FINANCIAL SERVICES IN THE TTIP: MAKING THE PRUDENTIAL EXCEPTION WORK

INU BARBEE* AND SIMON LESTER†

ABSTRACT

In the Transatlantic Trade and Investment Partnership (TTIP) negotiations, one point of contention has been the inclusion of financial services regulation. The United States considers itself very competitive in most service areas, and often pushes for more trade liberalization, but in financial services there has been great resistance among some in the U.S. government to open up the U.S. market to competition. Of particular concern is that appropriate "prudential" regulation may not be possible because the typical exceptions for prudential measures in trade and investment agreements do not function very well. This Article argues that concerns about an ineffective prudential exception have been overstated, but nevertheless, improved language in this area could bring certainty and reassure critics that trade liberalization will not undermine domestic regulation.

* Inu Barbee is a Ph.D. Candidate at the Georgetown University Department of Government.

† Simon Lester is a Trade Policy Analyst at the Cato Institute and the President of WorldTradeLaw.net. Thanks to Todd Tucker for his comments. All errors remain our own.

I. INTRODUCTION

In his 2013 State of the Union Address, President Obama announced a major new trade initiative, the Transatlantic Trade and Investment Partnership (TTIP), which would create a long sought after free trade area with the European Union (EU). Negotiations began in July 2013 and are now well underway. The TTIP joins the Trans Pacific Partnership (TPP) as the twin pillars of a more active U.S. trade agenda.

The TTIP talks will address a wide range of trade in goods and services, regulations, and intellectual property. With regard to services, in most service sectors, the United States considers itself very competitive and thus pushes for more trade liberalization. In financial services, however, it has been the EU demanding more liberalization; in response, there has been great resistance among many in the U.S. government to open up the U.S. market to competition.[1] One important reason for this resistance appears to be a concern that including financial services rules in trade agreements might undermine the ability of the U.S. government to regulate domestic financial services markets.[2]

A particular concern in this regard is that appropriate "prudential" regulation will not be possible because the typical exceptions for prudential measures in trade and investment agreements do not function very well. Loosely speaking, prudential regulation involves government actions taken to mitigate risks to the financial system. As set out in more detail below, two main issues have been articulated in regard to the prudential exception. First, some argue that it does not cover enough measures; in particular, it does not allow for measures that deal with systemic risks. And second, some critics assert that particular aspects of the exception language simply do not work. While they may have been intended to serve as an exception, they are drafted so badly that they do not function at all.

In this Article, we argue that the concerns about an ineffective prudential exception are speculative and have been overstated. There are no actual disputes or rulings in this area that would lend credence to the fears. Nevertheless, improved language in this area could bring certainty and reassure critics that trade liberalization will not undermine appropriate domestic regulation. If the negotiators could address

1. Jamila Trindle & Tom Fairless, *U.S. Wants Financial Services Off Table in EU Trade Talks*, WALL ST. J., July 15, 2013.

2. *Lew Resolute On Excluding Financial Rules From TTIP, Citing Potential For Weakening Standards*, Inside U.S. Trade, Dec. 17, 2013.

the concerns, perhaps the critics would withdraw their objections to including financial services in the TTIP.

Trade liberalization rules for financial services, if drafted properly, can provide all the benefits of increased international competition, without constraining the ability of domestic governments to regulate appropriately. The TTIP will not be a tool for deregulation, as critics fear; rather, governments may still choose their own level of regulation. The main objectives of the TTIP are to remove discriminatory regulations and to address arbitrary divergence of regulations through mutual recognition and cooperation.[3] There are great benefits to doing so, and it can be done without undue interference with domestic policy making.

The Article proceeds as follows. Part II examines the current language used in the prudential exceptions in the General Agreement on Trade in Services, U.S. Model Bilateral Investment Treaty, and the United States-Korea Free Trade Agreement, in order to highlight the inconsistent and vague language that is typically used. Part III considers in depth various criticisms leveled at the language of these exceptions, as well as high-level officials' interpretations of the language that respond to such criticisms. Part IV presents two alternative models for crafting the language of the prudential exception in order to avoid confusion, and Part V presents new recommended language for a prudential exception, to be inserted into future trade and investment agreements. Such language would be particularly valuable for the TTIP, where financial services has been a sticking point in the early stages of the talks.

