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The Subject Matter of the Study

1.1 The Issue

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

Some authoritative documents, including the 2009 *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System*, have pointed to trade agreements – both at the multilateral as well as the bilateral level – as being among the drivers for the deregulation that has taken place in many jurisdictions since the mid-1990s.[1] In particular, the claim is that trade liberalisation has limited the possibility for domestic governments to support the stability of their financial systems.

Most trade agreements dealing with financial services include a provision that aims to preserve some regulatory freedom for Members wishing to step in and modify the existing domestic rules on financial services for 'prudential reasons'. The paradigmatic example in this regard is the PCO of the GATS, which allows WTO Members to adopt measures they deem appropriate for prudential reasons when regulating trade in financial services. Due to the importance of the objectives pursued by the provision, it is extremely important to clarify its scope of application and legal function in light of the 2007–8 financial crisis and the worldwide regulatory developments that ensued.

[1] See para. 208: 'The framework for financial market liberalization under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors.' The document is available at www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf. All websites were last accessed on 30 October 2017.

The GATS PCO has been a 'sleeping beauty' for more than twenty years. Recently, the Panel in *Argentina – Financial Services* was confronted with the issue. The Panel immediately classified the provision as an exception and deliberately ignored supplementary means of interpretation in its assessment. This volume argues that there is at least one other permissible interpretation of the provision, which would classify it as a 'provision that excludes the application of other provisions'.

The issue of the classification and the legal function performed by a provision of an international agreement is not a mere academic quandary. Grando[2] has conducted a comprehensive analysis of the way in which WTO case law distinguishes between the various rules that allow Members to be exempted from compliance with more generic rules. The author subdivided the various provisions she analysed into two categories: 'exceptions' and 'provisions that exclude the application of other provisions'.

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

The classification of the PCO as a 'provision that excludes the application of other provisions' implies that, in the event of a dispute, the burden of proof should be allocated to the Member alleging a violation of one or more WTO obligations and not on the regulating Member. Moreover, WTO panels and the Appellate Body should be extremely careful when scrutinising the policy choices made by domestic governments in pursuit of prudential objectives as the text and the rationale of the PCO allow them substantial freedom.

The aim of this volume, moreover, is to provide the first comprehensive overview and analysis of prudential carve-outs in free trade agreements on financial services; such analysis had never been conducted. The relevance of this study is twofold: first, it provides an analysis of the state of the art of the evolution of trade rules at the bilateral level (i.e. the only domain where there has been such evolution in light of the deadlock of the multilateral

[2] Michelle T. Grando, *Evidence, Proof and Fact-Finding in WTO Dispute Settlement* (Oxford: Oxford University Press, 2009), p. 152.

negotiations at the WTO); second, it provides ideas for amendments to the current formulation of the GATS PCO, which is admittedly not drafted in the clearest possible fashion.

1.2 Presentation of the Rest of the Volume

The remainder of this volume is structured as follows. Chapter 2 provides the necessary context to the analysis that is conducted in the book. It first recalls the history of the negotiations of the GATS Annex on Financial Services and the role played by prudential concerns at that time. The chapter then examines the economic rationales for prudential regulation and gives account of the evolution of prudential concerns at the national and international level since the entry into force of the GATS. In particular, the chapter looks at regulatory developments that have taken place in national jurisdictions in the aftermath of financial disruptions and provides an overview of the work done by international standard-setting forums. The chapter also gives an account of the most common prudential measures adopted by domestic legislative authorities.

Chapter 3 describes the current understanding of the GATS PCO. It first examines the way in which the provision has been interpreted by the literature so far, then offers an account of the discussions conducted within the Committee on Trade in Financial Services of the GATS in which several Members have indicated that they are not at ease with the formulation of the provision and have even submitted proposals for reform. The chapter also reviews the way in which the GATS PCO was dealt with in the only WTO dispute so far where it was invoked: *Argentina – Financial Services*.

In Chapter 4, an examination is conducted to establish whether PCOs are included in preferential trade agreements (PTAs) and to identify common patterns as well as the different typologies of provisions that have emerged since the late 1990s. It is noted that the model set up in the GATS is still the most commonly adopted in trade negotiations. It is also shown that Members, when they want to 'lock in' their trade commitments and ensure that the PCO is narrowly interpreted or only available upon satisfaction of one or more requirements (be it a necessity test or a non-discriminatory application of prudential measures), have the necessary tools to do so. It is emphasised that this happens only in a minority of cases, given that the overwhelming majority of preferential PCOs give parties substantial leeway when they regulate financial markets according to prudential concerns. Finally, developments in current negotiations are also examined. Given that the PCO in the GATS is rather obscure

in terms of its language and not particularly efficient, an overview of the developments in preferential negotiations is instrumental in understanding whether some already existing features in other trade agreements can be imported at the multilateral stage.

Chapter 5 seeks to illustrate that there are a number of problematic implications of the mainstream interpretation of the PCO. By importing the case law on exceptions into the domain of the PCO, this volume shows how the former cannot easily be reconciled with the wording of the PCO, the intention of the drafters or the economic rationale behind prudential regulation.

The economic analysis, combined with the negotiating history of the PCO, shows that the main desire of the negotiators was to avoid Type I errors (false positives), i.e. situations in which the court finds against a defendant, even though the behaviour of the latter was not unlawful. This outcome can hardly be reconciled with the mainstream interpretation advanced by the few scholars who have attempted to analyse the PCO. The classification of the PCO as an exception would imply a different rationale for the provision, namely that of avoiding Type II errors (false negatives), which are those cases in which the judges find in favour of the defendant even though its behaviour was unlawful. In other words, in the realm of 'exceptions', a legal system considers erring in favour of the complainant a less harmful option than erring in favour of the Member invoking the exception in the event of a dispute. The discussion conducted in Chapter 5 proves that there are solid textual, contextual, historical and economic reasons that permit an alternative interpretation of the PCO.

Chapter 6 concludes the work. It acknowledges that, notwithstanding the various readings that can be made of the PCO, the language of the latter is not sufficiently clear and reveals inefficiencies in its construction. Therefore, the present volume suggests possible paths that can be followed should WTO Members decide to reform the provision, mostly drawing inspiration from preferential PCOs.