinf2020d3_en.pdf, Last accessed 12th July 2020.

⁴³⁷ Jeffrey Golden and Peter Werner, ‘The Modern Role of Arbitration in Banking and Finance, in *International Financial Disputes: Arbitration and Mediation*’, March 2015, Edited by Jeffrey Golden, Carolyn Lamm, <https://olrl.ouplaw.com/view/10.1093/law/9780199687862.001.0001/law-9780199687862-chapter-1#law-9780199687862-chapter-1-note-5>.

⁴³⁸ ICC Commission report, *Investment Arbitration and Financial Institutions*, 2016, Last accessed on 24/02/2020 at: <https://iccwbo.org/content/uploads/sites/3/2016/11/icc-financial-institutions-and-international-arbitration-icc-arbitration-adr-commission-report.pdf>.

⁴³⁹ Office of the United States Trade Representative, ‘2018 Trade Policy Agenda and 2017 Annual Report of the President of the United States on the Trade Agreements Pro-

not to ‘make law’ but to help resolve trade disputes⁴⁴⁰. In regard to substantive interpretation, meanwhile, the US noted that some Appellate Body decisions interpreted WTO covered agreements in ways that add to or diminish the rights and obligations provided for in the WTO covered agreements⁴⁴¹. In the absence of ‘cogent reasons’, the US expressed its reservations on Appellate Body claims that its reports be treated as precedent by subsequent panel reports⁴⁴². This may raise issues in the context of the applicability of jurisprudence, such as through divergences on the legal weightage of dispute settlement, e.g. the US’s views on WTO Appellate Body jurisprudence.

In order to resolve the Appellate Body deadlock, as an interim measure, 19 countries including the EU nations, China, and Canada agreed to an alternate system of appeals to deal with disputes. The multi-party interim appeal arbitration arrangement was formally notified to the WTO as a temporary measure pending the functioning of the WTO’s Appellate Body⁴⁴³. The status of this multi-party temporary arbitration arrangement in the context of dispute settlement in the financial sector is yet to be ascertained in terms of its continuity and the application of dispute settlement outcomes to larger DSB body jurisprudence, amongst other issues.

Some commentators have pointed out that dispute settlement reform on trade and ISDS seem to be moving in opposite directions, i.e. ISDS towards a centralised court-like system, while in the case of the WTO the functioning of the current

gram’, 2018, Last accessed 10/09/2021 at <https://ustr.gov/sites/default/files/files/Press/Reports/2018/AR/2018%20Annual%20Report%20FINAL.PDF>.

⁴⁴⁰ Office of the United States Trade Representative, ‘2018 Trade Policy Agenda and 2017 Annual Report of the President of the United States on the Trade Agreements Program’, 2018, Page 26, Last accessed 10/09/2021 at <https://ustr.gov/sites/default/files/files/Press/Reports/2018/AR/2018%20Annual%20Report%20FINAL.PDF>.

⁴⁴¹ Office of the United States Trade Representative, ‘2018 Trade Policy Agenda and 2017 Annual Report of the President of the United States on the Trade Agreements Program’, 2018, Page 23, Last accessed 10/09/2021 at <https://ustr.gov/sites/default/files/files/Press/Reports/2018/AR/2018%20Annual%20Report%20FINAL.PDF>.

⁴⁴² Office of the United States Trade Representative, ‘2018 Trade Policy Agenda and 2017 Annual Report of the President of the United States on the Trade Agreements Program’, 2018, Page 28, Last accessed 10/09/2021 at <https://ustr.gov/sites/default/files/files/Press/Reports/2018/AR/2018%20Annual%20Report%20FINAL.PDF>.

⁴⁴³ Arij Limam, ‘New Trade Appeals Body gets around US Block of WTO’, 2 May, 2020 Accessible at: <https://newseu.cgtn.com/news/2020-05-02/New-trade-appeals-body-gets-around-U-S-block-on-WTO-Q96My9VYQM/index.html>.

dispute settlement body is being questioned by some member states⁴⁴⁴. In the case of financial disputes that are either trade- or investment-related, the question is what the impact of these developments and any subsequent reform is likely to be.

Within Europe, the EU has proposed to set up a multilateral ISDS court. While discussions were stalled during the COVID-19 pandemic, there is a strong likelihood that they will be revisited once the pandemic ends⁴⁴⁵ – and discussions within UNCITRAL did indeed pick up by the end of 2020⁴⁴⁶. These discussions have explored a wide range of issues related to ISDS. Some of the issues under consideration are calculation of damages, each state's right to regulate, and the 'regulatory freeze' impact of ISDS, with differing views being expressed on each of these. Moreover, several states are not interested in the multilateral investment court as a court of first, but more as a court of appeal, with a preference for the continued system of arbitration.

Canada-EU Comprehensive Economic and Trade Agreement

The Canada-EU Comprehensive Economic and Trade Agreement was entered into in 2017. Chapter 8 sets out the ISDS resolution procedures that will come into force once all EU member states have ratified the agreement. As of March 2021, 15 of 27 EU member states gave notice of CETA ratification. In January 2021, four decisions adopting rules for the functioning and composition of appellate tribunals, procedures for modifying/reversing legal findings and conclusions, a Code of Conduct for judges including prevention from acting as a counsel for three years from the end of their term, rules for mediation, and finally rules for binding interpretations, ensuring that provisions are interpreted as originally intended.

The implications for the trade and investment and financial architecture interface relate to how the issue of investor/trade agreement protections vis-à-vis regulatory flexibility in the financial sector will be addressed. Would financial regulation and systemic stability be considered to be in the 'public interest'? Will the CETA Investment Court provide a model for future investor-state arbitration disputes?

⁴⁴⁴ Federico Ortino and Maria Laura Marceddu, 'Recent Legal and Policy Developments Regarding the Interactions Between Foreign Investment and Trade', 2 July, 2019, Pages 2, 11-13, Yearbook of International Investment Law and Policy, Oxford University Press.

⁴⁴⁵ See European Parliament, 'Multilateral Investment Court: Overview of Reform, Prospects and Proposals', 28 January 2020. Last accessed 27/02/2021 at [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/646147/EPRS_BRI\(2020\)646147_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/646147/EPRS_BRI(2020)646147_EN.pdf).

⁴⁴⁶ See deliberations of UNCITRAL Working Group 3 on Investor-State Dispute Settlement Reform, last accessed 15th September 2021 at https://uncitral.un.org/en/working_groups/3/investor-state.

The EC has included ISDS supportive provisions in several FTAs, such as the EU-Canada Comprehensive Economic and Trade Agreement ('CETA') and the EU-Vietnam Free Trade Agreement, both of which envisage the formation of a permanent multilateral forum for ISDS. The CETA, for example, states that Canada and the EU 'shall pursue with other trading partners the establishment of a multilateral investment tribunal and appellate mechanism for the resolution of investment disputes' and that this new system, once implemented, must have jurisdiction over disputes arising from CETA⁴⁴⁷.

It is possible that the EU-Canada CETA ISDS forum may become a model for all EU ISDS settlement and potentially the EU's proposal for an ISDS Court. Part of the reason for the EC's investment court proposal is to address issues of transparency, due process, choice of judges, and the perception that ISDS is weighted in favour of foreign investors, thereby impeding a state's right to legislate and regulate. The implications for financial services dispute settlement could include scope of coverage of such an ISDS Court, choice of arbitrators, and approaches taken in arbitration jurisprudence, i.e. a more private-sector-based approach or a friendly regulatory approach, amongst others.

Furthermore, the European Commission's opposition to investment treaties between EU member states culminated in the 2018 *Slovak Republic v. Achmea* decision, where an 'intra-EU' investment treaty between the Netherlands and Slovakia was found to be incompatible with EU law⁴⁴⁸. This effectively wiped out the intra-EU BIT regime.

A larger question relates to the potential incompatibility of extra EU investment agreements, i.e. between EU member states and non-EU member states. Following the *Achmea* judgement, EU member states may be required to terminate the agreement, the enforceability of awards at a national level may be in doubt, and obligations and enforcement under the ICSID Convention may be called into question⁴⁴⁹.

⁴⁴⁷ Article 8.29 of the EU-Canada Comprehensive Economic and Trade Agreement, 2016.

⁴⁴⁸ The Court of Justice of the European Union's *Slovak Republic v. Achmea BV* decision in 2018, Case No. C284/16.

⁴⁴⁹ Laurens Ankersmit, 'Achmea: The Beginning of the End for ISDS in and with Europe?', April 4, 2018, IISD Investment Treaty News, Last Accessed 25/2/2021 at <https://www.iisd.org/itn/en/2018/04/24/achmea-the-beginning-of-the-end-for-isds-in-and-with-europe-laurens-ankersmit/>.

The rise in ISDS in the financial sector, therefore, seems a real possibility. The lack of conformity between macro and microprudential regulation and trade and investment commitments can be considered grounds for challenge under trade and investment agreements. Meanwhile, the worldwide network of investment treaties continues to provide a powerful tool to investors/financial service suppliers when they face adverse action by a state, and this is likely to remain the case⁴⁵⁰.

2. Coverage of Dispute Settlement Provisions within the International Trade and Investment Architecture

The forum and structure for trade and investment dispute settlement is provided for by a network of nearly 3,400 trade and investment treaties. These trade and investment treaties provide minimum standards of protection (market access, national treatment, fair and equitable treatment, free transfer of funds, protection from state expropriation, amongst others) to investors and financial service suppliers, based on which they make their operational decisions. Almost all the 3,400 trade and investment treaties contain some manner of dispute settlement, normally beginning with a process of consultation and mediation, arbitration, or state-to-state dispute settlement, e.g. WTO and/or ISDS.

Dispute settlement is a key provision in the investment chapters of FTAs and BITS, allowing investors to bring disputes regarding the treaty's substantive provisions. Almost all PTAs provide for a mechanism for consultations and state-to-state dispute settlement and 77% provide for ISDS. Some agreements, such as the EU and EFTA agreements, provide for a state-to-state arbitral mechanism (e.g. EFTA's PTAs with Singapore and Korea have ISDS)⁴⁵¹.

For dispute settlement in trade in services, an assessment of 144 services PTAs found that 72% positive-list-type agreements refer to state-to-state dispute settlement, while the remaining positive-list agreements also include ISDS for relevant

⁴⁵⁰ Alexander Uff, *Claims Against States, Investment Treaties and the Financial Sector*, *Financier Worldwide*, January 2019, Last visited 21/03/2020, accessible at: https://www.financierworldwide.com/claims-against-states-investment-treaties-and-the-financial-sector#.XnaF_YhKg2z.

⁴⁵¹ Jo-Ann Crawford and Barbara Kotschwar, 'Investment Provisions in Preferential Trade Agreements: Evolution and Current Trends', 14th December 2018, WTO Staff Working Paper ERSD-2018-14. The paper focuses on investment chapters/provisions of 111 PTAs, and not on investment-related provisions that might be found in services chapters as for Mode 3.

Mode 3 issues. Most negative-list agreements (84%) include provisions covering both state-to-state and ISDS⁴⁵².

A perusal of select FTAs suggests that most dispute settlement processes begin with an initial consultation and mediation phase (e.g. TPP, EU-Singapore, US-Korea, US-Singapore, EFTA-Singapore, India-Singapore CECA, ASEAN Investment Agreement). There is reference to ISDS including applicable forum and related international legislation such as ICSID, UNCITRAL, VCLT, WTO Agreements (e.g. TPP, EU-Singapore, US-Korea, US-Singapore, EFTA-Singapore, India-Singapore CECA, ASEAN Investment Agreement), and state-to-state dispute settlement (WTO, ASEAN Investment Agreement). Some FTAs contain national dispute settlement requirements such as a requirement for submission to national court before ISDS and exclusion of certain sectors (e.g. TPP), while others contain a requirement for panelists with expertise in the financial sector (e.g. TPP, US-Korea, US-Singapore, India-Singapore CECA), and some like the US-Singapore FTA provide for special treatment of the prudential exception in related disputes (*see Table 34: Dispute Settlement Provisions in select FTAs*

Thus, dispute settlement is a key provision in all FTAs and BITS, often providing for a range of dispute settlement mechanisms within the same agreement. Almost all agreements contain provisions for consultation and state-to-state dispute settlement, while over three-quarters of them provide for ISDS. Some agreements require special treatment of financial disputes either through choice of panelists, special treatment in case of use of the prudential exception, or exclusion of certain sectors.

⁴⁵² Batshur Gootiiz, Giulia Joentzko, Joscelyn Magdeleine, Juan Marchetti, and Aaditya Mattoo, ‘Services-Chapter 4’, in *Handbook of Deep Trade Agreements*, 2020, Mattoo, (Aaditya Mattoo, Nadia Rocha, and Michele Ruta, eds. 2020. *Handbook of Deep Trade Agreements*. Washington, DC: World Bank). This dataset contains information for 144 services PTAs signed by 105 economies.

Table 35: Dispute Settlement Provisions in select FTAs

Agreement	Coverage of dispute settlement
TPP	Investment chapter – Dispute settlement, initially through consultation and negotiation, including conciliation or mediation. If not resolved within six months, there exists the possibility to request ISDS under and through ICSID, UNCITRAL, or a mutually agreed third forum of arbitration/ rules (Article 9. 19). Tribunal can award separately or in combination monetary damages and any applicable interest and/or restitution of investors' property (Article 9.29). Exceptions: Mexico has made ISDS arbitration reservations for certain areas relating to infrastructure services. Malaysia has taken a time exception for contracts below a certain value linked to government procurement, for a period of three years after the signing of the TPP. Chile, Mexico, Peru, and Vietnam have stated that where an investor submits to a domestic court/administrative tribunal, the decision of the court is final, and the investor may not subsequently submit to ISDS. Broadly, Australia, Canada, New Zealand, and Mexico have provided that foreign investment proposal approvals shall not be subject to the ISDS. Financial Services Chapter – Article 11.22 – Requirement for consultation on non-conforming measure, setting up of a tribunal in case of arbitration, requirement for panelist to have FS expertise.
EU-Singapore 2015	– Under the investment chapter provision for consultation, mediation, and arbitration (ICSID rules) but not ISDS. Chapter 15 on dispute settlement incorporates VCLT and WTO Agreements as well as WTO's DSB.
US-Korea 2007	Financial Services Chapter – Dispute settlement by way of consultation (Article 13.18). – Investor-state dispute settlement permitted. – Investor-state dispute settlement under ICSID and UNCITRAL (section B 11.5 onwards). – Financial services dispute panelists are required to have expertise in FS law and to be independent. – Where a measure is inconsistent with the FTA, there exists the possibility to suspend benefits in the financial services sector (Article 13.18 (4)).

(Continued)

Table 35: *(Continued)*

Agreement	Coverage of dispute settlement
	In case of financial-services-related investment disputes, where the prudential exceptions are invoked, strict timelines are set out for respondents to reply to submission of claims to arbitration (120 days). The response has to set out a valid defense to the claim to the FS committee (Article 13.19).
US-Singapore 2003	Financial Services Chapter – Dispute settlement by way of consultation (Article 10.17). – Investor-state dispute settlement permitted. – Investor-state dispute settlement under ICSID and UNCITRAL (section C 15.15 onwards). – FS panelists are required to have expertise in FS law and to be independent. – Where a measure is inconsistent with the FTA, there exists a possibility to suspend benefits in the FS sector (Article 10.18 (4)). – In case of FS-related investment disputes, where the prudential exceptions are invoked, the matter has to be referred to the FS committee, which will determine whether and to what extent the exceptions of Article 10.10 can be invoked in defense. Strict timelines are set out for respondent to reply to submission of claims to arbitration. The response has to set out a valid defense to the claim to the FS committee (Article 10.19). – Investment chapter provides coverage of dispute settlement.
EFTA-Singapore 2002	– For investment chapter: Initially through consultation and negotiation, Article 48 for investor-state dispute settlement provides for consultations and ICSID consultations/arbitrations.
India-Singapore CECA 2005	– For investment chapter: Disputes to be settled through consultations and negotiations (Article 6.21), or if parties/investor have agreed on ICSID for conciliation/arbitration. Investor-state dispute settlement are therefore provided for. Provides for compulsory investor-state dispute settlement in case of pre-establishment. – Services: disputes on prudential issues and financial services should have the necessary expertise (Annex 7C, para 8).

(Continued)

Table 35: *(Continued)*

Agreement	Coverage of dispute settlement
ASEAN ASEAN Investment Agreements (1987, 1998, 2009) ASEAN Framework Agreement on Trade in Services (1995)	– Investor-state dispute settlement through consultation, Arbitration ICSID, Kuala Lumpur Regional Centre for arbitration, or any other (ASEAN Agreement on Investment Article X). Also, in ASEAN Comprehensive Investment Agreement provisions providing for disputes amongst member states (Article 27) and extensive provisions for investor-state dispute settlement (Section B, Article 28 onwards).

Source: Author Compilation

C. Grounds for Dispute Settlement Case Filings in the Financial Services Sector

As set out in the preceding chapters, following the 2008 crisis, many states moved to a more interventionist approach to regulation, resulting in significant change in the legal environment for foreign investors and services providers in the financial sector. Most foreign investors and financial services suppliers relied on the minimum standards of protection (market access, national treatment, FET, free transfer of funds, protection from state expropriation amongst others) contained in nearly 3,400 trade and investment treaties at the time of commencing operations. The trade and investment architecture is therefore an important framework guaranteeing far-reaching protections against arbitrary conduct by the host state⁴⁵³. It preserves the right of foreign investors and financial service suppliers to bring claims directly or indirectly in an agreed forum of dispute settlement.

Claims for breach of a trade and investment treaty arise in accordance with the principles of international law, independent of contractual claims, and broadly require consideration of two key issues:

⁴⁵³ See also, December 2016 by the ICC Commission Task Force on Financial Institutions and International Arbitration.

- a) whether there has been a breach of existing rules/obligations, i.e. GATS, FTAs, BITs, FET, and if yes, where does jurisdiction lie?; and
- b) the need to determine the balance between regulatory flexibility and investor/trade protection?

1. Has a Breach of existing Trade/Investment Obligations occurred?

A breach of obligations or cause for action gives rise to a dispute settlement claim. It can occur due to contraventions between macro and microprudential regulation and the trade and investment architecture or contradictions/incongruities within and between trade and investment agreements related to the financial sector. Possible contraventions related to select macro and microprudential regulation in the context of the trade and investment architecture have been set out in earlier chapters, specifically Chapters 3 and 4 (*summarised in Table 32: on Contraventions related to the GATS and FTAs*).

The substantial regulatory intervention in the financial sector provides banks and financial institutions with claims under investment and trade treaties that they would not be able to directly pursue outside of the ISDS framework. Many of the post-financial-crisis regulatory measures taken by states to protect systemic stability were not contemplated by the negotiators of investment and trade treaties. As a result, there has been ‘an unprecedented wave of claims by and against financial institutions, as well as among them’⁴⁵⁴.

The grounds for post-2008 financial crisis claims ranged from debt recovery and foreclosure actions over collateral, to claims by borrowers and their shareholders against financial institutions on grounds of negligence and claims alleging breach of the lenders’ and financial advisors’ duty of care⁴⁵⁵. Financial rescue measures that governments undertook to prevent failing global systemically important banks (G-SIBs) from collapsing often led to alleged expropriation or discriminatory measures with, in certain cases, arguable breaches of state-aid laws and the

⁴⁵⁴ ICC Commission on Arbitration and ADR Task Force, Report on Financial Institutions and International Arbitration, 2016, Last accessed 23/03/2020 at https://www.icc-portugal.com/images/documentos/comissao_de_arbitragem/Financial_Institutions_and_International_Arbitration.pdf.

⁴⁵⁵ ICC Commission on Arbitration and ADR Task Force, Report on Financial Institutions and International Arbitration, 2016, Last accessed 23/03/2020 at https://www.icc-portugal.com/images/documentos/comissao_de_arbitragem/Financial_Institutions_and_International_Arbitration.pdf.

principle of FET of foreign investments. Bailed-in bond holders and depositors, unsecured creditors, and shareholders of nationalised financial institutions (some of whom are themselves financial institutions) filed claims before investment arbitral tribunals, as well as in national courts, relating to state measures⁴⁵⁶.