II. Current Formulations of the Prudential Exception

Many of the criticisms directed at existing prudential exception provisions focus on their ambiguous phrasing. The concern is that even if these provisions are intended to serve as a "carve out" for prudential matters, they do not work due to the way they have been drafted. As a result, it is worth examining the specific language of the various agreements in which they appear in detail. In this regard, we look at the prudential exception as articulated in the General Agreement on Trade in Services, the 2012 U.S. Model Bilateral Investment

3. *See generally*, Simon Lester & Inu Barbee, *The Challenge of Cooperation: Regulatory Trade Barriers in the Transatlantic Trade and Investment Partnership*, 16 J. Int'l Econ. L. 4, 847-67 (2014); Simon Lester & Inu Barbee, *Will Regulations Sink EU-U.S. Free Trade?*, National Interest (Oct. 15, 2013), http://nationalinterest.org/commentary/will-regulations-sink-eu-us-free-trade-9229.

Treaty, and the United States-Korea Free Trade Agreement, the main areas where concerns have been raised.

A. *General Agreement on Trade in Services*

The prudential exception language in the General Agreement on Trade in Services (GATS) annex on financial services reads as follows:

> 2. Domestic Regulation
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> a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial 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.[4]

There are two sentences here, each with important implications for the scope of the provision. The first sentence starts with "[n]otwithstanding any other provisions of the Agreement," which is a common way of setting out exceptions in WTO rules.[5] In essence, it means that even if another provision of the agreement has been violated by a measure, the measure is nonetheless permitted. As the next part of the sentence makes clear, "a Member shall not be prevented from taking" these measures. In this context, the designated measures relate to "prudential" matters, a number of examples of which are set out. On this point, the provision refers to "ensur[ing] the integrity and stability of the financial system," which is broadly stated and is not limited to specific financial services issues. Note also that the permitted measures' connection to prudential reasons is stated very simply: the measures must be "for" prudential reasons. There is no requirement that they be "neces-

4. General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS 284 (1999), 1869 U.N.T.S. 183, 33 I.L.M. 1167 (1994) [hereinafter GATS].

5. For similar formulations, *see* General Agreement on Tariffs and Trade art. XII:1, Oct. 30, 1947, 61 Stat. A-11 55 U.N.T.S. 194 [hereinafter GATT]; GATS, *supra* note 4, art. X:2; World Trade Organization, *Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries*, ¶ 1, L/4903 (Nov. 28, 1979).

sary," a stricter term used in other exceptions provisions. As is well-known, necessity defenses have been very controversial in the GATT/WTO context, with concerns expressed about the difficulty of satisfying them.[6]

The second sentence reinforces members' ability to take measures for prudential reasons but has been a source of great confusion and contention. As will be discussed further below, the opening clause—"Where such measures do not conform with the provisions of the Agreement"—is duplicative; and the statement that measures "shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement" is vague. This sentence supposedly works to prevent abuse of the exception, but as we will see later, its scope is unclear.

B. *U.S. Model Bilateral Investment Treaty*

The language used in the GATS is similar to that which appears in the 2012 U.S. Model Bilateral Investment Treaty (BIT):

> 20. Financial Services
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> 1. Notwithstanding any other provision of this Treaty, a Party shall not be prevented from adopting or maintaining measures relating to financial services for prudential reasons, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system.* Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party's commitments or obligations under this Treaty.[7]

The first sentence of the provision includes a footnote that further defines "prudential reasons":

> * It is understood that the term "prudential reasons" includes the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions, as well

6. *See, e.g.*, Note by the Secretariat, *Necessity Tests in the WTO*, S/WPDR/W/27, Dec. 2, 2003.

7. 2012 U.S. Model Bilateral Investment Treaty, Office of the U.S. Trade Representative (2012), http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf.

> as the maintenance of the safety and financial and operational integrity of payment and clearing systems.[8]

Article 20(1) is almost identical to GATS Article 2(a); the confusingly worded second sentence remains the same. One minor difference is that the Model BIT provision reads, "measures relating to financial services for prudential reasons," rather than just "measures for prudential reasons," but that is unlikely to have much impact on the meaning. Another difference is that it refers to "the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions, as well as the maintenance of the safety and financial and operational integrity of payment and clearing systems," which may be narrower than the GATS version.