Once a cause of action is established, the determination of jurisdiction or whether an investor or financial services provider can seek the protection or coverage of a given investment or trade agreement at the point of dispute settlement arises. The issue of jurisdiction is strongly related to the contents of treaty definitions, which determine the validity of a claim, i.e. the assets covered as well as the boundaries of a State's liability and involvement within a jurisdiction⁴⁵⁷.

The scope of treaty definitions relates to (a) the object/target of investment or financial service provision (e.g. definitions of 'investment' and 'financial service'); (b) the person permitted to make the investment or provide the financial service (e.g. 'investor', 'financial service supplier'), and (c) related definitions such as 'trade in services', 'financial services', 'measure affecting services', and the four modes of services, with Mode 1 (cross-border trade in services) and Mode 3 (commercial presence) being of particular relevance (*see Chapter 2 on the International Trade and Investment Architecture*).

Definitions related to the 'object/target' of investment/financial services can be grouped broadly into four categories: 'asset-based' (which includes various kinds of assets and interests such as shares, moveable and immoveable property, bonds, etc.), 'list-based' (with finite examples of assets covered by the treaty), 'enterprise-based' (which comprises the establishment or acquisition of a business enterprise, as well as a share that provides the investor control over an enterprise, broadly utilised in US FTAs), and 'commercial-presence-based' (based on commercial presence services' liberalisation provisions of the GATS and broadly utilised in EU FTAs) (*see Chapter 2 on the International Trade and Investment Architecture*).

⁴⁵⁶ ICC Commission on Arbitration and ADR Task Force, Report on Financial Institutions and International Arbitration, 2016, Last accessed 23/03/2020 at https://www.icc-portugal.com/images/documentos/comissao_de_arbitragem/Financial_Institutions_and_International_Arbitration.pdf.

⁴⁵⁷ UNCTAD/ITE/IIA/2006/5 – E.06.II.D.16, 01/02/07 Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking, available at http://www.unctad.org/en/docs/iteia20065_en.pdf at 7–11.

Definitions related to the person making the investment such as ‘investor’ and/or ‘financial services supplier’ are generally set out within the context of treaties, i.e. BITS/FTAs or national law as the case may be. Most BITs define investors as natural or legal persons having a certain degree of connection – through nationality, control, or economic/other links – with the Contracting States to the agreement⁴⁵⁸, and in turn natural persons include nationals, citizens, and in some cases even permanent residents. In ISDS dispute settlement, claimants typically must satisfy nationality criteria by demonstrating that they (a) are a national of a state that is a party to the treaty containing the ISDS agreement, and (b) have an investment in the territory of another state that is a party to the treaty. Legal persons generally include those entities whose principal place of incorporation or business is the investor state⁴⁵⁹. Depending on the treaty, incorporation in the home state is often sufficient to qualify as an ‘investor’.

The approach taken on the choice of definition in an FTA/BIT depends on the intention of the parties concerned, and often reflects several factors such as the structure of their investment or financial regime, trade/investment sectors, and interests, amongst others.

Definitions may be set in BITs or FTAs, but at the point of dispute settlement their interpretation lies with the dispute settlement tribunal. In the case of ICSID jurisprudence, definitions relating to investment have not only been relatively broad and varied but also at times contradictory. In *Salini v. Morocco* (2000) an ICSID tribunal set out the so called ‘Salini test’, highlighting the inherent properties of a protected investment including a substantial commitment of resources or capital, a sufficient duration, the assumption of risk and a contribution to the development of the host state. This criterion has enabled the determination of the types of investment in the financial sector and financial products that can qualify as an investment attracting protection under a treaty.

Several investment arbitral awards found that varying financial instruments qualify as investments and benefit from protection under investment treaties. Financial instruments considered to be qualifying investments include straightforward

⁴⁵⁸ OECD, ‘Definition of Investor and Investment in International Investment Agreements International Investment Law: Understanding Concepts and Tracking Innovations’, 2008, last accessed 5th October 2020 at <http://www.oecd.org/investment/international-investmentagreements/40471468.pdf>.

⁴⁵⁹ UNCTAD, ‘Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking’, February 2, 2007, Page 15, Last accessed 5th October 2020 at http://www.unctad.org/en/docs/iteiia20065_en.pdf at 7–11.

loans, negotiable instruments, sovereign bonds, and oil price hedges in several cases⁴⁶⁰. Loans have been found to be protected under treaties which contain a broad definition of investments that includes ‘claim to money’ or ‘obligations’⁴⁶¹. Other instruments include shareholdings, bank guarantees⁴⁶², promissory notes⁴⁶³, depository receipts⁴⁶⁴, convertible debentures⁴⁶⁵, and dematerialised government bonds⁴⁶⁶.

ISDS arbitral interpretations can also be contradictory at times. Sovereign bonds were considered to be qualifying investments in three ICSID cases but not in a

⁴⁶⁰ *Oko Pankki Oyj v. Republic of Estonia* (ICSID Case ARB/04/6), Award (19 November 2007); *Fedax N.V. v. Bolivarian Republic of Venezuela* (ICSID Case ARB/96/3), Award (9 March 1998); *Abaclat v. Argentine Republic* (ICSID Case ARB/07/5), Decision on Jurisdiction and Admissibility (4 August 2011).

⁴⁶¹ *British Caribbean Bank v. Belize* concerned a default under a loan. In *Standard Chartered Bank v. Tanzania*, a loan held by a subsidiary did not qualify as an investment by the parent bank where the parent had no involvement or knowledge of the decision to purchase the loan.

⁴⁶² *Joy Mining Machinery Ltd. v. Arab Republic of Egypt* (ICSID Case ARB/03/11), Award on Jurisdiction (6 August 2004).

⁴⁶³ In *Fedax v. Venezuela*, Government-issued promissory notes were found to constitute investments as the treaty’s definition of investments included ‘titles to money’.

⁴⁶⁴ In *Renta4 v. Russia*, depository receipts were held to fall within ‘all types of assets’ for purposes of the definition of investment in the Russia-Spain investment treaty. The tribunal determined that depository receipts represent a property interest covered by the treaty, despite the fact that the recorded owner was a third-party intermediary and not the beneficiary.

⁴⁶⁵ Convertible debentures were held to qualify as investments under the NAFTA in *Fireman’s Fund v. Mexico*. Although loans were excluded from protection under the treaty, Mexican law which governed the debentures treated them as capital, which was subject to regulation in Mexico by the financial authorities.

⁴⁶⁶ Dematerialised government bonds were found to qualify as investments in *Abaclat v. Argentina* and *Ambiente Ufficio v. Argentina*. In *Abaclat v. Argentina*, which was a mass claim on behalf of 60,000 bondholders, the tribunal held that the inclusion of ‘obligations’ within the Argentina-Italy treaty’s definition of investment implicitly included sovereign debt and that this extended to the economic value incorporated in a credit title representing a loan, including bonds. The tribunal further noted that the sovereign debt could also constitute ‘securities’ – another example listed within the definition of investments in the treaty – and that bonds are covered investments in any event.

fourth case⁴⁶⁷. Similarly, a bank guarantee was considered a qualifying investment in a Permanent Court of Arbitration case under the UNCITRAL Arbitration Rules but was denied that benefit in an ICSID case⁴⁶⁸.

From a dispute settlement perspective, several issues arise in relation to definitions. First is the importance of definition formulation and interpretation at the point of treaty negotiation and during dispute settlement proceedings. This is because definitions determine the cause of action and jurisdiction and can potentially cover a wide range of financial-sector-linked investments, services, and transactions. Therefore, definitions in negotiations and dispute settlement under investment and trade treaties are important as they can have a direct impact on the possibility of filing dispute settlement cases and on the outcome of future dispute settlement cases in the financial sector.

Second, several FTAs, particularly more recent ones, contain independent chapters on investment, services, and sometimes cross-border services or financial services (*see Table 8: Coverage of Investment, Trade in Service, Financial Services and Cross Border Services in select FTAs*). Definitions and in fact the provisions relating to investment, trade in services, and financial services within and among FTAs/BITS as well as in comparison to national law need to be cross-referenced, particularly at the time of dispute settlement. More recent FTAs tend to delineate definitions in the same FTA, but where they are not specifically excluded in application there can be ambiguity as to which definition (i.e. which chapter services or investment) would apply, as well as the appropriate manner of application.

Third, there is a variance of ‘like definitions’ or ‘linked definitions’ within, between, and amongst trade and investment agreements as well as within related jurisprudence⁴⁶⁹ provides an overview of the kind and depth of investment definitions

⁴⁶⁷ *Abaclat v. Argentina; Ambiente Ufficio S.p.A. v. Argentine Republic* (ICSID Case ARB/08/9), Decision on Jurisdiction and Admissibility (8 February 2013); *Giovanni Alemanni v. Argentine Republic* (ICSID Case ARB/07/8), Decision on Jurisdiction and Admissibility (17 November 2014); *Poštová banka, a.s. and ISTROKAPITAL SE v. Hellenic Republic* (ICSID Case ARB/13/8), Award (9 April 2015).

⁴⁶⁸ *Joy Mining Machinery Ltd. v. Arab Republic of Egypt* (ICSID Case ARB/03/11), Award on Jurisdiction (6 August 2004).

⁴⁶⁹ In this context, ‘like definition’ refers to similar definitions that may be addressed differently in different trade/investment agreements or national law. These include different definitions of investment that may exist between trade/investment agreements involving the same Parties, within the same agreement, or in national law. ‘Linked definitions’, meanwhile, are definitions that rely on or are interlinked with one another.

contained in investment chapters of FTAs notified to the WTO. These variations raise the possibility of contradictions, incongruity, or at the very least ambiguities in ‘like definitions’ or ‘linked definitions’.

Further definitions under an FTA/BIT may vary from definitions under national law. In fact, the clash between definitions in FTA/BITS and national law has been the subject of ISDS, where, for instance, a contract between an investor and a host state for the performance of certain pre-inspection services was held to constitute an investment under the Swiss-Pakistan BIT, even though it would not have qualified as a foreign investment under the respondent state’s law⁴⁷⁰.

Fourth, ICSID jurisprudence has also enabled a wide and detailed interpretation of what constitutes investment, investor, etc. Most financial sector operations would satisfy the categories of the ‘Salini test’ relating to the commitment of resources, duration, assumption of risk, and contribution to the host state’s development. Characterisation of a qualifying investment, however, can vary in individual cases and at times be contradictory; hence, there appears to be ample leeway in an arbitrator’s interpretation. Moreover, different tribunals may vary in their findings, even when faced with similar facts and treaty provisions.

The question of jurisdiction or issues of *ratione loci* seeks to determine the location of the court or deciding authority in the case of arising disputes, which is easier to achieve once the cause of action has been established. Most FTAs/BITS make clear provisions on the choice of jurisdiction as well as the procedure to be followed in case of any arising dispute. However, given the multijurisdictional and

For example, the definition of investment is covered by the definition of Mode 3 or commercial presence, which in turn is linked to the definition of trade in services and financial services.

⁴⁷⁰ *Société Générale de Surveillance SA v. Pakistan*, Decision on Objections to Jurisdiction, ICSID Case No ARB/01/13, (2003). The respondent state, Pakistan, argued that the investor SGS’s activities under the Pre-Shipment Inspection (PSI) Agreement did not constitute an investment within the territory of Pakistan and within the meaning of Article 2(1) of the Swiss-Pakistan BIT because SGS’s obligations were performed outside Pakistan. The tribunal held that the expenditures made by SGS pursuant to a Pre-Shipment Inspection Agreement constituted an investment within the meaning of Article 2(1) of the Swiss-Pakistan BIT and Article 25(1) of the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (18 March 1965). The non-exhaustive definition of investment in the BIT was broad enough to encompass the PSI Agreement because the Agreement’s performance gave rise to ‘claims of money’. As quoted in Malik Mahnaz, ‘Definition of Investment and International Investment Agreements’, August 2009, IISD Bulletin No. 1.

complex nature of cross-border financial services, determining where the ‘cause of action’ lies can be a more complicated process. The determination of whether an investment/economic activity can be considered an investment ‘in the territory’ of the host state for jurisdictional purposes can therefore involve an assessment of ambiguous facts and law.

Finally, it is important to recall that the universe of BITS/FTAs has followed a historical development trajectory that global and economic developments. Prior to the foundation of the General Agreement on Trade and Tariffs, BITS and FTAs were concerned primarily with the liberalisation of trade in goods and the securing of investment interests in natural resources. These bilateral treaties known as friendship, commerce, and navigation agreements can be seen in the late eighteenth century in the United States – and to a lesser extent in Japan and a few European countries⁴⁷¹. They therefore do not reflect the global, regional, and national economic developments today.

2. Regulatory Discretion vis-à-vis Trade and Investment Protections and Dispute Settlement Considerations

A second key question in dispute settlement within the context of the financial sector relates to the extent of regulatory flexibility vis-à-vis trade and investment commitments. BITS/FTAs define and protect investor/financial service suppliers while simultaneously providing regulatory flexibility and dispute settlement, leading to a degree of tension, especially at the point of dispute settlement.

Regulation for the preservation of ‘systemic stability’ is a national and potentially global public good, given the importance of the financial sector to the larger economy and its role as an intermediary and infrastructural service. In view of regulators’ role in maintaining systemic stability, WTO, FTA, and BITS tend to provide for flexibility in the form of ‘prudential exceptions’, capital transfer exceptions, and balance-of-payment safeguards (*see Chapter 2 on the International Trade and Investment Architecture, for a discussion on the prudential carve-out and Chapter 3 for a discussion on capital transfer exceptions and Balance of Payment Safeguards*).

Overall, WTO and investment arbitration tribunals have shown deference to legitimate regulatory activity in the financial sector – to what is viewed as being

⁴⁷¹ UNCTAD, ‘Investment Provisions in Economic Integration Agreements’, 2006, UNCTAD/ITE/IIT/2005/10.

legitimate regulatory activity with respect to financial institutions⁴⁷². Several ISDS cases – *Saluka vs Czech Republic* (2006), *Duke Energy et al. v. Ecuador* (2008), *Pope & Talbot Incorporated v. Canada* (2002), amongst others – have emphasised the importance of regulatory flexibility (*see Chapter 2 on the International Trade and Investment Architecture, Investor Protection vis a vis legitimacy of Host State's regulatory action and Host State's regulatory flexibility*). These tribunal proceedings read alongside the 'prudential exceptions' and balance-of-payment safeguards contained in international trade and investment agreements, as well as the special case of the financial sector which warrants greater regulatory flexibility, can provide for regulators in dispute settlement cases involving micro and macroprudential regulation.

However, the 'exceptions' in trade and investment agreements specify that regulation must not be taken as a means to avoid trade commitments. Furthermore, tribunals, especially ISDS ones, must recognise investor and trade protection provisions, as they form the basis for trade and investment decisions. In fact, there have been a reasonable number of ISDS cases where tribunals have upheld 'investment protection' measures such as the FET standard. Consequently, determining when regulatory activity may give rise to a dispute settlement claim almost invariably involves balancing perceived legitimate regulatory interests against investor/financial service supplier interests that are perceived as not being equally legitimate⁴⁷³.

In practice, it is difficult to predict when the actions of a state will violate the FET standard and provisions of trade agreements. Treaty provisions can be ambiguous, which has led tribunals, at least in the case of ISDS, to deliver widely differing interpretations. On top of this, it has been suggested in cases invoking the FET standard that the investor should not expect absolute legal stability as, generally, a state's right to regulate will not be unreasonably impaired⁴⁷⁴.

Commentators observe that tribunals in ISDS cases seek to address this question of investment protection vis-à-vis regulatory flexibility through a narrow 'private-sector-focused' treaty interpretation and application approach. Consequently, the impact of dispute settlement outcomes on a State can be disproportionate, impacting not just regulatory regimes and policy objectives, but also leading to the State having to make large financial payouts amounting to a portion of

⁴⁷² See, e.g. *Continental Casualty*; Renée Rose Levy de Levi; Invesmart; and, with respect to certain matters, notably suspension of the trading of certain securities, *Saluka*.

⁴⁷³ See Renée Rose Levy de Levi, Award (14 February 2014) paras. 157ff.

⁴⁷⁴ *Saluka*, Partial Award (17 March 2006) para. 305.

their GDP as in the case of Ecuador⁴⁷⁵ and Pakistan. In 2019, Pakistan was ordered to pay USD 6 billion in compensation to a single foreign investor, which is equivalent to the total amount received in the IMF bailout package for the same year⁴⁷⁶. In reality, therefore, the stakes in ISDS are much higher than a focused ‘private sector perspective’, with economic and political ramifications that go beyond narrow treaty interpretation and application.

Furthermore, it is important to recall that BITs in particular but also several FTAs were entered into at a time when capital-importing states were keen to attract FDI, generally to capital-intensive industries such as traditional mining, oil and gas, and production sectors (brick-and-mortar industries) and not necessarily for investments in financial institutions and financial products. As a result, investors in financial institutions and their products may not unequivocally be subject to the protections offered in the relevant BITS and FTAs⁴⁷⁷.

D. Direct and Indirect Economic Costs of Post-2008 Crisis Financial Regulation Accruing to Investors/Financial Services Suppliers and the Regulator

Post-2008 crisis financial regulation resulted in economic costs accruing to investors/financial services suppliers. Economic costs incurred by investor/financial services suppliers arise out of the cost of implementation of new regulatory measures as well as trade-and-investment-like barriers that new regulatory measures can create, e.g. the requirement to operate as a subsidiary as opposed to a branch, which requires a change in business model. Non-compliance with the post-crisis financial measures is not an option and can result in hefty penalties.

From 2006–2014, many countries tightened regulations on banks’ international operations, while only a few loosened them⁴⁷⁸. Macro and microprudential rules

⁴⁷⁵ In 2004, a US investor won an arbitration against Ecuador, exceeding the Ecuadorian government’s annual budget on health, which was around 7%.

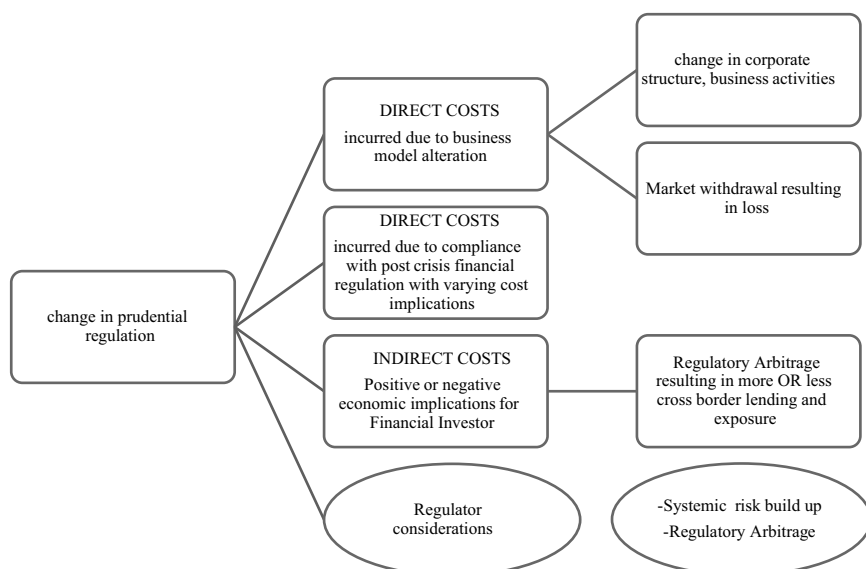
⁴⁷⁶ *Tethyan Copper Company Private Limited v. Government of Pakistan*, ICSID Case. No. ARB/12/1, Award, 12 July 2019.

⁴⁷⁷ See also ICC Commission on Arbitration and ADR Task Force, Report on Financial Institutions and International Arbitration, 2016, Last accessed 23/03/2020 at https://www.icc-portugal.com/images/documentos/comissao_de_arbitragem/Financial_Institutions_and_International_Arbitration.pdf.

⁴⁷⁸ Ichiue Hibiki and Lambert Frederic, Post-Crisis International Banking: An Analysis of New Regulatory Survey Data, Page 9, IMF Working Paper WP/16/88, April 2016.

implemented by home and/or host countries had direct and indirect policy spillovers and economic costs for domestic banks and foreign affiliates (bank branches or subsidiaries) located in the host country, as well as the foreign activities of a reporting country's global banks⁴⁷⁹ (see Figure 15: *Economic costs to investors/financial service suppliers arising from post-crisis prudential regulation*). Investors/financial the consequent financial crisis owing to the fact that non-implementation of appropriate prudential regulation is even higher.

Figure 8: Economic Costs to Investors/Financial Service Suppliers arising from Post Crisis Prudential Regulation



(Source: Author Construction)

⁴⁷⁹ See Claudia Buch and Claudia Goldberg, 'Cross-Border Prudential Policy Spillovers: How Much? How Important? Evidence from the International Banking Research Network', International Journal of Central Banking, March 2017. The focus of the paper is to provide evidence on prudential policy effects and international spillovers as part of a multi-study initiative of the International Banking Research Network. The analytical focus on evidence for international policy spillovers through multiple channels is as follows: inward transmission addresses how foreign regulations affect the domestic activities of domestic banks or foreign affiliates (bank branches or subsidiaries) located in the host country; outward transmission to foreign economies addresses the effects of foreign policies on the foreign activities of a reporting country's global banks.

The determination of economic costs is important in both the policy and business context as well as the dispute settlement context. Quantification of economic costs can be a tangible indicator of damage suffered by financial service providers and investors as a result of implementing post-2008 financial crisis regulation. Several studies already quantify investors' economic costs arising from a changed business and legal environment landscape. Oliver Wyman estimates that between 2.5% and 3.5% of North American, European, and Australian financial institutions' total costs come from meeting the elaborate new regulatory guidelines⁴⁸⁰. McKinsey documents a 65% fall in gross cross-border capital flows since 2007, arising out of several factors including the implementation of post-2008 financial crisis regulation⁴⁸¹.

In the dispute settlement context, economic costs are an important component of calculating compensatory damage, determination of relief measures, and understanding to whom damage has accrued. In dispute settlement cases, investors, financial service suppliers, and governments have asked for and been successful in securing various forms of relief, including monetary compensation, restitution or return of property, and injunctive relief (i.e. an order telling the government to take, or refrain from taking, certain action).

Economic costs accruing to investors and financial services suppliers from the implementation of post-2008 financial crisis regulation can be direct and indirect. *Figure 4: Economic Costs accruing to financial firms from the post-financial-crisis regulatory reform.*

1. Direct Economic Costs arising out of Implementation of Prudential Regulation

Direct economic costs arise from implementing new/changed regulation, which require changes in business structure – e.g. separation of businesses, setting up of different entities, compliance with varying regulations and ensuring internal

⁴⁸⁰ Oliver Wyman, '18th State of Financial Services Industry Report', 2015, Available at: <http://www.oliverwyman.com/our-expertise/insights/2015/jan/state-of-the-financial-services-2015-managing-complexity.html>.

⁴⁸¹ McKinsey Global Institute, *The New Dynamics of Financial Globalization*, August 2017. The McKinsey report identifies several factors including the reappraisal of country risk; the recognition that foreign business was less profitable than domestic business for many banks; national policies that promote domestic lending; and new regulations on capital and liquidity that create disincentives for the added scale and complexity that foreign operations entail.

operational coherence – and new systems for monitoring and supervision within the company. The magnitude of direct economic costs varies from minimal to relatively substantial depending on the kind of regulation to be implemented and companies' existing compliance mechanisms. If implementation of regulation – e.g. required changes in legal form or separation of trading activities – requires changes in the corporate structure and potentially a rethinking of a financial entity's market entry or operational strategies, then the costs can be substantial.

In the case of macroprudential regulation, capital controls may hamper current business in terms of restricting the size and nature of operations domestically as well as across borders. Ringfencing is a good example of economic costs arising from the implementation of microprudential regulation, as it poses an operational challenge for banks as they implement separate management strategies and undertake large and complicated programmes with significant changes to their organisational and operational structures prior to the new regime coming into force on 1 January 2019⁴⁸². Ringfenced banks are also required to have higher levels of capital⁴⁸³. The changes that banks made also affected their customers, counterparties, and suppliers.

2. Indirect Economic Costs arising out of Implementation of Prudential Regulation

Indirect economic costs arise primarily from regulatory arbitrage-like situations, an outcome of differing regulations in home and host country. The sheer complexity of the emerging post-2008 FS regulation, as well as newer regulation relating to fintech, Brexit, and other areas, creates the possibility of an unlevel playing field potentially favouring domestic over foreign institutions or in some cases vice versa. Reservations on the potential conflict between emerging post-crisis financial regulation and the trade and investment architecture, especially in terms of the potential for regulatory arbitrage between home and host country, has been voiced by several policymakers⁴⁸⁴. Differing regulatory approaches involve eco-

⁴⁸² See Financial Services (Banking Reform) Act 2013, www.legislation.gov.uk/ukpga/2013/33/contents/enacted. In October 2016.

⁴⁸³ McKinsey Global Institute, 'The New Dynamics of Financial Globalization', August 2017, Pg. 2.

⁴⁸⁴ United Nations, Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, September 21, 2009. Also, comments made by Governor YV Reddy, at UNCTAD Expert Meeting on Trade in Services, 2010.

economic costs for cross-border financial service suppliers. The current patchwork of global financial regulations costs USD 780 billion a year as a result of inconsistencies between different jurisdictions. An OECD-IFAC study (2018) found that regulatory divergence costs financial institutions between 5% and 10% of annual revenue turnover⁴⁸⁵. Smaller institutions are twice as likely as their larger counterparts to experience very material costs⁴⁸⁶.

Economic costs incurred by regulatory arbitrage arise in several ways. Tighter prudential regulations in the home or host country may either curtail a firm's ability to enter new markets due to insufficient capital or result in an opportunity cost related to pulling out of existing markets of operation. Cross-jurisdictional regulatory differences can therefore determine an investor/financial service suppliers' decision to enter, remain, or leave specific markets. An in-depth study by Claessens and van Horen (2014), for instance, found that the absolute difference between home and host country regulation is a significant factor in foreign bank presence⁴⁸⁷.

Regulators' preference for certain kinds of legal forms may influence a bank's entry into the market owing to costs arising from changes to be made in their

⁴⁸⁵ Report 'Regulatory Divergence: Costs, Risk, Impact: An International Financial Sector Study', International Federation of Accountants and Business at OECD (BIAC), February, 2018. The survey was conducted on 250 regulatory and compliance professionals from major global financial institutions. Smaller institutions were defined as institutions having an annual turnover of less than \$100m. Report accessible at: http://biac.org/wp-content/uploads/2018/04/IFAC-OECD_Regulatory-Divergence_V9_singles.pdf The factors behind this cost included an increased number of staff to deal with cross-jurisdictional regulatory matters, training costs for personnel, systems costs required for multiple systems, restructuring of compliance departments, and costs of external consultants.

⁴⁸⁶ Report 'Regulatory Divergence: Costs, Risk, Impact: An International Financial Sector Study', International Federation of Accountants and Business at OECD (BIAC), February, 2018. The survey was conducted on 250 regulatory and compliance professionals from major global financial institutions. Smaller institutions were defined as institutions having an annual turnover less than \$100m. Report accessible at: http://biac.org/wp-content/uploads/2018/04/IFAC-OECD_Regulatory-Divergence_V9_singles.pdf The factors behind this cost included an increased number of staff to deal with cross-jurisdictional regulatory matters, training costs for personnel, systems costs required for multiple systems, restructuring of compliance departments and costs of external consultants.

⁴⁸⁷ Claessens, S., and N. van Horen. 2014. 'Location Decisions of Foreign Banks and Competitor Remoteness', *Journal of Money, Credit and Banking* 46 (1): 145–70. The study uses a large database of 1,199 foreign banks from 75 home countries present in 110 host countries.

existing business structures. Ringfenced banks, for instance, are required to have higher levels of capital, with approximately 75% of UK retail deposits to be held within banking groups subject to ringfencing. Furthermore, cross-border lending falls outside the ringfence, making it more difficult to fund such activities⁴⁸⁸. Similarly, differences in regulation relating to the segregation of risky trading activities between the EU, UK, US, and Germany impact a banking group's business model and make the economic costs of cross-country operations more expensive.

The existence and extent of economic cost accruing to the investor or financial services supplier will depend on the nature and restrictiveness of prudential regulation undertaken and by whom, i.e. home or host country. *Figure 16: Economic cost accruing to investor/financial service supplier in home and host country* provides possible scenarios arising from restrictive prudential regulations in the home and host country.

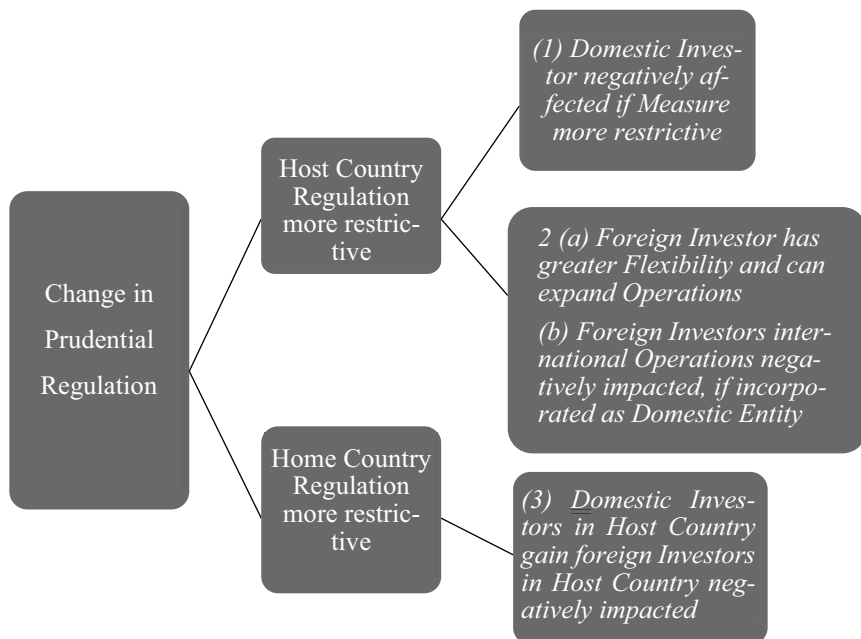
A more restrictive host country prudential environment can incur economic costs for investors/financial services suppliers by negatively affecting their international operations⁴⁸⁹. Tightening of prudential regulation normally arises out of the host countries concern of increased contagion especially during a crisis. Several studies have shown that (funding) shocks to parent banks can be transmitted to their foreign subsidiaries with negative consequences for their lending operations⁴⁹⁰.

As a result of tightening host country regulation, a foreign bank may be subject to tighter domestic prudential regulatory requirements in the host country (*Figure 16, Scenario 2*). The economic costs here could vary depending on whether the international bank is operating as a branch or a subsidiary and on the manner of host country supervision. For instance, an IMF study found in the case of subsidiaries and branches that regulations on banks' international operations affect cross-border lending from banks' headquarters (branches) more than local lending

⁴⁸⁸ McKinsey Global Institute, *The New Dynamics of Financial Globalization*, Pg. 2, August 2017.

⁴⁸⁹ Ichiue Hibiki and Lambert Frederic, *Post-Crisis International Banking: An Analysis of New Regulatory Survey Data*, Page 24, IMF Working Paper WP/16/88, April 2016.

⁴⁹⁰ See, for instance, Cetorelli, Nicola and Linda Goldberg, 'Global Banks and International Shock Transmission: Evidence from the Crisis', 2011, IMF Economic Review, 59:41–76, and Chava, Sudheer and Amiyatosh Purnanandam, 'The Effect of Banking Crisis on Bank-Dependent Borrowers', 2011, Journal of Financial Economics, 99:116–35.

Figure 9: Economic Cost accruing to Investor/Financial Service Supplier in Home and Host Country

(Source: Author Construction)

does from banks' affiliates (subsidiaries)⁴⁹¹. This in effect means that when prudential regulation is tightened in the host country, international banks become more risk averse in the case of their branch activities as compared to their subsidiary

⁴⁹¹ Hibiki Ichiue and Frederic Lambert, 'Post-Crisis International Banking: An Analysis of New Regulatory Survey Data', IMF Working Paper WP/16/88, April 2016. The IMF study analyses 40 advanced and emerging economies that are amongst the top recipients of foreign banking claims according to BIS data. The survey asked 31 questions, classified into 6 categories, for both home and host country regulations over the period 2006–2014. Questions covered possible restrictions on the presence of foreign banks, the type of activities they conduct, supervisory discretion in limiting those activities, information sharing with foreign supervisors, resolution power over branches of foreign banks, and other structural measures that could affect a bank's decision to operate in foreign countries. Countries covered included Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Croatia, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Indonesia, Ireland, Italy, Japan, Luxembourg, Malaysia, Mexico, the Netherlands, Norway, the Philippines, Portugal, Romania, Russia, Saudi Arabia, Singapore, the Slovak Republic, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Kingdom, and the United States.

activities. A cross-border bank's branch-based business model would therefore put it at a disadvantage when there is a tightening of host country regulation resulting in economic costs from the potential loss of market share. In a situation where the foreign bank incurs economic costs, it may choose to (i) withdraw from the market under consideration or (ii) incorporate and operate as a subsidiary.

Foreign banks active in a host country may also leverage regulatory arbitrage positively to circumvent adverse local prudential regulation through their branches and cross-border lending⁴⁹². Foreign banks can increase their lending activities when domestic competitors are constrained by prudential policy, thereby taking over domestic banks' market share⁴⁹³. The reasons for this increase in foreign affiliates' local lending is that foreign branches are not subject to the reserve requirements of the destination country, and foreign subsidiaries (which are subject to such requirements) can obtain funding from their parent. Thus, foreign branches and foreign subsidiaries leverage regulatory arbitrage to replace domestic banks when reserve requirements increase⁴⁹⁴.

In their data set of 25 Dutch banks, including both local (branch and subsidiary) activities and cross-border lending, Frost, de Haan, and van Horen found that Dutch banks increase their activities when domestic competitors are constrained by prudential policy⁴⁹⁵. The authors note that these results are consistent with earlier studies for the United Kingdom (Aiyar, Calomiris, and Wieladek, 2014; Reinhardt and Sowerbutts, 2015) and with work on cross-sector substitution effects of macroprudential policy (Cizel, Frost, Houben, and Wierst, 2016)⁴⁹⁶. These

⁴⁹² Jon Frost, Jakob de Haan, and Neeltje van Horen, 'International Banking and Cross-Border Effects of Regulation: Lessons from the Netherlands', Pg. 302, *International Journal of Central Banking*, 2017.

⁴⁹³ Jon Frost, Jakob de Haan, and Neeltje van Horen, 'International Banking and Cross-Border Effects of Regulation: Lessons from the Netherlands', Pg. 302, *International Journal of Central Banking*, 2017. The results were found to be consistent not only for Dutch banks but French and Italian banks too.

⁴⁹⁴ See also Stefan Avdjiev, Catherine Koch, Patrick McGuire, and Goetz von Peter, 2017, 'International Prudential Policy Spillovers: A Global Perspective', *International Journal of Central Banking* 13 (S1).

⁴⁹⁵ Jon Frost, Jakob de Haan, and Neeltje van Horen, 'International Banking and Cross-Border Effects of Regulation: Lessons from the Netherlands', 2017, *International Journal of Central Banking*, Pg. 302.

⁴⁹⁶ See also (1) Shekhar Aiyar, Charles Calomiris, and Tomasz Wieladek. 2014. 'Does Macroprudential Regulation Leak? Evidence from a UK Policy Experiment', *Journal of Money, Credit and Banking* 46 (s1): 181–214. (2) Cizel, J., J. Frost, A. Houben,

findings were similar for German and Canadian banks. Frost, de Haan, and van Horen offer two competing interpretations for these results. The first is that Dutch banks engage in regulatory arbitrage: when domestic banks in destination markets are constrained by prudential policy measures, Dutch banks, not bound by such measures, may sense an opportunity to increase lending and gain market share. A question linked to the possibility of disputes here is whether a third-country investor or financial services supplier who does not benefit from a better prudential environment in their home country can receive similar benefits?

Tightening of host country prudential regulation may leave domestic banks faced with an unlevel playing field and subject to higher prudential requirements. Foreign bank maximisation of regulatory arbitrage for profit gains may disadvantage local banks and foreign subsidiaries, resulting in potential loss of market. Domestic banks in turn may raise a challenge with the national regulator as to the seemingly ‘preferential treatment’ enjoyed by foreign banks, which discriminates against their own banking operations⁴⁹⁷. And third-country foreign investors who may be in a position similar to disadvantaged domestic financial services suppliers/investors, may also challenge the impact of the regulator’s measures on similar grounds.

A second scenario is indirect economic costs that are incurred by foreign investors or financial services suppliers when home country prudential regulation becomes more restrictive. For instance, higher capital reserve requirements in the home country can have a negative impact on banks’ international operations in terms of capital availability for international lending (*see Figure 16: Economic cost accruing to investor/financial service supplier in home and host country*).

While larger reserves make banks more stable in a crisis, some experts believe that this can come at a cost⁴⁹⁸. For instance, Bank of England researchers found that each additional percentage point increase in capital requirements is associated with a 5.5 percentage-point reduction in the long-run growth rate of cross-border lend-

and P. Wierst. 2016. ‘Effective Macroprudential Policy: Cross-Sector Substitution of Price and Quantity Measures’, IMF Working Paper No. 16/94. (3) Reinhardt, D., and R. Sowerbutts. ‘Regulatory Arbitrage in Action: Evidence from Banking Flows and Macroprudential Policy’, 2015, Staff Working Paper No. 546, Bank of England.

⁴⁹⁷ Jon Frost, Jakob de Haan, and Neeltje van Horen, ‘International Banking and Cross-Border Effects of Regulation: Lessons from the Netherlands’, 2017, *International Journal of Central Banking*, Pg. 306.

⁴⁹⁸ McKinsey Global Institute, ‘The New Dynamics of Financial Globalization’, August 2017, Pg. 2.

ing⁴⁹⁹. Another study estimates that the impact of an additional percentage point of capital requirements results in a 3.4 percentage-point reduction in the growth of cross-border lending globally⁵⁰⁰. From the microprudential regulation perspective, higher capital reserve requirements can impact a bank's business model in terms of structure, e.g. choice of legal form and banks operations in terms of available capital for cross-border lending or banks' expansion plans.

3. Other Issues related to Economic Costs arising from Implementing Post-2008 Financial Regulation

Ambiguity in regulation, either because the regulation is under development or in terms of wording, coverage, and application, can also incur costs. For the investor/financial service supplier, this creates a degree of uncertainty in terms of regulatory application, differential implementation, and varying reporting requirements. For instance, in US regulation there is no definition of proprietary trading, although there are some key features as to what could constitute 'proprietary trading'⁵⁰¹. The definition or description of the excluded activities under proprietary trading was left up to competent government authorities⁵⁰². This makes it a subjective and complicated criterion. In the case of the UK's ringfencing regulation, an important consideration is defining where the ringfence should fall given the existence of several grey areas, e.g. placement of large corporate loans and syndicated lending.

Finally, some economic cost also accrues to the financial regulator who may find that a regulation put in place to achieve a specific regulatory objective does not achieve this objective or has an undesired consequence. For instance, a 2014 study found that Dutch banks increase lending in countries experiencing strong GDP

⁴⁹⁹ Shekhar Aiyar, Charles W. Calomiris, and John Hooley, Yevgeniya Korniyenko, and Tomasz Wieladek, 'The international transmission of bank capital requirements: Evidence from the United Kingdom', April, 2014, Bank of England working paper number 497.

⁵⁰⁰ Kristin Forbes, Dennis Reinhardt, and Tomasz Wieladek, 'The spillovers, interactions, and (un)intended consequences of monetary and regulatory policy', June 2016, NBER working paper number 22307.

⁵⁰¹ See 12 U.S.C. § 1851(h)(4).

⁵⁰² The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). The first four of these agencies have submitted a common rule on 10 December 2013,²³ while the CFTC published its own final rule on 31 January 2014.

and credit growth, reflecting greater loan demand and greater risk appetite among Dutch banks in these countries. This is problematic from a policy perspective, as it implies that banks tend to increase activities at precisely the moment that credit excesses are building up, which is a situation that prudential policies seek to mitigate⁵⁰³. The changed prudential measure may therefore have the opposite intended effect, i.e. foreign banks lend more, as local banks are less willing to lend, thereby creating a credit bubble and invalidating the regulators' objective of containing systemic risk.