C. *United States-Korea Free Trade Agreement*

The United States-Korea Free Trade Agreement (KORUS FTA) contains a prudential exception in its chapter on financial services. This follows the general outline of the BIT. The provision reads:

> 13.10. Exceptions
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> 1. Notwithstanding any other provision of this Chapter or Chapter Eleven (Investment), Fourteen (Telecommunications), including specifically Article 14.23 (Relation to Other Chapters), or Fifteen (Electronic Commerce), and, in addition, Article 12.1.3 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, a Party shall not be prevented from adopting or maintaining 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 institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Agreement referred to in this paragraph, they shall not be used as a means of avoiding the Party's commitments or obligations under such provisions.
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> * It is understood that the term "prudential reasons" includes the maintenance of the safety, soundness, integrity,

8. *Id.*

> or financial responsibility of individual financial institutions or cross-border financial service suppliers.[9]

Regarding the issues discussed under the other provisions, the KORUS FTA uses the simpler GATS reference to "for" to connect measures and the objective of prudential regulation; it covers actions "to ensure the integrity and stability of the financial system"; and it maintains the second sentence's vague anti-abuse language.

III. The Prudential Exception and its Discontents

A number of critics have raised concerns about the prudential exception under one of these agreements. In this Part, we discuss some of the main criticisms.

A. *Concerns from Global Trade Watch*

Global Trade Watch, an NGO and trade critic, has raised strongly worded concerns over the prudential exception, focusing on the second sentence in Article 2(a) of the GATS. In this regard, Global Trade Watch interprets this provision to mean that "prudential measures *are only allowed* under GATS rules *if they do not violate any of the GATS rules*, which are very expansive,"[10] and argues that it is thus

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9. Free Trade Agreement, U.S.-S. Kor. (June 30, 2007), http://www.ustr.gov/trade-agreements/free-trade-agreements/korus-fta/final-text.

10. Lori Wallach & Todd Tucker, *Memo: Answering Critical Questions About Conflicts Between Financial Reregulation and WTO Rules Hitherto Unaddressed by the WTO Secretariat and Other Official Sources*, Public Citizen (May 21, 2010), https://www.citizen.org/documents/Memo%20-%20Unanswered%20questions%20memo%20for%20Geneva.pdf (emphasis in original); Todd Tucker, writing for Global Trade Watch, has expanded on this by giving four interpretations of GATS Article 2(a):

- [The provision] provides no defense under any circumstances and that a WTO panel would have to give it no weight: no prudential policies are allowed;
- [The provision] imposes no constraint under any circumstance: every allegedly prudential policy is allowed;
- [The provision] has to mean SOMETHING. Lawyers are not politicians, and they require every clause in an agreement to have legal effect (known as the "effectiveness" principle). WTO tribunalists would look to the ample jurisprudence from GATT Article XX and GATS Article XIV, which lays out a host of ways in which countries can violate GATS under certain conditions, like when a measure is "necessary to protect human, animal or plant life or health";
- This interpretation starts from the point of view that financial services firms were the most active proponents of GATS in the first place, and "regulators" in developed countries were often more interested in exporting financial services than in defend-

"self-cancelling."[11] As a result, the provision does not function at all as an exception.

This interpretation may be a stretch. A better interpretation is that the exception functions as follows.

The first sentence suggests that WTO Members can take measures for "prudential reasons," even if these measures would otherwise violate other GATS provisions. This part is a fairly typical WTO "exception."[12] Generally speaking, there will be some objective determination as to whether the measure is actually "for prudential reasons," rather than just accepting the Member's declaration of the purpose without further scrutiny. For example, a means-ends test could be applied to the measure and the stated policy goal.

The second sentence narrows the scope of this "exception" to some extent by stating that if the measure at issue violates GATS provisions, it is not completely off the hook when it is found to be for "prudential reasons." Rather, there is an additional legal obligation that still applies: "they shall not be used as a means of avoiding the Party's commitments or obligations." This language has parallels in the GATT Article XX chapeau.[13] In essence, both the second sentence here and

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> ing domestic regulations. For this reason, we would expect the WTO rules on financial services to be less protective of financial services policy space than, say, retail services policy space. Financial firms pushed hard for the toughest disciplines, and created different tiers of obligations for concentric circles of coalitions of the mostly unwilling, the mostly willing, and the most willing.

Todd Tucker, *PMD: "Strictly Business" Interpretations Of A WTO Rule*, PUBLIC CITIZEN, EYES ON TRADE (April 29, 2011), http://citizen.typepad.com/eyesontrade/2011/04/reflections-on-meaning-of-prudential-language-in-the-wto.html. In another publication, he notes "the principle of effective treaty interpretation, which requires that two treaty obligations described using different words be given different meanings. Treaty negotiators and interpreters are familiar with the standard anti-abuse language of the so-called chapeau of GATT Article XX. They chose not to utilize that language, and instead create sui generis language of the PMD." Todd Tucker & Jayati Ghosh, *WTO Conflict with Financial Re-regulation*, ECON. & POL. WEEKLY (Dec. 17, 2011), http://indiaenvironmentportal.org.in/files/file/WTO.pdf.

11. Global Trade Watch, *No Meaningful Safeguards for Prudential Measures in World Trade Organization's Financial Service Deregulation Agreements*, PUBLIC CITIZEN (Sept. 2009), http://www.citizen.org/documents/report-prudential-measures.pdf.

12. To take the most obvious example, *see* GATT, *supra* note 5, art. XX; *see also* GATS, *supra* note 4, art. XIV.

13. The Article XX chapeau begins: "Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, . . ." GATT, *supra* note 5, art. XX.

the Article XX chapeau indicate that the non-protectionist purposes offered to justify the measure must be authentic and real.[14]

The issue, however, is not quite that simple, because the second sentence of the prudential exception is worded in a more confusing fashion than the chapeau. The second sentence of Article 2(a) starts with "[w]here such measures do not conform with the provisions of the Agreement," which is somewhat duplicative of the "[n]otwithstanding any other provisions of the Agreement" language from the first sentence. Implicit in the "notwithstanding" language is that there was a violation of another provision. Restating this point in the second sentence as "[w]here such measures do not conform" may make it seem like this is an additional obligation not to violate the GATS that applies subsequent to the application of the first sentence. Read as a whole, however, the prudential exception corresponds to the chapeau, with the impact that any measures taken for the stated policy reasons not be disguised trade restrictions. But some uncertainty on this remains, as there have been no formal interpretations of this provision in dispute settlement.

B. *Concerns from the U.S. Congress*

In May of 2012, Rep. Sander Levin and then Rep. Barney Frank raised concerns over the language used in U.S. free trade agreements and bilateral investment treaties pertaining to the prudential exception.[15] One concern was that although the exception seems to cover micro-prudential policies of individual financial institutions, it does not appear to "allow governments to respond to system-wide risks to ensure the safety and soundness of the entire financial system" through the use of capital controls.[16] In addition, the Congressmen had concerns with the second sentence in Article 13.10 of the KORUS FTA, suggesting that this sentence "undoes the first part of the clause."[17] With these concerns in mind, they asked Timothy Geithner, who was Treasury

14. As the Appellate Body has stated: "the purpose and object of the introductory clauses of Article XX is generally the prevention of 'abuse of the exceptions.'" Appellate Body Report, *United States—Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, 22, May 20, 1996.

15. Letter from Reps. Sander Levin & Barney Frank to Tim Geithner, Treasury Secretary, Inside U.S. Trade (May 23, 2012), http://insidetrade.com/iwpfile.html?file=may2012%2Fwto2012_1144a.pdf.

16. *Id.* at 2.

17. *Id.*

Secretary at the time, to provide further clarification on the language of the prudential exception.[18]

There are two issues at play here. First, what is the scope of the prudential exception, in terms of whether it covers macroprudential intervention? Second, is the language of the exception stated clearly enough to function as a defense in investor-state disputes or other dispute settlement mechanisms?