From a macroeconomic perspective, too, there are economic costs. The effects of macroprudential measures sometimes spill over borders through bank lending with varying positive or negative outcomes. Spillovers of foreign regulations into home lending are more likely to arise through hosted affiliates of foreign banks⁵⁰⁴. After the 2008 crisis, for instance, when foreign countries tightened general capital requirements, positive spillovers to home loan growth by global banks were observed across US., German, and Chilean banks, whereas negative inward spillovers were observed for UK and Swiss global banks⁵⁰⁵.

Quantification of direct and indirect economic costs incurred by investors/financial services suppliers potentially enable the quantification of damage suffered as a result of contravened trade and investment commitments including those relating to an investor's legitimate expectation under the FET standard.

Economic costs accruing to investors/financial services suppliers should be weighed against the costs of financial crises arising from the loss of systemic stability owing to a financial system that is not effectively regulated. The goal of prudential regulation is to safeguard the financial system. Microprudential regulation protects small depositors by limiting the frequency and cost of individual bank failures (Bhattacharya and Thakor, 1993; Freixas and Rochet, 2008). macroprudential regulation seeks to smooth excessive financial and credit cycles limiting system-wide financial risk, and the incidence of disruptions in the provision of key

⁵⁰³ Jon Frost, Jakob de Haan, and Neeltje van Horen, 'International Banking and Cross-Border Effects of Regulation: Lessons from the Netherlands', 2017, *International Journal of Central Banking*, Page 306.

⁵⁰⁴ Claudia Buch and Claudia Goldberg, 'Cross-Border Prudential Policy Spillovers: How Much? How Important? Evidence from the International Banking Research Network', Page 546, 547, *International Journal of Central Banking*, March 2017.

⁵⁰⁵ Claudia Buch and Claudia Goldberg, 'Cross-Border Prudential Policy Spillovers: How Much? How Important? Evidence from the International Banking Research Network', Page 536, *International Journal of Central Banking*, March 2017.

financial services that can have serious consequences for the real economy (FSB, BIS, IMF, 2011).

A compilation of banking crises around the world (147 countries) covering the period 1970–2011 found that the average fiscal cost of resolving a banking crisis is approximately 7% of GDP (Laeven and Valencia, 2013). The global financial crisis of 2008 developed into a full-blown international banking crisis, meaning the cost of non-implementation of effective prudential regulation to safeguard the financial system and the wider economy is substantially larger in this case, not just in terms of direct financial sector losses but also larger economy-wide losses. Furthermore, the impacts on unemployment, spending capacity, inflation, and interest rates also need to be factored in.

E. Conclusions

The lack of conformity between macro and microprudential regulation and trade and investment commitments can be grounds for challenge under trade and investment agreements. The structure and fora for trade and investment dispute settlement is provided for by a network of nearly 3,400 trade and investment treaties which simultaneously provide for minimum standards of protection (to investors and financial service suppliers), regulatory flexibility, and dispute settlement.

Almost all FTAs and BITS provide for a range of dispute settlement mechanisms within the same agreement, ranging from consultation/mediation to state-to-state dispute settlement, while over three-quarters of FTAs/BITS provides for ISDS with some agreements requiring special treatment of financial. The preference for international dispute settlement, appears to arise as investors and FS suppliers relied on trade and investment frameworks to make their investments. Many of the post-financial crisis regulatory measures taken by states to protect global economic stability, were not contemplated by the negotiators of investment and trade treaties nor investors or financial services suppliers at the time of making their operational decisions.

Since 2008, there has been growth in financial-sector-linked disputes, in particular ISDS, as a result of several existing and emerging factors. First, the importance of the financial sector, its multitransactional nature, and the intermediary and infrastructural role it plays in the wider economy, make it one of the most highly regulated sectors. Second, modern financial transactions have resulted in a complex world of connected markets, involving multi-party, multi-contract, and multiple modes of delivery, and therefore multijurisdictional legal relationships.

Third, technological (e.g. fintech and cryptocurrencies) and political developments (e.g. Brexit) have created additional regulatory considerations and avenues for dispute settlement, going beyond cross-border elements of regulation, to include data, privacy, security, and other issues not adequately addressed in the existing global and national financial, trade, and investment architecture.

Fourth, the very architecture of the trade and investment dispute settlement mechanism is under review under the WTO and in the context of ISDS. The WTO's temporary arbitration arrangement may raise questions in terms of the application of its dispute settlement outcomes and acceptance by the larger WTO membership. ISDS in its present form has become controversial, with observers disagreeing on the value and fairness of the mechanism. The European proposal aims to address some of these concerns by establishing a multilateral ISDS court bolstered by ISDS supportive provisions in several FTAs such as the EU-Canada CETA, as well as the EU-Vietnam. Part of the rationale for the EU's investment court proposal is to address issues of transparency, due process, choice of judges and the perception that ISDS is weighted in favor of foreign investors, impeding a state's right to regulate. All these issues are highly relevant in case of financial-sector-linked ISDS.

Discussions surrounding the dispute settlement architecture are currently on hold because of COVID-19, but they are likely to be revisited once the pandemic ends. In the interim, they raise several questions such as the implications of an 'ISDS Court' for financial services dispute settlement in terms of scope, coverage and approach, interlinkages with dispute settlement mechanisms, and jurisprudence established in other trade fora such as FTAs, e.g., WTO, ASEAN, US FTAs, the choice of arbitrators, and approaches taken in arbitration jurisprudence, i.e. a more private-sector approach or a regulatory friendly approach. In terms of the WTO dispute settlement body, questions relate to the continued utilisation of the 'interim mechanism', as well as concerns raised by WTO member states regarding 'judicial activism' and 'substantive interpretation', both of which can have implications for financial sector disputes filed before the WTO.

The BITS regime has also undergone a process of reform, as can be seen from the ECJ's *Achmea* judgement, India and South Africa's model BIT. The dispute settlement implications of this for the financial sector and its operators need to be ascertained.

Substantively, three key areas must be addressed in determining whether the trade and investment dispute settlement mechanism can be invoked, namely whether a breach of obligations has occurred, what the qualifying jurisdiction is, and how to determine the balance between regulatory flexibility and investor/trade protection.

A breach of obligations or cause for action gives rise to a dispute settlement claim. This can occur due to contraventions between macro and microprudential regulation and the trade and investment architecture, or contradictions/incongruities within and between trade and investment agreements related to the financial sector. The unprecedented level of regulatory intervention in the financial sector in the wake of the 2008 crisis provided banks and financial institutions with the possibility of claims under investment and trade treaties. In practice, it is difficult to predict when the actions of a state will violate the FET standard and provisions of trade agreements.

Once a cause of action is established, an investor or financial services provider can seek the protection of an investment or trade agreement at the point of dispute settlement. This in turn depends significantly on the scope of treaty definitions relating to (a) the object/target of investment or financial service provision (e.g. definitions of ‘investment’ and ‘financial service’; (b) the person permitted to make the investment or provide the financial service (e.g. ‘investor’ or ‘financial service supplier’; and (c) related definitions such as ‘trade in services’, ‘financial services’, ‘measure affecting services’, and the four modes of services, with Mode 1 (cross-border trade in services) and Mode 3 (commercial presence) being of particular relevance.

The contents of a definition are significant in a dispute settlement context as they determine the validity of a claim, i.e. assets and persons covered, the boundaries of a State’s liability and involvement within a jurisdiction, and the protections afforded to investors/financial service suppliers.

The coverage of definitions can be broad, thus providing vast scope for dispute settlement claims. The GATS Annex on FS defines a range of financial transactions that can be considered to be ‘financial services’. ICSID jurisprudence has also enabled a broad and detailed interpretation of what constitutes investment, investor, etc. – and indeed most financial sector operations would satisfy the categories of the ‘Salini test’ relating to commitment of resources, duration, assumption of risk, and contribution to the host state’s development. Several investment arbitral awards found that varying financial instruments qualify as investments and benefit from protection under investment treaties, including straightforward loans, negotiable instruments, sovereign bonds and oil price hedges, shareholdings, bank guarantees, promissory notes, and depository receipts, amongst others.

Furthermore, definitions contained in FTAs and BITS can vary within and between agreements with variability in ‘like definitions’ or ‘linked definitions’ with variations raising the possibility of contradiction, incongruity, or at the very least

ambiguity. Variations in definitions also exist in jurisprudence, as well as between national law and treaty provisions. Definitions, and in fact the provisions relating to investment, trade in services, and financial services within and among FTAs/BITS as well as in comparison to national law, need to be cross-referenced, particularly at the time of dispute settlement.

The issue of jurisdiction has two components, the first being where the ‘cause of action’ lies, as seen above, which can be complicated given the multijurisdictional, multitransactional nature of cross-border financial services. A further issue is the choice of dispute settlement forum, which is normally agreed to by Parties within the BITS/FTA at the time of signing.

A second key question linked to whether cause of action exists and to the extent of damages is the question of regulatory flexibility vis-à-vis trade and investment protection. BITS/FTAs define and protect investors/financial service suppliers from State interference. At the same time, most FTAs/BITS provide for some manner of regulatory flexibility and almost all provide for dispute settlement. This inherent tension between the international trade and investment architecture and the financial architecture is tested at the point of dispute settlement.

Regulation for the preservation of ‘systemic stability’ is a national and potentially a global public good because of the importance of the financial sector to the larger economy and its role as an intermediary and infrastructural service. In view of the regulator’s role in maintaining systemic stability, both WTO and investment arbitration tribunals have generally shown deference to legitimate regulatory activity in the financial sector. The key consideration here is the extent of and weightage given to what is perceived as legitimate regulatory interests as opposed to investors/financial service suppliers’ rights and protection which may not be perceived as being equally legitimate. Where applicable, tribunals have explored the ‘exceptions provisions’ in BITS and FTAs, such as the ‘prudential exception or prudential carve-out’, capital transfer exceptions, and balance-of-payment safeguards.

However, the ‘exceptions’ in trade and investment agreements specify that regulation must not be taken as a means to avoid trade commitments. Furthermore, tribunals, especially ISDS ones, must recognise investor and trade protection provisions, as they form the basis of trade and investment decisions. In fact, there have been a reasonable number of ISDS cases where tribunals have upheld ‘investment protection’ measures such as the FET standard.

Commentators observe that tribunals in ISDS cases seek to address this question of investment protection vis-à-vis regulatory flexibility through a narrow

‘private-sector-focused’ treaty interpretation and application approach. The impact of dispute settlement outcomes on a State can be disproportionate, impacting not just regulatory regimes and policy objectives, but also leading to States having to make large financial payouts amounting to a portion of their GDP, as in the cases of Ecuador⁵⁰⁶ and Pakistan. In 2019, Pakistan was ordered to pay USD 6 billion in compensation to a single foreign investor, equivalent to the total amount received in the IMF bailout package for the same year⁵⁰⁷.

Therefore, the stakes in ISDS are much higher than a focused ‘private sector perspective’, with economic and political ramifications that go beyond narrow treaty interpretation and application. Thus, more careful attention and concrete steps need to be taken to address and uphold the State’s ability to regulate in the financial sector in the interests of preserving ‘systemic stability’, especially in ISDS cases, moving beyond literal treaty interpretation to a recognition of regulatory objectives.

Direct and indirect Economic Costs of Post-2008 Crisis Financial Regulation:

The determination of economic costs in the dispute settlement context are crucial to estimating the amount of compensatory damage or provision of relief measures that are required. Investors, financial service suppliers, and governments have succeeded in securing various forms and amounts of monetary compensation through dispute settlement.

Post-2008 crisis financial regulation resulted in direct and indirect economic costs accruing to investors/financial services suppliers. The kind and extent of the economic costs accruing to the investor or financial services supplier depends on the restrictiveness of prudential regulation undertaken by the home or host country.

Direct economic costs from implementing new/changed regulation requires changes in business/operational structures. In the case of macroprudential regulation, changes in capital control measures may restrict the size and nature of domestic and/or cross-border operations. In the case of microprudential regulation, ringfencing requirements pose an operational challenge for banks looking to implement large and complicated programmes. Changes also affect customers, counterparties, and suppliers.

⁵⁰⁶ In 2004, a US investor won an arbitration against Ecuador, exceeding the Ecuadorian government’s annual budget on health, which was around 7%.

⁵⁰⁷ Tethyan Copper Company Private Limited v. Government of Pakistan, ICSID Case. No. ARB/12/1, Award, 12 July 2019.

Indirect economic costs, meanwhile, arise primarily from regulatory arbitrage or differences in regulatory approaches, which makes cross-country operations more expensive.

Tighter prudential regulations in the home or host country may result in foreign financial institutions choosing not to enter a market or, if already present, to exit a market, with both situations implying economic and opportunity lost costs. On the flip side, foreign investors/financial service suppliers may leverage regulatory arbitrage positively, circumventing adverse host country regulation through its branches, increasing lending activity, and capturing larger domestic market share at the cost of domestic competitors.

Indirect economic costs may also accrue when home country prudential regulation becomes more restrictive. For instance, higher capital reserve requirements in the home country can have a negative impact on banks' international operations in terms of capital availability for international lending.

Finally, economic cost also accrues to the financial regulator and the wider economy. Regulators may find that a regulation does not achieve its regulatory objective, is not being appropriately implemented, or has an undesired consequence.

Economic costs accruing to investors/financial services suppliers should also be weighed against the costs of financial crisis arising from a lack of effective regulation. The cost of the non-implementation of effective prudential regulation to safeguard the financial system and the wider economy is substantial, not just in terms of direct financial sector losses but also larger economy-wide losses too – losses that are ultimately borne by governments and taxpayers.

As in the case of environment externalities⁵⁰⁸, it can be argued that the negative externalities arising out of private sector operators in financial markets should be costed and budgeted for as an enterprise cost rather than being absorbed by the State and taxpayers at the point of financial crisis. To some extent, the larger capital reserve ratio requirements since the 2008 financial crisis can be considered an attempt at building in financial costs. However, a clear mechanism for examining how these costs can be built into the system may be useful and perhaps lessons from environment costing can be identified.

⁵⁰⁸ Environmental externalities refer to the economic concept of uncompensated environmental effects of production and consumption that affect consumer utility and enterprise cost outside the market mechanism. As a consequence of negative externalities, private costs of production tend to be lower than the 'social' costs. It is the aim of the 'polluter/user-pays' principle to prompt households and enterprises to internalise externalities in their plans and budgets. Source OECD Glossary.

VI. Concluding Chapter

A. Introduction

The regulatory landscape in the wake of the 2008 financial crisis has and will continue to change according to developments in and related to the financial sector. The regulatory rationale is to prevent the build-up of systemic risk. Conversely, the binding trade and investment architecture (WTO, FTAs, and BITS) that protects investors/financial service suppliers has remained static. This is further complicated by dispute settlement provisions that exist at the WTO, all FTAs, and BITS providing for state-to-state dispute settlement or ISDS.

At the interface of the binding trade and investment architecture and the emerging financial architecture lie several structural, procedural, and operational incongruities and contradictions that raise several key questions regarding policy, international law, commercial interests, dispute settlement, and most notably the question of regulatory flexibility versus investor/financial service supplier protections.

It is important to recall that these frictions between the trade and investment architecture and the financial sphere specifically as it relates to financial regulators' flexibility and the protection of investors/financial services suppliers are not new. However, this situation is currently exacerbated by emerging trends in the financial sector, e.g. fintech, dispute settlement, increasing financial sector disputes, restructuring of ISDS, and the underlying regulatory rationale of preserving 'systemic stability'. Further developments such as Brexit, COVID-19, cryptocurrencies, and sustainable finance are likely to exacerbate these frictions. Taken together, these conditions call for a reconsideration of or at the very least a dialogue on the emerging issues at the interface of financial sector regulation and the binding trade and investment architecture.

Part B of this concluding chapter outlines the key observations arising out of the changing financial regulatory landscape, the binding trade and investment architecture, and the protection it offers to both investors/financial services suppliers and regulators. Part C then describes the contraventions at the interface of the trade and investment architecture and financial regulation, including those within and between trade/investment agreements, as well as outlining the role, structure, and grounds for dispute settlement in the context of financial regulation.

After that, Part D and E, sets out broad and specific issues for further consideration based on Parts B and C, including those relating to regulatory flexibility, international law issues (including the silo or coherent approach to finance and trade

and the role of *lex specialis* therein), the application of CIL and/or soft law, the question of economic costs accruing to investors/financial services suppliers but also to taxpayers, and the increasing trend towards dispute settlement in the financial sector. Finally, Part F addresses the key questions the thesis has raised, and Part G concludes with suggestions relating to global coordination in two areas: (i) the interface between emerging financial regulation and the trade and investment architecture, and (ii) dispute settlement in the financial sector.

B. Key Observations on Emerging Financial Regulatory Landscape and the Trade and Investment Architecture

1. Changing Post-2008 Crisis Financial Regulatory Landscape with the Objective of maintaining systemic Stability

Since the 2008 financial crisis, the macro and microprudential regulatory landscape has changed considerably, with some even arguing that it has reversed traditional thinking on the thrust of regulation in these areas. The regulatory rationale is to prevent the build-up of systemic risk.

In the case of macroprudential regulation relating to CFMs, massive capital inflows followed by rapid outflows have had devastating economic or financial-sector-wide impacts. Volatile capital outflows can lead to banking/currency crises or even instability within financial markets and the wider economy, while the economic jury remains divided on the effectiveness of CFMs given that their success is situation-, time-, and target-specific. It can be argued, though, that CFMs, provided they are not used for protectionist purposes, are necessary regulatory tools for preventing systemic risk build-up swift action in times of crisis.

In the case of microprudential regulation, too, the post-2008 regulatory rationale was the prevention of systemic risk build-up through greater control and oversight over bank operations. Regulation relating to proprietary trading and ringfencing was implemented in several countries post 2008 in order to protect against market and counterparty risks. Regulation that favoured ‘subsidiarisation’ as opposed to ‘branchification’ was implemented for better control – subsidiaries being more attuned to local economic conditions – and supervision.

The issue of home versus host country regulation has also been called into question, with regulators evaluating home country regulatory standards and requiring greater local compliance. Home and host country regulation also has implications from the trade and investment perspective given that for financial service suppliers

and investors it determines the point of compliance and, in the case of disputes, the jurisdiction. Additionally, it is important for the regulator to ensure adequate regulatory oversight.

Given the overarching objective of preventing ‘systemic risk’ build-up, maintaining regulatory flexibility to decide what is best for their markets is important, and many would argue indispensable, in light of the subprime mortgage crisis and other such crises. However, from an investment/trade perspective these drastic changes in the regulatory landscape resulted in substantial economic costs for investors/financial service suppliers arising from regulatory compliance, changes in banks’ business models, opportunity costs, and cross-jurisdictional regulatory differences, amongst others. The emerging regulation after the 2008 crisis has rolled back, if not contravened, provisions of the trade and investment architecture. Regulatory flexibility therefore has to be balanced against the loss in efficiency of financial services provision and issues of regulatory arbitrage and risk shifting to unregulated financial sectors.

2. The Trade and Investment Architecture simultaneously protects Investors/Financial Services Suppliers, provides for Regulatory Flexibility and Dispute Settlement

The binding trade and investment architecture can be considered to be general commitments made to investors and financial services suppliers, since they are directly linked to ‘covered investments’ and ‘financial services commitments’ undertaken in the WTO, FTAs, or BITS.

a. Investor and Trade Protections: Market Access, National Treatment, Fair and Equitable Standard

The trade and investment architecture relating to market access, national treatment, and FET protects the interests of investors and financial services suppliers. Market access and national treatment commitments are made by WTO member states in their GATS/FTA schedules of commitments or scheduled as per the Understanding on Financial services. In addition, most BITS and several FTAs contain FET clauses, which are among the most invoked standards in ISDS dispute settlement.

Depending on the circumstances and the provisions of the FTA/BIT under consideration, trade and investment provisions cover micro and macroprudential regulation under (a) a wide definition of ‘investment’ or ‘financial services’ to include a multitude of financial transactions and (b) case law established elements as for

instance in the case of the FET standard, fulfilling the ‘legitimate expectations of investors’ or ‘maintaining a stable business and legal environment’.

However, despite this coverage under treaty provisions, the likelihood of the application of the FET standard as well as market access/national treatment provisions to financial sector disputes is limited or at the very least unclear as a result of regulatory flexibility and the evolving elements of the FET standard in subsequent case law. In addition, the application of investor/trade protection provision to financial sector disputes may interfere with the State’s regulatory mission, so if regulation does not discriminate against foreign investors, is proportionate, and is in the public interest, it should be applicable.

b. Protection of Regulatory Flexibility: Prudential Carve-Out and Balance-of-Payment Safeguard

At the same time, most trade and investment agreements provide for regulatory flexibility in the financial sector through the prudential carve-out and BoP exceptions, thereby *maintaining a balance between protecting investor/financial services suppliers’ interests, while upholding regulatory flexibility*.

The prudential carve-out contained in the GATS and FTAs affords WTO Members and Parties to an FTA a high level of discretion regarding measures implemented for prudential reasons. GATS or FTA obligations can be breached provided such a derogation is not used for protectionist purposes to avoid commitments/obligations undertaken. In comparison to other GATS exceptions such as environment and security, the prudential carve-out provides greater flexibility as it does not require a ‘necessity test’. A prudential measure undertaken under the prudential carve-out is therefore unlikely to be challenged on the grounds of ‘necessity’ or being ‘least trade restrictive’.

The seemingly broad scope of the prudential carve-out (with a pro-regulation touch) allows for authorities to adopt measures to protect the safety and soundness of their financial system. Macro and microprudential regulation set out by financial regulators after the financial crisis are linked to clear prudential reasons and would therefore fall under the prudential carve-out, provided they are implemented in good faith.

However, the prudential carve-out is still to be fully interpreted by a WTO dispute settlement body. The WTO’s Argentina – Financial Services dispute (2016), which was the first case to address the prudential carve-out while upholding regulatory flexibility, stressed the importance of linking the cause (i.e. the prudential reason)

to the effect (i.e. the measure), which highlighted that any decision should be based on the design, structure, and architecture of the measure and finally stressed that risk/injury does not have to be imminent. The WTO's DSB did not go into the definition of prudential reasons, and at the same time recognised the protection of investor rights, leaving an area of ambiguity. The natural corollary of the decisions of the Panel and Appellate Body, if applied to post-2008 crisis financial regulation, is that unless implemented for protectionist reasons, financial regulation would be covered under the prudential carve-out, subject to meeting certain criteria.

Furthermore, the issue of the classification of prudential measures may be relevant depending on member states' intentions, given that there is no clarity as to what the term 'prudential' would entail. The list of 'prudential reasons' contained in the Annex on FS is only broadly indicative of what constitutes 'prudential reasons', as these definitions may evolve over time. The new focus of microprudential regulation could raise questions around the classification of prudential regulation because the goal of microprudential regulation since the 2008 crisis has been the same as macroprudential regulation (i.e. the prevention of systemic risk build-up). Economic evidence and weightage may also be relevant in the determination of what can be considered prudential. For instance, the Financial Stability Forum raised questions on the effectiveness and duration of CFM measures.

Since prudential carve-outs in FTAs follow the GATS model, they raise the same issues. However, given variations in provisions of some US FTAs, there is greater leeway for ISDS given the express reference to it. Moreover, some US FTAs provide for a narrow interpretation of 'prudential measures' focusing on individual financial institutions, which may not cover systemic considerations or macroprudential regulation such as capital controls⁵⁰⁹.

An unexplored exception that may also provide for a certain degree of regulatory flexibility subject to reasonableness and objectivity is the GATS disciplines on

⁵⁰⁹ It would, however, be relevant to note that the US, which was a third party in the WTO Argentina-Panama Financial Services case, did argue for a wide interpretation of the prudential carve-out clause to include 'the prudential exception preserves the broad discretion of national authorities to protect the financial system, and includes measures directed at individual financial institutions or cross-border financial services suppliers and measures to promote systemic stability.' The United States also argued that 'the term "prudential measures" includes "precautionary measures"'. Thus, there appears to be a change in US thinking on the scope of the prudential carve-out clause.

Domestic Regulation⁵¹⁰, which would apply as long as the undertaken regulation does not nullify/impact commitments undertaken⁵¹¹. In order to ensure that regulations do not nullify/impair commitments undertaken, GATS Article VI.4 requires WTO members to develop domestic regulation disciplines based on objective and transparent criteria that are no more burdensome than necessary to ensure the quality of the service, so that in the case of licensing procedures they do not act as a restriction to the supply of service⁵¹². A moot question is how disciplines on domestic regulation, if adopted, would interact with the financial sector regulations and trade and investment provisions.

C. Contraventions at the Interface of the Trade/Investment Architecture and Financial Regulation and its Implications for Dispute Settlement

1. Contraventions exist between and within the Trade and Investment Architecture and emerging Post-2008 Financial Crisis Regulation

Given the existing binding trade and investment architecture and the evolving post-2008 financial crisis regulation, several points of incompatibility have arisen as well as trade-barrier-like effects arising out of business restructuring and economic costs. The evolution of the finance and trade/investment architecture in their respective silos, as well as certain aspects of post-2008 financial regulation that amount to reregulation/new regulation and that have been discouraged within the existing trade and investment architecture, are key causes for these contraventions.

Trade and investment commitments take some time to negotiate but once negotiated they are binding, in the same period financial regulation has gone through a process of complete deregulation pre financial crisis and then reregulation post the 2008 financial crisis. Incongruities/contraventions arising from the cyclical nature of financial regulation as compared to the binding obligations of the trade

⁵¹⁰ GATS Article VI covers disciplines on Domestic Regulation and Article VI.1 specifies that WTO members should ensure that ‘measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner’.

⁵¹¹ GATS article VI: 5

⁵¹² GATS Article VI: 4 paragraphs a, b, and c detail how work on the development of domestic regulation disciplines is currently being undertaken by the WTO’s Working Party on Domestic Regulation.

and investment architecture have implications for investors/financial services suppliers and regulators.

a. Contraventions/Incompatibility within the existing Trade and Investment Architecture

The classic contravention within the existing trade and investment architecture arises from potentially conflicting provisions within and between trade/investment agreements, such as investor/trade protection and regulatory flexibility provisions. Issues of inconsistency between and within treaties in the context of ISDS have also been raised within the UN and academia⁵¹³.

In the case of macroprudential regulation such as capital controls, on the one hand trade and investment agreements contain provisions relating to the free transfer of funds linked to covered investments and trade in services (investment or cross-border commitments)⁵¹⁴. On the other hand, the same agreements provide for regulatory flexibility by way of the prudential exceptions and balance-of-payment safeguard measures if measures are not used to circumvent undertaken obligations. There are also differences in approaches between US and EU FTAs in respect of provisions related to capital transfers.

Similarly, BITS may provide for the free transfer of funds for covered investments including financial products, whereas an FTA between the same parties may provide for regulatory flexibility. Thus, *contradictions/incompatibilities within and between trade and investment agreements exist, as for instance in relation to investment/trade protection vis-à-vis regulatory flexibility* in the financial sector.

b. Contraventions between specific financial Regulation and the existing Trade and Investment Architecture

The focus of this thesis is the contradictions/incompatibilities of select macro and microprudential regulation vis-à-vis the broader trade and investment architec-

⁵¹³ See discussions of UNCITRAL Working Group 3 on Investor-State Dispute Settlement Reform, accessible at https://uncitral.un.org/en/working_groups/3/investor-state, see also Arato, J., Brown, C., Ortino, F, 'Parsing and Managing Inconsistency in Investor-State Dispute Settlement', 22nd June, 2020, The Journal of World Investment and Trade, 21(2-3), Pages 336–373.

⁵¹⁴ Investment definitions include intangible assets such as mortgages, liens, and pledges, as well as portfolio investment in the form of shares, stocks, debts, or interests in the property of local companies.

ture, which are broadly summarised in *Table 35: Potential Areas of Contravention between select financial Regulation and the Trade/Investment Architecture*.

Table 36: Potential Areas of Contravention between select financial Regulation and the Trade/Investment Architecture

Area of potential contravention	Microprudential (legal form, proprietary trading, ringfencing)	Macroprudential (CFMs)
Coverage (GATS, FTAs, BITs)	– Yes, trade in services, financial services, cross-border services, Mode 3, prudential carve-out, FET	– Yes, capital transfer provisions, prudential carve-out, balance-of-payment safeguard, FET
Market access and national treatment	– Yes, on total number of operations, service output, limitations on legal form, etc.	– No, but it is a necessary condition to give effect to MA and NT commitments
Modal contraventions	– Yes, for Modes 1 and 3	Yes
Understanding on FS	– Yes, for standstill on reregulation or new regulation	– Yes, for standstill on reregulation or new regulation
Differing provisions in trade/investment agreements	– Yes, leads to regulatory arbitrage	– Yes, can cause procedural problems, prevent swift action in crisis situations
Prudential carve-out	Yes	Yes
Balance-of-payment safeguard	No	Yes
FET standard	Yes	Yes
Trade-barrier-like effect of contraventions on investment/financial service supply	Yes	Yes

Source: Author Construction

c. Contraventions related to Trade and Investment Commitments

Given the wide coverage of trade in financial services and investment, the legal framework coverage of general and specific obligations undertaken in trade and investment agreements (GATS, FTAs, and BITs) covers aspects of micro and macroprudential regulation relating to legal form, separation of risky banking activities, and the use of CFMs.

In the case of microprudential regulation, once market access and national treatment commitments are undertaken, limitations on the size of the service, number of branches, types of products offered, legal character, foreign capital participation, and indication of a preference for domestic service suppliers are not permitted. Select post-2008 microprudential regulation can impose limitations on market access, effectively rolling back on commitments made. For instance, requirements for the separation of risky activities either through ringfencing or proprietary trading could amount to market access limitations on the total number of service operations or service output by requiring universal banks to separate into investment and retail operations or by not permitting a bank to trade for its own account.

Similarly, microprudential regulation requiring incorporation as a subsidiary could contravene limitations on legal form, Mode 1 (cross-border trade) and Mode 3 (commercial presence) where such commitments are undertaken. The prudential rationale behind ‘subsidiarisation’ as opposed to ‘branchification’ is that cross-border credit (Mode 1) tends to be less stable than the supply of credit by subsidiaries (Mode 3), particularly in times of crisis. In the case of national treatment commitments, the post-2008 crisis microprudential regulations may constitute different provisions for foreign suppliers than for domestic suppliers.

Where trade-in-services commitments are undertaken as per the Understanding on FS, which provides for a ‘standstill provision’ (i.e. non-creation of new regulation or reverse liberalisation), the contraventions can be even more obvious. For instance, if post-2008 crisis microprudential regulation requires incorporation as a subsidiary or prevents cross-border trading or asset management activities owing to new rules on proprietary trading, this can be considered a roll back on trade-in-services commitments.

In the case of macroprudential regulation such as CFMs, an important theme that emerges from the review of GATS, FTA, and BITS is the tension between capital transfer provisions and the market access goals of trade/investment agreements. It can be argued that CFMs help maintain systemic stability, especially in crisis situations, and therefore should be permitted under the BoP safeguard or the prudential carve-out. BITs too contain emergency safeguard measures.

However, in practice, the usage of the BoP safeguard measures can be problematic. To begin with, while there is clear mention of ‘crisis situations’, there is no reference to derogations to maintain ‘financial stability’. Furthermore, the application of the BoP safeguard clause is temporary and necessitates the prior fulfillment of procedural requirements including those related to the IMF Articles of Agreement and consultations with the WTO’s balance-of-payment committee. This may delay a swift macroprudential regulatory imposition of CFMs. Further issues relate to conceptual understandings and what appears to be a built-in ‘necessity test’.

Regulatory flexibility for CFMs under the prudential carve-out and the BoP safeguard measures therefore appear to be constrained, subject to extra-national scrutiny including that of partner country traders and international organisations such as the IMF. In the case of FTAs, this regulatory flexibility vis-à-vis CFMs may be even more constrained. For instance, US FTAs tend to include a clear requirement for the free flow of capital linked to covered investment/services commitments and a narrow interpretation of the prudential exception limited to individual enterprises. The IMF has also expressed concerns that restrictions on capital controls in certain FTAs/BITs may conflict with the IMF’s authority to recommend capital controls, as was the case for Iceland.

Thus, in the case of both macro and microprudential regulation, the extent of contraventions or inconsistencies with the trade and investment architecture will ultimately depend on the exact nature of commitments undertaken by individual countries in their trade-in-services and BITS commitments. The likelihood of incompatibility is higher for FTAs where financial services commitments tend to be deeper than those undertaken under the GATS.

d. Contraventions Relating to the prudential Exception

It can be argued that the prudential carve-out contained in the GATS and FTAs should cover macro and microprudential regulation whose objective is the preservation of systemic stability. However, there are several inherent problems with the prudential carve-out, which leaves it open to interpretation and potential challenge including the need to demonstrate that the measure was undertaken for ‘prudential reasons’ and not used as a means to avoid trade obligations. The legitimacy of such macro and microprudential measures may therefore be questioned on the grounds of being ‘protectionist’ or ‘trade distorting’, specifically in the case of ISDS, as BITS do not include a prudential exception.

Furthermore, it can be argued that the economic rationale and effectiveness of micro and macroprudential regulation in preserving ‘systemic stability’ have not

been proved in all cases, such as in the case of CFMs, whose effectiveness is still debated in the economic literature. Other issues relate to ambiguity in concepts and definitions linked to the prudential carve-out. Tribunals (WTO and ISDS) generally avoided addressing the issue of the prudential carve-out, until the WTO's Argentina-Panama case, which upheld regulatory flexibility but also left areas of ambiguity.

e. Contraventions related to Investment Agreements-FET Standard

Macro and microprudential regulation can impact investment commitments related to the financial sector under the FET standard which requires the host state to meet the legitimate expectations of investors and to maintain a stable legal and business environment⁵¹⁵. Legitimate investor expectations arise from specific or general assurance given to an investor, based on which an investment is made.

In the case of macroprudential regulation, several CFMs – such as taxes on certain forms of capital flows, ceilings on different types of capital flows, and derivative operations – minimum stay periods potentially contravene free capital transfer provisions contained in trade and investment agreements. Similarly, in the case of microprudential regulation, the host state's commitment to permit certain kinds of financial services/investment may be contravened or rolled back by post-2008 microprudential regulation. It can therefore be argued that both post-2008 micro and macroprudential regulation have resulted in considerable business costs to investors, substantially altering the business and legal environment that foreign investors and financial services suppliers relied on at the time of making their investment.

At the same time, given the ambiguity of the FET standard, the evolving elements of the FET standard in case law, as well as tribunals' propensity to uphold the host state's right to regulate, *the success of dispute settlement in applying the FET standard to both micro and macroprudential regulation is unlikely and at the very least unclear as long as the regulation is non-discriminatory, proportionate, and in the public interest.*

⁵¹⁵ Some FTAs (TPP, US-Singapore, US-Korea) specify that a breach of investors' expectations alone will not constitute a breach of the FET standard, thereby implying that the breach of an investor's 'expectations' is relevant in establishing a violation of FET.

2. Trade Barrier Like Outcome arising out of Contraventions between Post-2008 Financial Crisis Regulation and the Trade and Investment Architecture

The trade-barrier-like effect is a key outcome of the contravention between post-2008 financial crisis regulation and the trade and investment architecture. Differing post-crisis micro and macroprudential regulations (e.g. segregation of activities, ringfencing, legal form requirements, and capital controls) occurring at differing levels and speeds can act as indirect barriers to trade by requiring substantial business restructuring and economic costs.

Business restructuring and economic costs are even more acute for cross-border firms faced with jurisdictionally differing micro and macroprudential regulation. In fact, an OECD-IFAC study found that regulatory divergence costs financial institutions between 5% and 10% of their annual revenue. As a result, national regulatory divergences have driven business model changes, as suggested by evidence in the US, Canada, the UK, Sweden, Germany, Austria, the Netherlands, France, Italy, Spain, and China, where half the banks surveyed pulled out of certain countries due to regulatory reasons.

Furthermore, the post-2008 financial crisis regulation is still developing and at times there is ambiguity in coverage, wording, and implementation, which creates a degree of uncertainty in regulatory application. For instance, the lack of a definition of proprietary trading in the US or in the case of the UK grey areas arising from defining where the ringfence falls, e.g. placement of large corporate loans and syndicated lending.

To summarise, the contraventions/implications as set out in *Table 36: Potential Contraventions of the Trade and Investment Architecture with select Post-Crisis macro and microprudential Regulation relating to Capital Controls, Legal Form, Ringfencing and Proprietary Trading* appear to be complex and complicated.

Table 37: Potential Contraventions of the Trade and Investment Architecture with select Post-Crisis macro and microprudential Regulation relating to Capital Controls, Legal Form, Ringfencing and Proprietary Trading appear to be complex and complicated

Measure	Direct or indirect effect on whom	Potential contravention with trade and investment architecture		Potential tension between regulatory prerogative and investor/trade rights
Capital controls	– Investors, financial services suppliers, potentially wider business environment	– Provisions on capital transfers, BoP and prudential carve-out – FET, legitimate expectations of investors – Trade-barrier-like effect due to economic costs		– Potential challenge under WTO/BITS provisions balanced against prudential carve-out exception and dispute settlement clauses – Will also depend on political will, implementation costs as regulation comes into place, and regulators’ upholding of systemic risk implications
Legal form	– Direct effect on investor from business restructuring, regulatory compliance, unclear regulatory landscape – Regulator as implementor and supervisor	– Market access, national treatment provisions, Mode 3, new financial product, understanding on FS commitments, Annex on FS and prudential carve-out, FET, Legitimate expectations of investors – Trade-barrier-like effect due to economic costs		
Ringfencing	Same as previous row	Same as above		
Proprietary trading	Same as above	Same as above	Same as above	

Source: Author Construction

3. **Dispute Settlement under the Trade and Investment Architecture: Addressing Increasing Investment and Financial Disputes**

The unprecedented level of regulatory intervention in the financial sector since the 2008 crisis provides financial institutions with the option of making claims under investment and trade treaties. The network of 3,400 trade and investment treaties, including the WTO, provide for a range of dispute settlement mechanisms, including consultation/mediation, state-to-state dispute settlement, and ISDS provided for in over three-quarters of FTAs/BITS.

The trade and investment dispute settlement regime is currently undergoing certain structural changes and developments such as the rise in ISDS and financial disputes, the WTO's interim dispute settlement measure, the EU proposal for an Investment Court, and more recently the EU's termination of all 190 intra-EU BITs⁵¹⁶, following the *Achmea Judgement*⁵¹⁷, which poses a problem for newly acceded EU member states in respect of third-party/country rights.

Financial service suppliers/investors also exhibit a preference for international dispute settlement, arising from their reliance on trade and investment frameworks while commencing their operations. However, many of the post-2008 financial crisis regulations were not contemplated by negotiators of investment and trade treaties at the time of negotiations.

Three key questions in determining grounds for trade and investment disputes are as follows: Has a breach of obligations occurred? What is the qualifying jurisdiction? and How is the balance between regulatory flexibility and investor/trade protection to be addressed?

In the case of the post-2008 financial crisis regulation, a breach of obligations or cause for action could occur due to contraventions between macro and micro-prudential regulation and the trade and investment architecture or contradictions/incongruities within and between trade and investment agreements related to the financial sector (*see Chapter 6, Part C, sections 1 and 2*).

The cause of action, in turn, depends significantly on the scope of treaty coverage and definitions. The contents of a definition are significant in a dispute settlement

⁵¹⁶ On 24 October 2019, the European Commission announced the plurilateral treaty for the termination of all intra-EU BITs.

⁵¹⁷ On 6 March 2018, the European Court of Justice ruled in the *Achmea* case that the investment arbitration clause contained in intra-EU BITs is incompatible with EU law, effectively putting an end to the intra-EU BITs.

context as they determine the validity of a claim, the persons covered, and State liability. Definitions of relevance relate to (a) the object/target of investment or financial service provision, (b) the person permitted to make the investment or provide the financial service, and (c) related definitions.