Geithner responded to their request, stating that "our FTAs and BITs provide very substantial and adequate flexibility for government policy makers to mitigate such risks, including through the so-called prudential exception and through the monetary and exchange rate policy exception."[19] He went on to say that the footnote to the prudential exception does not in fact limit the government's ability to take prudential measures, because it simply acts to provide "additional examples of measures adopted or maintained for prudential reasons."[20] As a result, it does not serve to outline the entire scope of what a prudential measure is, and who may undertake it.[21]

In response to the criticism of the last sentence in Article 13.10 of the KORUS FTA, Geithner noted that this is an anti-abuse provision "that effectively requires that any such measures are taken for legitimate, and not protectionist, reasons," and also said that this interpretation "is the standard, accepted interpretation of language that is widely incorporated in bilateral and multilateral trade and investment agreements."[22] As a result, Geithner saw no need to either revise the language or to provide any official elaboration on its meaning.

C. *Concerns from Trading Partners*

U.S. Congressmen are not alone in requesting clarification on the freedom to affect macroprudential change under the prudential exception. In October 2011, Ecuador proposed that the Ministerial Declaration for the 8th WTO Ministerial Conference include language instructing the Committee on Trade in Financial Services to "review the WTO rules so as to promote and ensure the preservation of policy space for macro-prudential regulations and the integrity and stability of

18. *Id.* at 3.

19. Letter from Timothy Geithner, Treasury Secretary, to Rep. Barney Frank, Inside U.S. Trade (July 19, 2012), http://insidetrade.com/iwpfile.html?file=dec2012%2Fwto2012_2846a.pdf.

20. *Id.*

21. *Id.*

22. *Id.*

the financial system."[23] At a Committee on Trade in Financial Services meeting soon after, Ecuador explained that "the objective of this proposal was to better understand the practical effect of GATS disciplines on Members' efforts to establish macro-prudential policies and to strengthen the stability of their financial systems."[24] In this regard, one of Ecuador's requests was that "it would be very useful if the Secretariat prepared a Note on the scope of the GATS and gave examples of prudential measures that Members might adopt."[25] Ecuador noted that "[t]he purpose of this proposal is to find the appropriate space to fulfil the objective of increasing Members' confidence in respect of GATS rules and their relationship with current thinking on macro-prudential regulation, while respecting the discussion limits requested by the entire Membership."[26] In reaction to Ecuador's proposals, many other WTO Members were concerned about asking for a formal interpretation, expressing the view that the existing language has functioned just fine. Canada argued that "the GATS prudential carve-out had functioned quite well and had provided Members with the flexibility to safeguard their domestic financial systems and reform their regulatory regimes";[27] it also said that "the GATS had not limited Members' ability to take prudential measures with a view to safeguarding financial stability and reforming their domestic regimes."[28] The EU contended that "the GATS had not limited Members' capacity to take prudential measures necessary to address risks related to the financial crisis. Moreover, any attempt to interpret the prudential carve-out might actually end up narrowing its scope."[29] And the United States said that "the exceptions in the GATS provided Members with wide latitude to

23. Committee on Trade in Financial Services, *Note by the Secretariat: Communication from Ecuador, Proposal for furthering work on Regulatory Measures in Financial Services, for inclusion in the Ministerial Declaration*, ¶ 4, S/FIN/W/80, (Oct. 7, 2011).

24. Committee on Trade in Financial Services, *Note by the Secretariat: Report of the Meeting Held on 31 October 2011*, ¶ 49, S/FIN/M/71, (Nov. 4, 2011).

25. Committee on Trade in Financial Services, *Note by the Secretariat: Report of the Meeting Held on 19 March 2012*, ¶ 5, S/FIN/M/72, (May 31, 2012).

26. Committee on Trade in Financial Services, *Communication from Ecuador, Proposal for Discussing Progress in Respect of Macro-Prudential Regulation and in Relationship with GATS Rules*, ¶ 15, S/FIN/W/84, (June 26, 2012).

27. Committee on Trade in Financial Services, *Note by the Secretariat: Report of the Meeting Held on 31 October 2011*, ¶ 54, S/FIN/M/71, (Nov. 4, 2011).

28. Committee on Trade in Financial Services, *Note by the Secretariat: Report of the Meeting Held on 19 March 2012*, ¶ 14, S/FIN/M/72, (May 31, 2012).