The issue of jurisdiction will depend on the location of the ‘cause of action’, which can be complicated given the multijurisdictional, multi-transactional nature of cross-border financial services. In the case of a regulatory challenge, the weighing of investor/trade rights versus regulatory flexibility will be a moot issue and it appears from current WTO cases, and to a lesser extent in ISDS cases, that regulatory flexibility will be given substantial weightage. However, this is not a certainty, given that a case-by-case approach is adopted by tribunals.

It is necessary to better understand and rationalise the impacts of dispute settlement on the financial sector, especially ISDS dispute settlement, given the range of dispute settlement fora and developments therein, coupled with post-2008 financial crisis regulatory developments. A further understanding of concepts, definitions, jurisdiction, and regulatory flexibility versus trade and investment commitments is also warranted in the dispute settlement context.

D. Identification of Broad and Specific Issues for Consideration

1. Broad Issues for Consideration

As a result of the confluence of these four developments, namely emerging post-2008 financial crisis regulation, the existing trade and investment architecture, the importance of regulatory flexibility in the financial sector, and the increasing trend towards financial sector dispute settlement, there is a need for identification of key issues. Many of these issues are not new, having been discussed in academic literature and tangentially through dispute settlement, most notably the WTO, but they are yet to be coherently addressed in light of new developments.

2. The Importance of Regulatory Flexibility for Minimising Systemic Risk versus Regulatory Burden on Investors and Financial Service Suppliers

At the interface of the trade and investment architecture and emerging financial architecture is the question of regulatory flexibility versus investor/trade protection, which is tested by post-2008 macro and microprudential regulation. The

objective of post-2008 macro and microprudential regulation has been the preservation of ‘systemic stability’ by minimising systemic risk build-up.

‘Systemic risk is the risk of threats to financial stability that impair the functioning of a large part of the financial system with significant adverse effect on the broader economy.’⁵¹⁸ It can originate in any part of the financial system and typically builds up over time (e.g. in periods of credit boom) in the absence of the appropriate policy response. Key drivers are financial innovation, financial globalisation, financial deregulation, competition, and monetary policy⁵¹⁹. The volatile nature of systemic risk makes regulatory flexibility in the design, implementation, and enforcement of micro and macroprudential regulation indispensable for consumer protection and financial integrity.

Post-2008 financial crisis regulation can play an important role in checking the build-up of systemic risk and preventing financial crisis, thus emphasising the importance of regulatory flexibility. Microprudential regulation protects small depositors by limiting the frequency and cost of individual bank failures, based on the notion that if bank supervisors can ensure individual banks/financial firms can manage their risks well, the risk they pose to the financial system would be negligible. By contrast, macroprudential regulation addresses broader systemic threats.

Given the importance of the financial sector to the economy as an intermediary and infrastructural service coupled with the dangers of systemic risk build-up, regulatory flexibility is important and can be considered a ‘public good’⁵²⁰. Ensuring national and global financial stability to support economic stability can therefore be argued to be a global public good⁵²¹.

At the same time, the substantial shifts both in volume and direction of financial regulation have resulted in cost to business. Financial regulation has shifted from the pre-crisis ‘laissez faire’ deregulation approach to the post-crisis new reg-

⁵¹⁸ European Central Bank, Financial Stability Review, December 2009, Pages 134, 135

⁵¹⁹ For an in-depth discussion on systemic risk, see Freixas X, Laeven L and Peydro J, ‘A Primer on Systemic Risk’, June 2015, Chapter 1, in *Systemic Risk, Crises and Macroprudential Regulation*, MIT Press

⁵²⁰ The financial sector plays an infrastructural role in the economy, facilitating domestic and international transactions, broadening the availability of credit for SMEs and households, channeling domestic savings, facilitating firm entry, and promoting competition.

⁵²¹ Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, September 21, 2009 – Stiglitz Report

ulation or reregulation approach, from micro to macroprudential regulation, and from home to host country regulation. Changes in regulatory approaches have implications for the investor/financial services supplier in terms of business costs, multiple points of regulatory compliance, and contravention of trade and investment commitments based on which operational decisions are made. Regulatory flexibility must therefore be balanced against business costs, which in turn could result in loss in efficiency of financial services provision, regulatory arbitrage,⁵²² or risk shifting to unregulated parts of the financial system.

In view of the regulator's role in maintaining systemic stability, both WTO and investment arbitration tribunals have generally shown deference to legitimate regulatory activity in the financial sector by exploring the 'exceptions provisions' in trade and investment agreements. At the same time, the 'exceptions' in trade and investment agreements specify that regulation must not be taken as a means to avoid trade commitments, while ambiguity regarding the scope of the exceptions in terms of conceptual understanding, procedure, and coverage remains. This ambiguity and lack of clarity in the use of trade and investment exceptions, especially as far as the financial sector is concerned, is best addressed at the policy level by ascertaining State Parties' intentions at the time of signing and currently⁵²².

It is, therefore, difficult to predict when the actions of a state violate the provisions of trade and investment agreements. The question remains as to the weightage given to what is perceived as legitimate regulatory interests as opposed to investor/financial service suppliers' protection which may not be perceived as being equally legitimate but which were used by investors as a basis for investment/trade decisions.

Tribunals in ISDS cases also tend to adopt a narrow 'private-sector-focused' treaty interpretation and application approach. As a result, the impact of dispute settlement outcomes on a State can be disproportionate, impacting not just regulatory regimes and policy objectives but also leading to large financial payouts amounting to a portion of their GDP, as in the cases of Ecuador⁵²³ and Pakistan. In 2019, Pakistan was ordered to pay USD 6 billion in compensation to a single foreign

⁵²² A similar suggestion to address the persistent lack of clarity with regard to FET and regulatory stability at the policy level rather than through tribunal decisions has been made by Ortino F, 'The Obligation of Regulatory Stability in the Fair and Equitable Treatment Standard: How Far Have We Come?', 2018, *Journal of International Economic Law*, Volume. 21, No. 4, pages 845–865.

⁵²³ In 2004, a US investor won an arbitration against Ecuador, exceeding the Ecuadorian government's annual budget on health, which was around 7%.

investor, equivalent to the total amount received in its IMF bailout package for the same year⁵²⁴.

Thus, in reality, the stakes in ISDS and trade disputes have economic and political ramifications that go beyond narrow treaty interpretation and a private sector focus. More careful attention and concrete steps need to be taken to address and uphold the State's legitimate ability to regulate in the financial sector, especially in light of post-2008 regulatory developments.

3. Economic Costs related to Implementation of Financial Regulation accruing to Investors/Financial Service Suppliers versus the Taxpayer

a. Direct and indirect Economic Costs of Post-2008 Crisis Financial Regulation

Post-2008 financial crisis regulation resulted in direct and indirect economic costs accruing to investors/financial services suppliers. Direct economic costs arise from changes in business structures caused by implementing new/changed regulation. In the case of macroprudential regulation, changes in capital control measures may restrict the size and nature of domestic or cross-border operations. In the case of microprudential regulation, ringfencing requirements pose an operational challenge for banks requiring the implementation of large and complicated programmes. Changes also affect customers, counterparties, and suppliers.

Indirect economic costs accrue largely as a result of differences in regulatory approaches, which makes cross-country operations more expensive. In fact, an OECD-IFAC study (2018) found that regulatory divergence costs financial institutions between 5% and 10% of their annual revenue turnover.

The determination of economic costs is important from a policy and dispute settlement perspective for the estimation of impact and compensatory damage and/or relief measures.

The kind and extent of the economic costs accruing to an investor or financial services supplier depends on the restrictiveness of the prudential regulation. Tighter prudential regulations may result in foreign financial institutions choosing not to enter a market or if already present to exit a market, with both situations implying economic and opportunity lost costs. In an environment where host country pru-

⁵²⁴ Tethyan Copper Company Private Limited v. Government of Pakistan, ICSID Case. No. ARB/12/1, Award, 12 July 2019.

dential regulation is more restrictive, foreign investors/financial services suppliers may be subject to tighter requirements, which affects their operations.

On the other hand, foreign investors/financial service suppliers may leverage regulatory arbitrage to circumvent adverse host country regulation, as is the case when branches increase lending activity and capture larger domestic market share at the cost of domestic competitors. This could negate the purpose of host country prudential regulation and disadvantage domestic and third-country subsidiaries.

Economic costs accruing to investors/financial services suppliers should be weighed against the costs accruing to taxpayers from financial crises. The cost of the non-implementation of effective prudential regulation can result in direct financial sector losses and larger economy-wide losses by way of financial crisis. A compilation of banking crises around the world (147 countries) covering the period 1970–2011 found that the average fiscal cost of resolving a banking crisis is approximately 7% of GDP and that the cumulative output loss average is 23% of GDP. Losses arising from financial crises are ultimately borne by taxpayers.

Given the infrastructural role of the financial sector and the economy-wide impact in case of failure, the stability of the sector can be considered to be a ‘public good’⁵²⁵, much like the environment. As in the case of environment externalities⁵²⁶, it can be argued that negative externalities⁵²⁷ in the financial sector should be costed and budgeted for as an enterprise cost rather than absorbed by the taxpayers at the point of financial crisis. To some extent, the larger capital reserve ratio requirements in the wake of the 2008 financial crisis can be considered an attempt to build in financial costs. However, from a policy perspective, a clear mechanism for examining what these costs are, how they can be avoided, and how they can be absorbed may be useful.

⁵²⁵ Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, September 21, 2009 – Stiglitz Report.

⁵²⁶ Environmental externalities refer to the economic concept of uncompensated environmental effects of production and consumption that affect consumer utility and enterprise cost outside the market mechanism. As a consequence of negative externalities, private costs of production tend to be lower than the ‘social’ costs. It is the aim of the ‘polluter/user-pays’ principle to prompt households and enterprises to internalise externalities in their plans and budgets. Source OECD Glossary.

⁵²⁷ A negative externality is a cost that is suffered by a third party as a consequence of an economic transaction.

4. International Law and Legal Regimes

The interface between the emerging post-2008 financial regulation and the international trade and investment architecture raises several questions in international law and dispute settlement linked to whether the finance and trade/investment regimes should continue to evolve separately in silos or coherently through a common consideration of overlapping and contradictory areas. Furthermore, how should soft law and potentially customary international law aspects of the financial regime be incorporated into trade and investment disputes?

a. Financial Versus the Trade and Investment Architecture: Silo or symbiotic Approach?

The financial sector and trade/investment regime tend to differ in terms of their objectives, structure, operation, stakeholders, oversight, governing regulation, dispute settlement, and broader economic impact (*see Table 37: Characteristics of the Trade and Investment Architecture and the financial Architecture*). Finance tends to be focused on national financial markets, policy, and regulation set by national financial regulators with loose global coordination. Trade and investment, on the other hand, are cross-border in nature, with binding global agreements/decisions and dispute settlement.

Thus far, *the two regimes have operated by and large independently, as reflected in differing approaches in national and international law. Yet, the two regimes are operationally and in terms of impact interlinked*, with overlaps in the very same areas that set them apart. This has led to arguments for a reconceptualisation of international economic law to bring it in line with developments on financial regulation⁵²⁸.

The key question here is as follows: Given the interlinkages between the two sectors, should they continue to be handled as silos or would a more coherent approach in policy, regulation, and dispute settlement be warranted, especially in light of newer developments in regulation, financial markets and dispute settlement? The silo versus symbiotic/coherence approach is especially important in areas of contradiction between the trade/investment architecture and financial regulation and consequent disputes that may arise.

⁵²⁸ A suggestion along these lines was made by the Swiss Government to the WTO's Committee on Trade in Financial Services in 2001. Communication by Switzerland to the CTFS, 2001, S/CSS/W/71. See also Alexander Kern, Redesigning Financial Regulation to Achieve Macro-prudential Objectives: A commentary on some of the regulatory challenges, Page 14, 2010, Available at: <https://www.ius.uzh.ch/dam/jcr:00000000-21d0-db9c-ffff-ffffa42d6c8/micro.pdf>.

Table 38: Characteristics of the Trade and Investment Architecture and the financial Architecture

Criteria	Trade and investment	Finance
Objective	– Enhance economic productivity through trade and investment between countries.	– Enhance economic productivity through an efficient financial sector, which is the backbone of the economy. – Includes trade and investment aspects.
Structure and direction of operation	– Cross-border, with traders/investors complying with regulations in jurisdictions of operation.	– National, as well as cross-border, requiring compliance with national financial regulation.
Governing framework	– WTO, FTAs, BITs, sector-specific national regulation.	– National regulation, primarily in the case of the EU regional regulation. – Soft law and dialogue through BCBS, FSB, IOSCO.
Regulation setting and oversight	– Ministries of trade, investment	– Central banks, ministry of finance, regulatory agencies
Accountability of private sector	– Shareholders, regulatory compliance	– Shareholders, regulatory compliance
Broader economic impact	– Generally limited to sector, so costs limited	– As a backbone infrastructure sector, extends to entire economy, so costs can be high, e.g. financial crises.
Dispute settlement	– Global level, state-to-state, investor-state	– None established at the global level, largely domestic, arbitration or investor-state

Source: Author Construction

A broader question that arises from a silo versus coherence approach to the international trade/investment and financial architecture is the issue of the fragmentation of international law including through the emergence of ‘self-contained regimes’. This question has evoked mixed responses, with views critical of the silo approach highlighting issues such as the erosion of general international law, the emergence of conflicting jurisprudence, forum-shopping, and loss of legal security, all of which are issues highlighted throughout this PhD thesis. In the context of ISDS, for instance, it has been argued that consistency and coherence

bring legal and economic benefits in terms of enhancing legal certainty and the predictability of the investment framework for both the State and the investor and promoting efficiency in litigation⁵²⁹.

Other scholars have viewed the fragmentation of international law as a natural phenomenon arising from the increase of international legal activity, which may be controlled using technical streamlining and coordination⁵³⁰. Conflicting laws and judicial outcomes are also found in the domestic and international context and are found to be problematic, particularly in situations of multiple proceedings⁵³¹. In the context of ISDS, for instance, it has been observed that divergent interpretations of treaty language are inevitable⁵³² and not in themselves a concern, as treaty interpretation could vary depending on the facts of the case and the evidence submitted. Inconsistency is concerning, though, when the same rule or standard (e.g. FET or rule of customary international law) is interpreted differently in the absence of justifiable grounds for the distinction⁵³³.

It should also be noted that greater fragmentation of regulation and law is likely to occur with changes in fintech, green finance, and Brexit, amongst other factors. Possible suggestions for streamlining and coordination is therefore an issue I seek to address in Part G of this chapter.

⁵²⁹ UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, Paragraph 24, A/CN.9/935.

⁵³⁰ ILC Report of the Study Group, ‘Fragmentation of International Law: Difficulties arising from the Diversification and Expansion of International Law’, Report of the fifty-eighth session Geneva, 1 May–9 June and 3 July–11 August 2006, Paragraph 7, UN General Assembly, A/CN.4/L.702.

⁵³¹ UNCITRAL Secretariat Note, ‘Possible Reforms of ISDS: Multiple proceedings and counterclaims’, 22 January, 2020, A/CN.9/WG.III/WP.193, UNCITRAL Working Group III (Investor-State Dispute Settlement Reform) thirty-ninth session New York, 30 March–3 April 2020.

⁵³² Examples include the application of the most-favoured-nation (MFN) clause and contradictory interpretations of the notions of investment and expropriation. 32. See Paragraphs 31, 32 of UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, A/CN.9/935.

⁵³³ UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, Paragraph 21, A/CN.9/935.

b. International Economic/Trade Law and Financial Law: Application of Lex Specialis

Contravention/incompatibilities between international trade/investment law and financial regulation can be addressed by the application of the doctrine of *lex specialis*⁵³⁴. The *lex specialis* doctrine states that if two laws govern the same factual situation, a law governing a specific subject matter (*lex specialis*) overrides a law governing general matters (*lex generalis*)⁵³⁵.

The relationship between the general standard and the specific rule can be conceived of in two ways. The first is that when they both point in the same direction, the specific rule should be read against the background of the general standard, e.g. to update or provide a technical specification of the general law⁵³⁶. In this context, it would theoretically be possible for *financial law as lex specialis to be used to provide a clearer understanding of the 'general law', i.e. an international trade/investment agreement*.

The second, and more narrow but widely accepted, use is *lex specialis* as a technique for the resolution of normative conflicts, where, for instance, two valid legal provisions with no hierarchical relationship provide incompatible interpretations of the same set of facts. Here the specific facts justify a deviation from the 'general law', providing context on what is 'normal' and what is 'exceptional'⁵³⁷, thereby

⁵³⁴ *Lex specialis derogat legi generali* translates into special law derogates from general law. Kindly note that the objective of this discussion is to draw the interlinkage between the application of *lex specialis* to the interface of finance and trade/investment law. It will not be delving into the intricacies of *lex specialis* and its application, as this would involve another body of work and would warrant another thesis in itself. The application of *lex specialis* in the context of the fragmentation of international law was extensively discussed by the International Law Commission in 2006.

⁵³⁵ International Law Commission Study Group Report, 'Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law', 13th April, 2006, finalised by Martti Koskenniemi, Paragraph 56, UNGA A/CN.4/L.682.

⁵³⁶ For example, many provisions in the 1987 Montreal Protocol on Substances that Deplete the Ozone Layer are special law in relation to the 1985 Vienna Convention on the Protection of the Ozone Layer. See International Law Commission Study Group Report, 'Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law', 13th April, 2006, finalised by Martti Koskenniemi, Paragraphs 98, 99, Page 54, UNGA A/CN.4/L.682.

⁵³⁷ The laws of war are *lex specialis* in relation to rules laying out the peacetime norms relating to the same subjects. See International Law Commission Study Group Report, 'Fragmentation of International Law: Difficulties Arising from the Diversification and

addressing a ‘conflict’ arising from the fragmentation of international law⁵³⁸. In the case of international trade and investment disputes, it is possible for financial law to be used as a means of legal interpretation, enabling a derogation from the general law, i.e. the trade and investment agreement.

The principle of *lex specialis* can be applied to conflicts between provisions of the same treaty, provisions between two or more treaties, and between a treaty and a non-treaty standard, as well as between two non-treaty standard⁵³⁹. *It can also be applied to resolve contraventions/contradictions between financial regulation and trade/investment architecture*, such as those that arise between trade/investment agreements and within the same agreement, as well as where there are conflicts between soft law (e.g. financial standards) and trade/investment agreements.

Thus, when international trade and investment law/agreements require that the rights of investors/financial services suppliers be upheld, with certain prudential exceptions, it could be argued that it is possible to turn to financial sector legislation to determine whether the prudential exception would cover post-2008 financial crisis macro and microprudential regulation.

This application of *lex specialis* to financial and trade/investment law raises certain questions relating to (a) whether financial law⁵⁴⁰ is a subset of international trade/investment law. One of the difficulties in applying the *lex specialis* rule comes from the challenges in determining the distinction between ‘general’ and ‘special’⁵⁴¹. As we have seen in *Table 37: Characteristics of the Trade and Invest-*

Expansion of International Law’, 13th April, 2006, finalised by Martti Koskenniemi, Paragraphs 103–105 Page 54, UNGA A/CN.4/L.682.

⁵³⁸ The issue of the fragmentation of international law is not a new one and was in fact dealt with at length by the International Law Commission in 2006.

⁵³⁹ International Law Commission, ‘Conclusions of the work of the Study Group on the Fragmentation of International Law: Difficulties arising from the Diversification and Expansion of International Law’, 2006, Adopted by the International Law Commission at its fifty-eighth session, in 2006, and submitted to the General Assembly as a part of the Commission’s report covering International Law Commission, 2006, vol. II, Part Two.

⁵⁴⁰ As contained in national financial regulation, in some FTAs that set out regulatory principles specific to the financial sector and/or issuances from international financial bodies such as the BCBS or the FSB, which can be considered to have the status of ‘soft law’.

⁵⁴¹ The ILC points out that the generality and specialty of a rule are relational, i.e. in relation to some other rule, normally in the context of the subject matter (fact description) or in regard to the number of actors whose behavior is regulated by it. International

ment Architecture and the financial Architecture, in terms of structure, operation, and objectives, it can be argued that the financial regime as it relates to cross-border financial services and investment is a subset of the international trade and investment regime.

This also relates to the question of (b) whether both international trade/investment and financial regimes qualify as *lex specialis*⁵⁴², forming specialized legal subsets. The ILC recognises self-contained regimes as a subcategory of *lex specialis* within the law of state responsibility⁵⁴³. These ‘self-contained regimes’ of law respond to new technical and functional requirements and have their own objectives, principles, and ‘ethos’, as is the case for environmental, trade, and human rights laws⁵⁴⁴.

While financial law has not been expressly addressed in the ILC report, international trade and investment law has been referred to as forming a kind of *lex specialis* in the same manner as environmental law or human rights. If both do indeed form ‘self-contained regimes’, then the question would be which one – i.e., trade/investment or financial law – would be applicable in the case of conflict, and which one would take precedence. Further variations in definitions/concepts in both financial and trade/investment regimes are likely to pose a challenge to the application of *lex specialis*.

The alternative to the application of *lex specialis* is to proceed to systemic integration by bringing together fragmented regimes of international law into a coherent order, without any hierarchy. This could be argued for under the Vienna Conven-

Law Commission Study Group Report, ‘Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law’, 13th April 2006, finalised by Martti Koskenniemi, Paragraph 112 UNGA A/CN.4/L.682.

⁵⁴² International Law Commission Study Group Report, ‘Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law’, 13th April 2006, finalised by Martti Koskenniemi, Paragraphs 56, 57, UNGA A/CN.4/L.682.

⁵⁴³ International Law Commission Study Group Report, ‘Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law’, 13th April 2006, finalised by Martti Koskenniemi, Paragraphs 123, 124, Pages 65, 66, UNGA A/CN.4/L.682.

⁵⁴⁴ International Law Commission, ‘Conclusions of the work of the Study Group on the Fragmentation of International Law: Difficulties arising from the Diversification and Expansion of International Law’, 2006, Paragraph 247, Adopted by the International Law Commission at its fifty-eighth session, in 2006, and submitted to the General Assembly as a part of the Commission’s report covering International Law Commission, 2006, vol. II, Part Two.

tion on the Law of Treaties⁵⁴⁵, i.e. to interpret each of the apparently conflicting rules in light of the others, which is likely to lead to the same results as the application of *lex specialis* maxim. In a similar vein, some academics have argued for a ‘deliberative approach’ which looks beyond immediate investment treaty provisions to accommodate other segments of economic policy (i.e. monetary, fiscal, and banking regulation, as well as development finance and investment law) and which gives weight to the broader macroeconomic goals of financial stability⁵⁴⁶.

Hypothetical Application of Lex Specialis in a Finance and Trade Dispute Settlement Case

If we were to take a trade and investment dispute involving regulation relating to proprietary trading as an example, then from a trade and investment perspective the investor/financial services supplier has a right to expect that regulation relating to proprietary trading does not change, as per trade-in-services commitments scheduled under the WTO or FTAs. Country A’s proprietary trading regulation may jeopardise the interests of financial services supplier B from country B. However, country A’s objective was to maintain systemic stability and should be protected under the ‘prudential carve-out’. In case of a dispute, the application of *lex specialis* would raise questions as to whether (i) national law on proprietary trading with the objective of systemic stability can be used to interpret/give context to trade and investment obligations undertaken and (ii) whether both financial regulations relating to proprietary trading and trade and investment commitments under the FTAs/WTO form *lex specialis* in their own right and which would take precedence. Can interpretation be sought through the application of the VCLT treaty provisions 31–33?

c. Application of Soft Law and Customary International Law in Financial Sector related Dispute Settlement

Another potential point of contravention between post-2008 financial crisis regulation and the existing trade and investment architecture is the identification and application of customary international law and ‘soft law’ in dispute settlement cases, both ISDS and FTA/WTO related⁵⁴⁷. In addition, most BITS and some FTAs

⁵⁴⁵ Articles 31 (3)(c) and Article 32 of the Vienna Convention on the Law of Treaties.

⁵⁴⁶ Matthias Goldmann, ‘International Investment Law and Financial Regulation: Towards a Deliberative Approach’, 2017, Pages 65, 69 and 84 in *International Investment Law and the Global Financial Architecture* (Editors Tams C, Schill C and Hofmann R) Elgar Cheltenham, Pages 57–85.

⁵⁴⁷ The term ‘soft law’ is used to denote agreements, principles, and declarations that are not legally binding. It covers UNGA resolutions and declarations, codes of practices, guidelines, principles, financial action task force recommendations, and G-20

contain the equivalent to the FET standard, which makes some manner of reference to CIL either directly through ‘the minimal standard treatment approach’ seen in US FTAs, or indirectly through ‘the autonomous approach’ seen in European FTAs/BITS.

This raises two questions in relation to the application of financial regulation and soft law to dispute settlement. First, can/will soft law be applied to dispute settlement cases? International financial bodies produce soft law instruments that are legally non-binding ‘but [which] have legal consequences through their interpretation or exposition of what binding obligations mean or how they will be interpreted and implemented’⁵⁴⁸. ‘Soft law’ has indeed been used by tribunals in the past seeking guidance on the meaning and purpose of trade and investment agreements. In the Brazil aircraft case, the WTO Panel relied on OECD Guidelines for Officially Supported Export Credits⁵⁴⁹. In the Argentina-Panama case, the WTO Panel in its assessment of the ‘necessity clause’ relied on the G-20, OECD, and FATF guidelines/documents relating to tax information, harmful tax practices, and money laundering⁵⁵⁰. It is therefore possible that provisions of the BASEL committee, IOSCO, FSB, IMF, and OECD as a form of soft law and potentially a source of CIL will be relied on in dispute settlement cases related to the financial sector.

Second, can the financial sector ‘soft law’ component generated by international financial bodies be considered a source of customary international law?

and FSB recommendations, amongst others. Abbott and Snidal note that ‘[t]he realm of “soft law” begins once legal arrangements are weakened along one or more of the dimensions of obligation, precision, and delegation.’ See Abbott Kenneth and Duncan Snidal, ‘Hard and Soft Law in International Governance’, 2000. International Organization, 54(3), Pages 421–456. Customary international law has several attributes in common with ‘soft law’.

⁵⁴⁸ Timothy Meyer, ‘From Contract to Legislation: The Logic of Modern International Law Making’, 2014, 14(2) Chicago Journal of International Law 559 at 573.

⁵⁴⁹ Brazil – Export Financing Programme for Aircraft, 28 August 2001, WTO Panel Report WT/DS46/29.

⁵⁵⁰ Argentina – Measures Relating to Trade in Goods and Services, Panel Report, WT/DS453/R, 30th September 2015, paragraph 7.511 quotes Global Forum on Transparency and Exchange Information, Tax Cooperation 2009: Towards a Level Playing Field (OECD, 2009), paragraphs 7.512 and 7.515 (both quote OECD Report, Addressing Base Erosion and Profit Shifting (2013). Reference is also made to the recognition of defensive measures by the OECD and G20 as a legitimate tool to protect tax systems and prevent harmful tax practices. (Paragraphs 7.713, 7.715–7.716). See also paragraphs 7.509–7.513 more generally.

International financial bodies have developed a range of globally formulated standards/guidelines/findings that can be considered ‘soft law’, *i.e. rules that are not formally binding but potentially with substantial adherence by countries*⁵⁵¹. While some international financial bodies such as the BCBS clearly indicate that their decisions have no legal force⁵⁵², they do, however, form standards/best practices that central banks can implement into national regulation.

As per the UN, sources of customary international law include treaties, decisions of national/international courts, national legislation, opinions of legal advisors, diplomatic correspondence, and practice of international organisations. In the context of financial regulation, this in effect could mean national financial regulation, IMF Articles of Association, G20 Declarations, OECD guidelines, BCBS standards, policy papers issued by international organisations, FSB policy papers, and jurisprudence of national and international courts, e.g. ISDS and WTO tribunals could act as sources of CIL and be referenced in future treaty-based disputes.

The International Court of Justice’s (‘ICJ’) application of international law tends to be stricter⁵⁵³, requiring the custom to be (a) evidence of general practice and (b) accepted as law or ‘opinio juris’. In terms of general state practice, the application of financial standards tends to be high across the financial sector. For instance, a BCBS survey of 189 banks (2019) found that all banks were complying with the so-called Basel III rules, agreed in 2010, which have been scheduled to be fully phased in by 2027⁵⁵⁴. ‘Opinio juris’ is, however, a more difficult concept to pin down⁵⁵⁵. Arguments have thus been made for the ICJ listing of formal sources of

⁵⁵¹ Joel Trachtman, ‘Addressing Regulatory Divergence through International Standards: Financial Services’, 2003, Chapter 3 in *Domestic Regulation and Services Trade Liberalization* (Editors: Matoo Aditya and Sauve Pierre), Page 27.

⁵⁵² See Basel Committee Charter, specifically Article 3 on ‘Legal Status’. The BCBS, for instance, sets out that it is the primary global standard setter for the prudential regulation of banks and does not possess any formal supranational authority, as its decisions have no legal force.

⁵⁵³ Statute of the International Court of Justice, Article 38(1)(a-d).

⁵⁵⁴ Financial Times, Claire Jones, ‘Banks’ Progress on Adhering to Stricter International Rules’, 20 March, 2019, Accessible at: <https://www.ft.com/content/c70df0a2-4ada-11e9-bbc9-6917dce3dc62>.

⁵⁵⁵ Opinio juris is the subjective element used to judge whether the practice of a state is due to a belief that it is legally obliged to perform a particular act. See Bederman, David, *International Law Frameworks*, 2001, New York Foundation Press. Pages. 15–16.

CIL to be more reflective of contemporary international law including ‘soft law’, owing to its evolving nature⁵⁵⁶.

Thus, international soft law relating to the financial sector and national financial regulation raise questions as to their potential status as sources of CIL.

Finally, the changing nature of financial regulation and policy stances impact the stability of their usage as identified sources of CIL and soft law. In the case of macro and microprudential regulation, the policy stance of international organisations and national governments has changed substantially since 2008 and has even been reversed in several areas. A good example is the shift from home to host country regulation, which prior to the 2008 financial crisis was encouraged by the BCBS and various trade fora, which has since been reconsidered. These shifts in regulatory approaches can create uncertainty around international bodies and national regulators as a source of CIL and soft law.

5. Increasing Dispute Settlement in the Financial Sector

Since 2008, there has been growth in financial-sector-linked disputes as a result of several emerging factors. First, the financial sector is one of the most regulated sectors of the economy, increasing the probability of a breach of obligations, especially after the 2008 financial crisis. Second, modern financial transactions have resulted in a complex world of connected markets, with transactions involving multi-party, multi-contract, and multiple modes of delivery, and therefore multijurisdictional legal relationships. Third, technological (e.g. fintech and cryptocurrencies), political (e.g., Brexit), and market (e.g. sustainable finance) developments, in combination with the effects of the COVID-19 pandemic, have created additional regulatory considerations and avenues for dispute settlement, going beyond cross-border elements of regulation to include data, privacy, and security – all of which are areas not adequately or holistically addressed in existing global and national financial, trade, and investment architecture.

Fourth, the very architecture of the trade and investment dispute settlement mechanism is under review in the WTO and in the context of ISDS. The WTO’s temporary arbitration arrangement may raise questions related to the acceptability of dispute settlement outcomes by the larger WTO membership. ISDS in its present

⁵⁵⁶ See Zen Chang, ‘A Revision of Article 38(1) of the Statute of the International Court of Justice?’, University of Sydney, April 2017, Available at SSRN: <https://ssrn.com/abstract=2972437> or <http://dx.doi.org/10.2139/ssrn.2972437>.

form has become controversial, with observers disagreeing on the value and fairness of the mechanism⁵⁵⁷.

The European Investment Court proposal aims to address some of these concerns by establishing a multilateral ISDS court reflected in several FTAs such as the EU-Canada CETA and the EU-Vietnam FTA. Part of the rationale for the EC's investment court proposal is to address issues of transparency, due process, choice of judges, and the perception that ISDS is weighted in favour of foreign investors, impeding a state's right to regulate.

Discussions surrounding the dispute settlement architecture raise several questions around issues such as the implications of an 'ISDS Court' for financial services dispute settlement in terms of scope, coverage, and approach, award of damages, preservation of regulatory flexibility (especially in light of systemically important financial regulation), interlinkages with dispute settlement mechanisms and jurisprudence established in other trade fora such as FTAs (e.g. WTO, ASEAN, US FTAs), the choice of arbitrators, and approaches taken in arbitration jurisprudence (i.e. a more private sector approach or a regulatory inclusive approach).

Finally, the BITS regime has also undergone a process of reform, as can be seen from the ECJs Achmea judgement, India and South Africa's model BIT. The dispute settlement implications of this for the financial sector needs to be ascertained.

E. Specific Areas for Consideration

1. Differences in Provisions within and between Trade and Investment Agreements create a complicated Web of interlinked Commitments

Structural anomalies and differences within and between trade and investment agreements and between the trade and investment architecture and the financial architecture create a complex web of commitments. While many FTAs/BITs have similar outlines, they may differ in terms of their definitions, specific provisions, scope, and coverage. Several FTAs contain independent chapters on investment, trade in services and cross-border services, or financial services. There is the potential for contradictions between provisions and chapters in the same agreement, such as in the trade in services chapter in an FTA as it relates to Mode 3 and

⁵⁵⁷ Lauge Skovgaard Poursen and Geoffrey Gertz, 'Reforming the Investment Treaty Regime: A backward-looking approach', March, 2021, Chatham House Briefing Paper.

the investment chapter, between agreements as for instance between an FTA and a BIT.

The practical implications of this are that a network of FTAs/RTAs with overlapping, potentially contradictory provisions, which create ambiguity for investors and financial services suppliers, specifically when they are applied to financial sector regulation and make dispute settlement claims and adjudication more complex.

2. Wide and varied Definitions and Ambiguity in conceptual Understandings

The contents of a definition are significant in the negotiations and dispute settlement context as they determine the validity of a claim, i.e. the assets and persons covered, the boundaries of a State's liability within a jurisdiction, and the protections afforded to investors/financial service suppliers.

The application, scope, and interpretation of the trade and investment architecture to micro and macroprudential regulation are determined by definitions contained in in GATS, FTAs, and BITS. In terms of scope, treaty definitions determine (a) the object/target of investment or financial service provision (e.g. definitions of 'investment', 'financial service', 'regulatory measure'); (b) the person permitted to make the investment or provide the financial service (e.g. 'investor', 'financial service supplier'); and (c) related definitions such as 'trade in services', 'financial services', 'measure affecting services' and the four modes of services.

Definitions contained in trade and investment agreements and jurisprudence tend to be broad, varied, lacking in clarity, and at times contradictory. The GATS Annex on FS and BITs definitions of investment, for instance, cover a range of financial transactions. ISDS jurisprudence has enabled a wide-ranging interpretation of what constitutes investment, investor, etc. – and indeed most financial sector operations would satisfy the categories of the 'Salini test'⁵⁵⁸. Further definitions can lack clarity, making operationalisation of the trade/investment provision more difficult, e.g. definitions for the term 'prudential', or in the case of BoP safeguards, 'necessary', 'temporary', and 'avoid unnecessary damage'. Definitions can also at

⁵⁵⁸ Investment arbitral awards have found that varying financial instruments qualify as investments, including straightforward loans, negotiable instruments, sovereign bonds, oil price hedges, shareholdings, bank guarantees, promissory notes, and depository receipts, amongst others.

times be varied or contradictory, given the large number of trade and investment agreements and varying ISDS tribunal decisions.

Moreover, *definitions contained in FTAs and BITS can vary within and between agreements with variability in 'like definitions' or 'linked definitions'*. These variations raise the possibility of contradiction or at the very least ambiguity. Variations in definitions also exist in ISDS jurisprudence, as well as between national law and treaty provisions. Definitions and in fact the provisions relating to investment, trade in services, and financial services within and among FTAs/BITS as well as in comparison to national law need to be cross-referenced.

In the case of wider treaty interpretation, understanding on key concepts lacks clarity. For instance, in the case of the prudential exception and the BoP safeguard, several interpretational issues relate to terms such as 'prudential', 'necessary', 'temporary', 'unnecessary damage', and 'essential part of services', as they all lack clarity.

F. Responding to Key Questions of the PHD Thesis

To answer the questions raised at the beginning of this thesis, the following is offered:

- 1. To what extent do certain aspects of post-crisis financial regulation conform to existing trade/investment commitments? Answer:** There are several points of inconsistency/non-conformity between the post-2008 crisis financial regulation and the existing trade/investment architecture. Given the growing tendency towards dispute settlement, financial sector trends such as fintech, BREXIT, dispute settlement changes in ISDS/WTO, and growth in financial-sector-linked disputes, these inconsistencies are a cause for concern. Serious inconsistencies between regulation and the trade and investment architecture, within the trade and investment architecture as it relates to the financial sector and in tribunal decisions are also a cause for concern as they could threaten the core of a mutually agreed rules-based system and create confusion for both investors/financial service suppliers and regulators. Issues for further consideration relate to the following: whether a continued silo or a more coherent approach to the trade/investment and finance regimes should be followed; the implications of *lex specialis* and soft law/customary international law considerations; conceptual and definition clarity at the point of negotiations of agreements and dispute settlement; and the need to address structural differences within/between trade and investment agreements and financial regulation.

2. **Does the conformity/lack thereof lead to possible trade/investment including FET violations? → Investor perspective. Answer:** Yes, contraventions of the trade and investment architecture exist owing to new regulation, reregulation, and trade-barrier-like effects. There is the possibility to argue for FET violations based on investors' legitimate expectations and the need to maintain a stable business and legal environment. Furthermore, given the economic costs incurred by banks in the post-2008 financial crisis environment as evidenced in the economic literature, there is an argument for compensatory damages. However, given the evolving elements of the FET standard in ISDS case law and the importance of non-discriminatory and proportional regulatory flexibility for maintaining financial sector stability, the application of the FET standard to financial sector disputes is likely to be limited. Investors costs must also be balanced against the larger cost accruing to taxpayers in the event of a financial or banking crisis and the 'public good' nature of the financial sector nationally and globally.

3. **How do 'inconsistencies' impact the flexibility of financial regulators? → Regulator perspective. Answer:** While the flexibility of regulators is by and large protected within the existing WTO/FTA-like prudential carve-out measures and BoP safeguards and upheld by tribunals, this is not a blanket provision, as regulatory measures are required to cohere with trade commitments undertaken. Furthermore, there is a lack of conceptual understanding of terms related to prudential concepts both in agreements and in jurisprudence and ISDS tribunals, while generally upholding the state's regulatory flexibility has also held in favour of investors. There is less regulatory flexibility in BITS, as, being older, they do not necessarily contain wider prudential carve-out-like measures.

The question of weighing the legitimacy of regulatory action versus investor/trade protection remains unclear in law and in jurisprudence. Given the current rise in financial sector disputes, the impact of Brexit, and an ever-changing financial system post COVID, the possibility of filing in particular investor-state financial disputes cannot be written off and creates a problem for regulators in terms of potential dispute settlement, but also potentially the fear of acting, i.e. 'regulatory chill'.

4. **A linked question is how important are inconsistencies/contradictions between financial regulation and the trade/investment architecture and within and between trade and investment agreements as they relate to the financial sector?**

While issues of inconsistency have been previously raised in academia and within the UN⁵⁵⁹, in reality they can be a natural outcome of the evolution of international law and therefore not necessarily a point of concern. However, it is important to uphold agreed trade/investment rules and standards to ensure that the system coheres and that there is predictability for both financial regulators and financial service suppliers and investors⁵⁶⁰.

The lack of clarity and consistency within the international trade and investment architecture and in post-2008 crisis financial regulation leads to (i) uncertainty, costs, and barriers for investors and financial service suppliers in terms of their investment, and may impact third-party rights; (ii) creates uncertainty for states in terms of the implementation of new regulation (e.g. in the case of fintech, sustainable finance etc., the possibility of financial disputes and rising ISDS creates a ‘regulatory chill’ factor that potentially prevents regulatory flexibility and financial regulators from taking necessary steps to ensure preservation of the financial system; and, finally, (iv) can lead to actionable claims resorting to consultation/mediation and/or ISDS or state-to-state dispute settlement.