29. Committee on Trade in Financial Services, *Note by the Secretariat: Report of the Meeting Held on 27 June 2012*, ¶ 15, S/FIN/M/73, (July 30, 2012).

impose prudential regulation" and "cautioned against suggestions of conducting a legal review of the prudential exception."[30] Costa Rica stated that "the GATS provided Members with an adequate margin of maneuver. It did not prevent Members from adopting prudential measures. Moreover, no Member had questioned the prudential carve-out so far."[31]

In reaction to these concerns, Ecuador adjusted the nature of its proposals, making clear that they "would not lead to an interpretation of GATS Rules."[32] Instead, it called for more general discussion on this issue, emphasizing that its main concern is:

> ensuring that all countries have the capacity to safeguard the stability of their financial systems, including against any possible escalation of the international financial crisis, on the basis of a clear and agreed understanding of existing WTO regulations, in particular in the context of the discussion on new forms of macro-prudential regulation.[33]

The WTO Secretariat had previously stated, in a background note on financial services, that the prudential carve-out does allow members to regulate as they see fit but that "it is not an unqualified exception."[34] It explained that:

> Even though a measure may have been taken for prudential reasons, and may be considered a priori covered, the measure concerned shall not be used as a means of avoiding commitments or obligations under the GATS. This provision is clearly intended to avoid abuse in the use of the exception.

This line of reasoning echoes the interpretation put forward by Geithner that the prudential exception, while allowing macroprudential regula-

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30. *Id.* ¶ 20.

31. *Id.* ¶ 25.

32. Committee on Trade in Financial Services, *Note by the Secretariat: Report of the Meeting Held on 5 December 2012*, ¶ 8, S/FIN/M/75, (Dec. 21, 2012); *see also*, *WTO Members Accept Scaled-Back Ecuador Financial Services Proposal*, Inside U.S. Trade (Dec. 13, 2012), http://insidetrade.com/Inside-US-Trade/Inside-U.S.-Trade-12/14/2012/wto-members-accept-scaled-back-ecuador-financial-services-proposal/menu-id-172.html.

33. Committee on Trade in Financial Services, *Communication from Ecuador, Proposal for Discussing Progress in Respect of Macro-Prudential Regulation and in Relationship with GATS Rules*, S/FIN/W/84, (June 26, 2012).

34. Committee on Trade in Financial Services, *Background Note by the Secretariat*, S/FIN/W/73, (Feb. 3, 2010).

tion, also includes language to prevent the abuse of the provision for protectionist measures.

IV. Alternative Formulations of the Prudential Exception

As is apparent in Ecuador's criticism, the problem with the defenses of the existing language is that it is not clear what measures qualify as abuse and what constitutes "avoiding commitments or obligations." But the GATS, the KORUS FTA, and the U.S. Model BIT are not the only examples of a prudential exception. Additional formulations contained in Canadian Foreign Investment Protection Agreements and an alternative model proposed by Canada, Japan, Sweden, and Switzerland during the 1991 negotiation of the GATS suggest potential alternatives to the language examined above. These alternatives could better address concerns over the exception and assuage critics.

In examining these alternatives, it is important to distinguish between two separate issues that are at the center of the debate: first, the language used to describe the requirements for meeting the exception (defining what qualifies as abuse); and second, the scope of the prudential measures countries may take in regulating their financial services markets.

A. *Canada's Foreign Investment Protection Agreements*

Canada has entered into a number of investment agreements, called Foreign Investment Protection Agreements (FIPAs), based, like U.S. investment treaties, on a single model. With regard to the prudential exception, Canada's Model FIPA looks a lot like NAFTA Article 1410, which uses similar language and construction. In 2012, Canada concluded a FIPA with the Czech Republic, Article IX of which sets out the prudential exception as follows:

> 2. Nothing in this Agreement shall be construed to prevent a Contracting Party from adopting or maintaining reasonable measures for prudential reasons, such as:
>   a. the protection of investors, depositors, financial market participants, policy-holders, policy-claimants, or persons to whom a fiduciary duty is owed by a financial institution;
>   b. the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions; and

> c. ensuring the integrity and stability of a Contracting Party's financial system.[35]

This provision takes a simple and direct approach to putting a check on the abuse of the prudential exception. The key language here is the use of the term "reasonable measures," which is the counterpart to the "means of avoiding the Party's commitments or obligations" language found in the U.S. Model BIT and the GATS. What measures are considered "reasonable," however, is still quite vague.