- 5. Is there a need to have more global approaches or at the very least discussions on issues at the interface of the trade/investment and finance systems? Answer:** Yes, at the very least the overlapping issues and contradictions, though not new, have been exacerbated by new developments in an evolving financial system and a (currently) static trade and investment architecture and therefore warrant systemic discussions which would benefit both investors/financial service suppliers and government. *See also Table 35: Potential Areas for Global Discussion at the Interface of Emerging Financial Regulation and the Trade and Investment Architecture.* From a broader perspective, the financial sector is too important to leave crucial policy discussions to dispute settlement outcomes, as ISDS outcomes in Ecuador, Pakistan, and Argentina seem to indicate.

It is important to recall that BITS and FTAs have seen an evolution over a period of time starting from the US Friendship, Commerce, and Navigations agreements in the 18th century, to the first BIT (Germany-Pakistan) in 1959.

⁵⁵⁹ See deliberations of UNCITRAL Working Group 3 on Investor-State Dispute Settlement Reform, last accessed 15th September 2021 at https://uncitral.un.org/en/working_groups/3/investor-state

⁵⁶⁰ Julian Arato, Chester Brown, and Federico Ortino, (2020), ‘Parsing and Managing Inconsistency in Investor-State Dispute Settlement’, 22nd June, 2020, *The Journal of World Investment and Trade*, 21(2–3), Pages 336–373.

This evolution is largely a response to the economic and political factors that have changed over time. Many of the nearly 3,700 agreements may not reflect the global, regional, and national economic developments of today, much less the ever-changing financial sector.

Global approaches, initiatives, and potentially a consolidated informal platform to begin would therefore be major value additions. The nature of this platform will have to be flexible and not bureaucratic if it is to adequately respond to rapidly changing conditions in the financial markets and could either be housed in existing financial/trade institutions or be created afresh.

G. Global Approaches to address the Interface of Financial Regulation and Trade/Investment – a few Suggestions

Suggestions for a more global approach to address issues arising out of the interface between the trade and investment architecture and the financial architecture:

The interplay of larger economic and institutional factors, such as the growth of fintech, the establishment of an ISDS fora, an emerging green finance regime, Brexit, and COVID-19, are likely to further deepen issues surrounding the interface of the trade and investment regime and the financial regime.

The argument for greater global coordination in the financial sector has already been made by several scholars. Andenas (2016), for instance, argues for global financial coordination, pointing out that global financial markets appear to offer permanently fertile ground for new crises, with dysfunctions and risks emerging on a global scale⁵⁶¹.

While global regulation and supervision of financial markets along the lines of the WTO, with its own dispute settlement mechanism, may be premature, as governments consider financial policy an important tool in managing the national economy, it is nonetheless important to consider several issues at the interface of international financial regulation and the international trade and investment architecture which could benefit from more global approaches. An outline of the trade and investment issues at the interface of prudential regulation, in light of ongoing work in international for a, is set out in *Table 35: Potential Areas for Global*

⁵⁶¹ Mads Andenas and Gudula Deipenbrock, 'More Risks than Achievements?' 2016, in: Andenas M., Deipenbrock G. (eds) *Regulating and Supervising European Financial Markets*. Springer, Cham., Pages 1–9.

Discussion at the Interface of Emerging Financial Regulation and the Trade and Investment Architecture.

Two areas where greater global coordination could be warranted are (i) financial regulation (because it impacts the trade and investment architecture) and (ii) dispute settlement in the financial sector (as it relates to the trade and investment architecture).

1. Global Coordination to address Issues arising at the Interface of Financial Regulation as it Impacts the Trade and Investment Architecture

There is a need to create a platform which would enable information sharing and dialogue between governments and the private sector, evaluate issues at the cusp of international trade/investment and financial regulation, and suggest possible solutions or best practices. Such a platform could enable greater transparency and an improved understanding of economic costs, as well as minimise regulatory arbitrage and address the FET issue of ‘investors’ legitimate expectations’. It would also alert financial regulators to the possible global fallout of the regulation they put in place and the potential of regulatory arbitrage.

Example: Function of International Fora on Capital Flow Measures

Given the current reaffirmation of the use of capital controls, a global approach to information/data on the use of CFMs, trade/investment, and regulatory implications can be useful to regulators and the private sector as well as for greater global coordination.

Some experts have argued for a global regime to handle CFMs. Carney (2019) suggests the creation of a Global Financial Safety Net, which would act as individual countries’ insurance against capital flows at risk. Instead, resources would be pooled with the IMF at lower levels and lower costs, to achieve the same objective, i.e. reserve adequacy in the face of future risky external balance sheets. This would take the potential challenge on the use of capital controls out of the hands of investors by effectively making ‘sustainable capital flows’ a kind of global public good.

While developing a coherent multilateral regime to address volatile capital flows can be a longer-term objective, in the shorter term the need for global surveillance and preferably coordination on CFM measures and their trade/investment effects would be useful from a policy, regulatory, and dispute settlement perspective. For instance, the forum can enable global coordination of CFMs, as well as evaluate their effectiveness, their impact on volatile capital flows, the tensions that arise given the capital transfer provisions and procedures of FTAs/BITs and WTO agreements and dispute settlement implications, among other areas.

After the 2008 financial crisis, the absence of a regulatory roadmap and conciliation of regulations with each other, presented banks and regulators with issues of redundancy, duplication, and rules working at cross-purposes⁵⁶². The costs of regulatory awareness and divergence are expected to continue post Brexit and into an era of fintech and sustainable finance. The creation of a regulatory knowledge hub in specific areas (e.g. proprietary trading, legal form, etc.) and an analysis of the impact of such regulation on existing trade and investment architecture could be useful to both the private sector and to regulators.

While the sharing of information on financial regulation, trends assessment, and standard setting is occurring amongst international bodies such as the BCBS, FSB, and IOSCO, these discussions tend to be disparate, meaning that a comprehensive evaluation of the implications of financial regulation for the trade and investment architecture or dispute settlement is missing. The WTO Committee on Trade in Financial Services currently touches upon some aspects of financial regulation, but this is normally at points of crisis and purely from a discussion perspective. Yet, on the basis of past developments, it is possible that output and deliberations of international bodies could be considered by default as opposed to express consent, a form of soft law or CIL, during dispute settlement cases.

To ensure coherence, the international platform can be placed within an existing international body/think tank (e.g., IMF; BCBS, World Bank, WTO, FSB) or within a newly set up platform.

2. Global Approach for Dispute Settlement Relating to the Financial Sector

Despite the complex, cross-border, and decentralised nature of financial transactions, the financial marketplace does not have access to a global or centralised dispute settlement mechanism. To meet the needs of financial sector dispute settlement, especially those relating to trade/investment, it is necessary to reconsider certain aspects of the existing dispute settlement mechanisms or to create an altogether independent financial-sector-linked dispute settlement mechanism⁵⁶³.

⁵⁶² Ernst and Young, 'Financial Regulatory Reform: What it means for bank business models', 2012, Page 10

⁵⁶³ Rosa Lastra, 'Do We Need a World Financial Organization?', December 2014, *Journal of International Economic Law*, Volume 17, Issue 4, Pages 787–805.

As a result of the multitude of trade and investment fora adjudicating on similar issues, two separate streams of dispute settlement have emerged. The first relates to trade and investment within the WTO/FTA dispute settlement mechanisms linked to WTO agreements and/or specific FTA, which tend to follow state-to-state and, in the case of FTAs, ISDS dispute settlement. The second relates to the investment regime under BITS, which tend to follow an ISDS approach, under ICSID and other fora.

The coherence of the trade regime on the one hand and the ISDS regime on the other hand in terms of hierarchy of law, cross-reference of ISDS and WTO jurisprudence, and the supremacy of both the body of law and dispute settlement mechanism are not clear. *See Table 35: Potential Areas for Global Discussion at the Interface of Emerging Financial Regulation and the Trade and Investment Architecture.* It is important to recall that the universe of BITS/FTAs have followed a historical development trajectory that reflects global and economic developments. Prior to the foundation of the GATT, BITS and FTAs were concerned primarily with the liberalisation of trade in goods and the securing of investment interests in natural resources. These bilateral treaties, known as friendship, commerce, and navigation agreements, were used in the late eighteenth century in the United States – and, to a lesser extent, in Japan and a few European countries⁵⁶⁴. They therefore do not reflect the global, regional, and national economic developments of today, much less the financial sector.

The approach to dispute settlement in ISDS differs from the approach adopted in state-to-state dispute settlement. State-to-state dispute settlement within the WTO/FTAs focuses on mediation/conciliation as a first step, tends to follow a quasi-legal-political approach (taking into account larger considerations, including regulatory flexibility and economy-wide factors), and, in terms of awards, argues for correction/restitution of regulatory measures or trade concession.

On the other hand, ISDS, as contained in BITS/some FTAs, is created with the express purpose of facilitating and protecting trade and investments. ISDS dispute settlement, therefore, tends to take a strictly legalistic approach, focusing on rights and obligations – generally those of the investor – and awarding substantial damages to be paid by defaulting government. The perception of ISDS being weighted in favour of foreign investors as opposed to the state's right to regulation and larger public interest exists. The implication for the trade/investment and financial

⁵⁶⁴ UNCTAD, 'Investment Provisions in Economic Integration Agreements', 2006, UNCTAD/ITE/IIT/2005/10.

architecture interface is how will the issue of investor protection vis-à-vis financial sector regulatory flexibility be addressed? Would financial regulation and systemic stability be considered in the ‘public interest’? Given the sensitivity of the financial sector, financial sector disputes may require some manner of differential treatment. There is therefore a need for some manner of rationalisation in ISDS and state-to-state dispute settlement as it relates to differing approaches, differing jurisprudence, and differing awards.

Furthermore, the background of arbitrators/adjudicators in ISDS versus state-to-state dispute settlement tends to differ, with potential implications for the final award. ISDS arbitrators and counsels tend to have a private practice background and switch roles from arbitrator to counsel more easily. Awards may not always consider larger economy considerations. The perception that arbitrators are less cognizant of public interest concerns as compared to judges holding a public office has been raised in other fora, especially in the context of the state’s right to regulate⁵⁶⁵. In addition, the practice of individuals acting as counsel and arbitrators or ‘double hatting’ in different ISDS proceedings, has been raised as possibly resulting in conflicts of interests⁵⁶⁶. State-to-state dispute settlement, on the other hand, has an established body of adjudicators, with a greater government and academic background, tending as a result to look beyond financial transactions to wider financial sector and economy-wide ramifications.

In terms of subject expertise, currently for ISDS, arbitrators are not required to have a finance background, as there is a reliance on expert opinion. However, adjudicators with a background in finance maybe better placed to appreciate the technicality and specificity of the financial sector, which is why several FTAs specifically ask for financial expertise in dispute settlement adjudication.

In the creation of a neutral (i.e. not private-sector-focused) dispute settlement forum, with judges/arbitrators that have a financial sector background, both the private and public sector are likely to be important in enabling more equitable financial-sector-linked dispute settlement solutions.

⁵⁶⁵ UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, Paragraph 82–88, A/CN.9/935.

⁵⁶⁶ UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-fifth session (New York, 23–27 April 2018), 14th May 2018, Paragraphs 78–79, A/CN.9/935.

Whatever the formulation of dispute settlement that emerges, there will be a need for it to reflect the specificities of the financial sector as it interlinks with the trade and investment architecture. See *Table 35: Potential Areas for Global Discussion at the Interface of Emerg-ing Financial Regulation and the Trade and Investment Architecture*. A common platform to discuss issues arising from financial sector dispute settlement would give governments an opportunity to share views, rather than be foisted with decisions of tribunals. Suggestions in this regard could include the following:

- Trends and institutional considerations:
 - a) Establishing a forum for taking stock of dispute settlement in the financial sector, exchanging views, and arriving at modalities to move forward on areas of importance. In the ISDS context, for instance, suggestions have been made for the creation of a multilateral mechanism for ‘plurilateral interpretative statements’ whereby governments endorse joint statements and clarify and define positions on contentious clauses in their existing investment treaties⁵⁶⁷. Other suggestions include the establishment of joint interpretative committees alongside arbitral tribunals, and publishing treaty-based ISDS, pleadings, and awards so that future parties and tribunals are aware of interpretative statements⁵⁶⁸. Similar approaches can be taken for specific financial sector disputes.
 - b) Evaluating financial market, regulatory, and broader trade and investment dispute settlement developments to ascertain their implications for financial sector dispute settlement. For instance, if we take the case of Fintech, the determination of a non-resident contracting party – whether investor or service supplier – is difficult to ascertain. From a regulatory perspective, the scope of regulation is unclear and raises once more the question of

⁵⁶⁷ Lauge Skovgaard Poulsen and Geoffrey Gertz, ‘Reforming the Investment Treaty Regime: A backward-looking approach’, March, 2021, Chatham House Briefing Paper. See also UNCITRAL Secretariat Note, ‘Possible reform of investor-state dispute settlement (ISDS): Interpretation of investment treaties by treaty parties’, Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-ninth session (New York, 30 March–3 April 2020), 17th January 2020, Paragraphs 8–12, A/CN.9/WG.III/WP.191.

⁵⁶⁸ UNCITRAL Secretariat Note, ‘Possible reform of investor-State dispute settlement (ISDS) Interpretation of investment treaties by treaty Parties’, Working Group III (Investor-State Dispute Settlement Reform) on the work of its thirty-ninth session (New York, 30 March–3 April 2020), 17th January, 2020, Paragraphs 8–12, A/CN.9/WG.III/WP.191.

home versus host country regulation, not just across the financial sector but across the technology sector as well. For instance, in the EU, tech platforms including fintechs are regulated within Europe. Supervision by a non-EU country, such as for seeking corporate information, is not a given. Furthermore, the emergence of differing fintech regulation (e.g. EU-specific, US-specific, China-specific, etc.) may complicate the regulation/supervision and operation of fintech services and operators. How these regulations then interact with existing trade/investment agreements, including in the dispute settlement context, raises another set of questions.

- c) Take stock of changing dispute settlement regimes WTO and especially ISDS in the EU, US, South Africa, NAFTA, India, and Brazil, and its implications for national governments and global coherence. Suggestions have been made in light of the COVID-19 pandemic to impose a moratorium on fresh ISDS cases and enforcement of pending ISDS judgments, so as to provide governments with policy space and to avoid heavy legal penalties against host governments⁵⁶⁹.
- d) Evaluation of ISDS versus state-to-state and national dispute settlement regimes for the financial sector, including the value of a global financial dispute settlement fora.
- A rethink of the legal principles and elements of the dispute settlement regime as it relates to the financial sector, including the following:
 - a) International law considerations such as a silo or coherent approach to the international trade/investment architecture and the financial architecture and the application of *lex specialis*, CIL, and soft law implications.
 - b) Original intention of state parties vis-à-vis current economic, political, market, and legal developments.
 - c) Definition and conceptual consideration and clarifications.
 - d) Taking stock of cross-treaty and intra-treaty comparisons as well as the feasibility of cross-referencing jurisprudence in similar areas
 - e) Regulatory flexibility versus investor/trade protections in the financial sector

⁵⁶⁹ James Bacchus and Jeffrey Sachs, ‘Why we need a moratorium on investment disputes during COVID-19’, The Hill, Last visited 23rd April, 2021 at <https://thehill.com/opinion/international/501872-why-we-need-a-moratorium-on-trade-disputes-during-covid-19>.

- f) Evaluation of economic costs accruing to investors/financial service suppliers as opposed to taxpayers
- g) Relief measures and damages
- Procedural issues:
 - a) degree of separation between the arbitrator and counsels
 - b) specialist tribunals and arbitrators with knowledge of the financial sector and appreciation of larger public policy objectives and economy-wide ramifications
 - c) transparency in proceedings

Table 39: Potential Areas for Global Discussion at the Interface of emerging Financial Regulation and the Trade and Investment Architecture

Needs/Issues	Relevance for specific regulation				Global fora coverage
	CFMS	Legal Form	Proprietary Trading	Ring fencing	
Financial-regulation-specific					
Information sharing on financial regulation	X	X	X	X	BCBS, FSB
Data on trade/investment impact of regulation	X	X	X	X	Limited extent IMF
Platform for dialogue	X	X	X	X	BCBS, FSB
Evaluation of intent/objective of trade/investment architecture vis-à-vis financial architecture	X	X	X	X	None
Analysis of interface between specific financial regulation and trade/investment architecture	X	X	X	X	None
Trend Implications, e.g. Fintech, green finance, Brexit, financial disputes, etc.		X	X	X	BCBS, FSB, not for disputes
Understanding of ‘systemic risk’ concept and implications for trade/investment	X	X	X	X	None

(Continued)

Table 39: (Continued)

Needs/Issues	Relevance for specific regulation				Global fora coverage
Importance of regulatory flexibility versus trade/investment protection	X	X	X	X	WTO limited extent
Identification of trade barriers arising from implementation of financial regulation		X	X	X	Limited extent WTO
Regulatory arbitrage impacts		X	X	X	None
International law specific					
International trade/investment law versus financial regulation: silo or complementary approach	X	X	X	X	None
Application of <i>lex specialis</i> and/or VCLT	X	X	X	X	ILC in 2016 generic discussion
Sources and application of customary international law in the financial sector, impact of regulatory shifts on CIL	X	X	X	X	ILC in 2016, generic discussion
Definitions*: providing clarity on (i) key definitions in both trade/investment and financial regulation and (ii) variations of definitions between and within trade/investment agreements, jurisprudence, and national law	X	X	X	X	None, on variations perhaps some discussion in UNCITRAL
Structural contraventions/contradictions within and between FTAs/BITS and between financial regulation and FTAs**	X	X	X	X	None, potential for WTO CTFS role
Evaluation of changes in the BITS/FTA regime and their implications for the financial sector	X	X	X	X	Limited extent WTO

(Continued)

Table 39: *(Continued)*

Needs/Issues	Relevance for specific regulation				Global fora coverage
International financial standard linkages to trade and investment architecture and disputes	X				Limited extent WTO
Evaluation of provisions relating to regulatory flexibility (e.g. prudential carve-out) and BoP safeguards versus those relating to investor protection (e.g. market access)	X	X	X	X	Limited extent and in a diffused manner WTO
Economic costs/damages – estimation of damages, extent, proportionality, and sustainability of damages awarded, weighing investor damages/costs against costs accruing to taxpayer in case of financial crisis	X	X	X	X	None
Financial stability (global, national) viewed as a public good	X	X	X	X	None, though limited post- 2008 crisis UN discussions
Dispute Settlement specific					
Understanding size, multi-tude, and scope of dispute settlement fora for finance	X	X	X	X	Limited extent WTO, ICSID
Collecting data on financial disputes					ICSID for ISDS, WTO
Understanding multi-party, multi-contract, multi-modes, and multi-jurisdictional implications of financial disputes	X	X	X	X	None
Regulatory flexibility in ISDS versus state-to-state disputes	X	X	X	X	None
Implications of state-to-state versus ISDS in the financial sector	X	X	X	X	None

Table 39: (Continued)

Needs/Issues	Relevance for specific regulation				Global fora coverage
Impact of changes in dispute settlement, e.g. EU investment court impact on third parties, scope, awards, regulatory flexibility, inter-linkages with other dispute settlement fora, choice of arbitrators, treaty coverage/ definitions	X	X	X	X	ICSID, WTO limited extent
Cross-referencing of jurisprudence on similar issues in different fora	X	X	X	X	maybe UNCITRAL
Dispute settlement approach beyond specifics of treaty to include larger economic ramifications	X	X	X	X	None
Methodology to determine costs/damage/relief	X	X	X	X	None
Choice of arbitrators/counsel with financial expertise and understanding of systemic issues	X	X	X	X	None
Larger global solutions					
Global CFMS regime	X				None, IMF limited role
Global platform for consideration of interface between international trade/finance and financial regulation	X	X	X	X	None
Global platform for financial sector dispute settlement	X	X	X	X	None

Source: Author Construction

Note: Examples include systemically important, prudential, investment, necessary, temporary, unnecessary damage, essential part of services, etc.

**Note: Contraventions relate to market access, national treatment, Modes 1 and 3, standstill obligations, roll back on services commitments, BoP safeguards, capital transfers, prudential carve-out, FET standard (e.g. investors' legitimate expectations)

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