In terms of the scope of the measures covered, there are three "reasons" given for prudential measures that serve as examples; preceded by "such as," they are not exclusive, leaving a whole host of other reasons a party might undertake prudential measures. This analysis is in line with Geithner's defense of the prudential exception, but it does not seem to assuage critics.[36] A question worth posing, then, is whether a prudential exception could list all the potential reasons for undertaking prudential measures, or whether this exercise may have the opposite effect and serve to restrict the actions of the contracting parties further by too specifically outlining their rights and obligations.

In contrast to the prudential exception, which is found in paragraph 2, in the Canada-Czech FIPA, that same agreement's language regarding balance of payments, in paragraph 3, is more specific about what actions constitute abuse:

> Article IX.3
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> a. Nothing in this Agreement shall be construed to prevent a Contracting Party from adopting or maintaining measures that restrict transfers where the Contracting Party experiences serious balance of payments difficulties, or the threat thereof, and such restrictions are consistent with subparagraph (b).
> b. Measures referred to in subparagraph (a) shall be equitable, neither arbitrary nor unjustifiably discriminatory, in good faith, of limited duration and may not go beyond what is necessary to remedy the balance of payments situation. A Contracting Party

35. Agreement for the Promotion and Protection of Investments, Can.-Czech, Canada Treaty Information, Jan. 22, 2012, http://www.treaty-accord.gc.ca/text-texte.aspx?id=105128&lang=eng.

36. *See, e.g.*, *No Meaningful Safeguards for Prudential Measures in World Trade Organization's Financial Service Deregulation Agreements*, PUBLIC CITIZEN (Sept. 2009), http://www.citizen.org/documents/report-prudential-measures.pdf.

> that imposes measures under this Article shall inform the other Contracting Party forthwith and present as soon as possible a time schedule for their removal. Such measures shall be taken in accordance with other international obligations of the Contracting Party concerned, including those under the WTO Agreement and the Articles of Agreement of the International Monetary Fund.

Paragraph 3.b explains that in undertaking such measures the contracting parties' measures "shall be equitable, neither arbitrary nor unjustifiably discriminatory, in good faith, of limited duration and may not go beyond what is necessary to remedy the balance of payments situation." This level of detail helps clarify the scope of the exception.

B. *Draft GATS Prudential Exception*

When examining the GATS negotiating history on the prudential exception, it becomes clear that the negotiating parties did not see eye to eye on the exception. In fact, there were a number of proposals on how the exception should be worded, and also on the scope of the measure itself.[37]

One noteworthy example was circulated by Canada, Japan, Sweden, and Switzerland to the GATS Trade Negotiating Committee on October 15, 1991. Alternative language on the prudential exception was put forward as follows:

> Nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Party of *reasonable measures* taken for prudential reasons, including for the protection of investors, depositors, policy-holders or person to whom a fiduciary duty is owned by a financial service provider, or to ensure the integrity and stability of a Party's financial system. Such measures shall not be applied in a manner which would constitute a means of *arbitrary or unjustifiable* (a) *restriction* on the provision of financial services by financial services providers of

37. Todd Tucker, *PMD: "Strictly Business" Interpretations of a WTO Rule*, Public Citizen, Eyes on Trade (Apr. 29, 2011), http://citizen.typepad.com/eyesontrade/2011/04/reflections-on-meaning-of-prudential-language-in-the-wto.html.

> another Party or (b) *discrimination* between domestic and foreign financial service providers or between countries.[38]

The proposal uses the term "reasonable measures," which is the language that is also employed in Canada's FIPAs. It also makes clear two additional points: that the measures not be "arbitrary or unjustifiable" restrictions on trade nor used as a means for "arbitrary or unjustifiable . . . discrimination between domestic and foreign financial service providers." The critical point here is that instead of using more general anti-abuse language, this version of the prudential exception specifically defines abuse as either "arbitrary or unjustifiable" trade restrictions or discrimination, terms that both have a clearer meaning than "means of avoiding the Party's commitments or obligations" as found in the GATS, the U.S. Model BIT, and the KORUS FTA.

V. Recommendations for Revising the Prudential Exception

Having outlined the flaws perceived by critics in the existing prudential exception provisions, we now offer suggestions for revised language in the context of the TTIP that will function properly and reassure skeptics. There are three elements to this proposal.

First, the "anti-avoidance" language should be better tailored to serve its actual purpose. In this regard, rather than a vague reference to "avoiding the Member's commitments or obligations," the provision should clearly set out its scope. Secretary Geithner has made clear that this provision is about avoiding "protectionism."[39] To better reflect this goal, the language should be changed to focus clearly on this principle. The standard GATT and GATS exception language in this area has worked well for this purpose: "Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail."[40]

Second, the duplicative introductory part to the second sentence—"Where such measures do not conform with the provisions of the Agreement"—should be removed. Its similarity to language in the first

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38. Trade Negotiations Committee, *Communication from Canada, Japan, Sweden and Switzerland*, 4, MTN.TNCIW/50/Add.2, (Oct. 15, 1991), www.wto.org/gatt_docs/English/SULPDF/92130041.pdf, (emphasis added).

39. Letter from Timothy Geithner, Treasury Secretary, to Rep. Barney Frank, Inside U.S. Trade, (July 19, 2012), *available at* http://insidetrade.com/iwpfile.html?file=dec2012%2Fwto2012_2846a.pdf.

40. *See* GATT, *supra* note 5, art. XX; GATS, *supra* note 4, art. XIV.

sentence has led to confusion and uncertainty about the operation of the provision.

And finally, it should be made clear that measures intended to prevent systemic risks are covered by the prudential exception. Existing explanations of prudential measures are merely illustrative, and do not exclude systemic issues, but it is worth clarifying that they are covered.

With all of these elements in mind, we offer the following language:

> Notwithstanding any other provisions of the agreement, and subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, 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.

A concern raised by one Treasury official is that any change in future treaties would be an admission that the current language does not work, and would thus affect the interpretation of existing treaties.[41] As an interpretive matter, it is not clear that this is true. If it were a real concern, though, clarifications could be added to existing treaties as to their scope.

As a further point, all the focus by critics on the legal aspects of this issue—legal claims and possible defenses—may distract from a more cooperative approach that is available. Paragraph 3(a) of the GATS Financial Services Annex makes it clear that governments can work together on these matters:

> A Member may recognize prudential measures of any other country in determining how the Member's measures relating to financial services shall be applied. Such recognition, which may be achieved through harmonization or otherwise, may be based upon an agreement or arrangement with the country concerned or may be accorded autonomously.

41. Letter from Reps. Sander Levin & Barney Frank to Tim Geithner, Treasury Secretary, Inside U.S. Trade, (May 23, 2012), *available at* http://insidetrade.com/iwpfile.html?file=may2012%2Fwto2012_1144a.pdf.

Paragraph 3(a) assumes that Members are likely to undertake diverse approaches to financial regulation. Divergence in regulation can therefore be expected, and Members must learn to work through these differences, or collaborate with other Members and attempt to bridge these divides. Article 3(a) goes on to say that "such recognition, which may be achieved through harmonization or otherwise, may be based upon an agreement or arrangement with the country concerned or may be accorded autonomously." This means that Members can unilaterally accept another Member's regulation as sufficient, or they can work together towards mutual recognition or harmonization of regulations. This provision acknowledges that prudential regulation of the financial services market is inevitable and is likely to diverge across markets. But it emphasizes that, to deal with any trade concerns, members can work out their differences cooperatively, without jumping into litigation.

VI. Conclusion

The EU has continued to push for liberalization of financial services through the TTIP.[42] There are many complex issues in this regard, but to the extent that the prudential exception raises concerns for the U.S. negotiators and regulators, simple drafting fixes should make it clear that liberalization will not interfere with appropriate prudential regulation. Abuse of the exception can be avoided by requiring that measures be made for well-defined prudential reasons and that they not discriminate against trading partners.

42. European Commission, EU-US Transatlantic Trade And Investment Partnership (TTIP), Cooperation on Financial Services Regulation, Jan. 27, 2014, http://trade.ec.europa.eu/doclib/docs/2014/january/tradoc_152101.pdf. In a paper on the subject, the Commission put it this way: "The need to address regulatory barriers is particularly evident in the financial services sector. The financial crisis showed in stark clarity that financial markets are global and deeply interconnected. The global nature of financial services allows systemic risks to be transmitted across national borders. Financial stability is not served by a fragmented regulatory approach, inconsistent rules and a low level of co-operation among supervisors."