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Memo

To: Honorable Members of the Senate Finance Committee
From: Lori Wallach and Todd Tucker, Public Citizen
Date: May 21, 2010
Re: Answering critical questions about conflicts between financial reregulation and WTO rules raised by Finance Committee Trade Subcommittee Chair Wyden that USTR dismissed

In the wake of the worst financial and economic crisis since the Great Depression, diverse government officials, legislators and scholars have been raising questions about the potential for U.S. trade and investment agreements to conflict with needed financial services reregulation. Of particular concern are the provisions in the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS), which set limits on the policies WTO signatories can maintain or establish with respect to financial service sectors they have committed to GATS.

Senate Finance Committee Trade Subcommittee Chair Ron Wyden (D-Ore.) submitted a written question on this matter after Ambassador Ron Kirk of the Office of the U.S. Trade Representative (USTR) testified to the committee on March 3, 2010. USTR's response did not address one element of Senator Wyden's inquiry (concerning the GATS' ban on capital controls) and summarily dismissed the others.

However, Senator Wyden was spot on in his questions and has identified a serious problem that requires redress.

In this memo we provide a more fulsome response, which demonstrates that, in fact, the possible conflict Senator Wyden raised between WTO rules and financial regulation is a serious concern. Senator Wyden's inquiries are very timely. Proposals submitted prior to the global financial crisis by the United States and other WTO nations remain on the table in WTO Doha Round negotiations. These proposals would impose further regulatory constraints on the financial sector.

The conflict about which Senator Wyden inquired was highlighted in the 2009 report of the UN Commission of Experts on Reforms of the International Monetary and Financial System, chaired by Nobel Prize winner Joseph Stiglitz:

> "Agreements that restrict a country's ability to revise its regulatory regime – including not only domestic prudential but, crucially, capital account regulations – obviously have to be altered, in light of what has been learned about deficiencies in this crisis. In particular, there is concern that existing agreements under the WTO's Financial Services Agreement might, were they enforced, impede countries from revising their regulatory structures in ways that would promote growth, equity, and stability." …[1]

Indeed, the GATS and the financial service chapters of U.S. free trade agreements (FTAs) conflate *liberalization* of financial services with *deregulation*. These pacts' market access rules specifically forbid maintaining or establishing a list of non-discriminatory regulatory measures with respect to financial sectors countries have committed to liberalization. The pacts also contain provisions setting disciplines on other forms of domestic regulation, such as licensing and technical standards. The pacts also discipline facially neutral regulations of general application that might have a less favorable effect on foreign firms and services. (For more information on these rules, please see our report "To Promote Economic Stability, Nations Must Free Themselves from WTO Financial Deregulation Dictates," available at:
http://www.citizen.org/documents/IntroductionToWTODeregulation.pdf.)

In summarily stating in its response to Senator Wyden's written question that WTO rules present no limits on financial regulation, USTR is relying heavily on a GATS prudential measures defense provision that countries can employ if a financial regulation were challenged as violating GATS policy constraints. This provision – codified in the GATS Annex on Financial Services Article 2(a) – has also been included with minor changes in various FTAs and U.S. bilateral investment treaties (BITS). This provision contains language that is at best extremely ambiguous, and according to some legal scholars, makes the measure almost impossible to use to defend prudential measures that might violate GATS terms. In a paper we produced for the Ford Foundation last year, we argue that several GATS rules related to financial services, including the prudential measures defense provision, urgently require reform. These GATS terms were agreed in the mid-1990s during the height of the deregulation craze. Now, post-crisis, they require alteration to provide policy space for reregulation.[2]

This memo specifically addresses Senator Wyden's questions. It also briefly examines the historical record – including information on the GATS' regulatory constraints, and a 1990 memo from now-Treasury Secretary Geithner (then a junior Treasury staffer in the first Bush administration) obtained through an ongoing Freedom of Information Act (FOIA) request by Public Citizen. These documents show that legislators do not have to start from scratch when contemplating how the GATS rules conflict with financial regulatory policies, or how to fix this problem.

USTR'S UNFORTUNATE DISMISSAL OF SEN. WYDEN'S GOOD QUESTIONS

Senator Wyden submitted the following written questions after the March 3 hearing with USTR Kirk:

> "Some have suggested that the WTO General Agreement on Trade in Services contains rules that can limit the types of financial service regulations we can apply here in the United States. Furthermore, it has been argued that the current WTO rules prohibit regulatory bans and policies that restrict unfettered capital flow, which could make it more difficult to limit the size of financial firms and the types of services and products they provide. What is the USTR's view about these arguments? Is the USTR considering proposing any changes to WTO rules to ensure that the U.S. is not limited in any way to impose reforms to manner in which financial services are regulated, including stricter prudential standards?"

USTR responded that [for convenience, we number their key points]:

> "The WTO and all of our free trade agreements provide flexibility for governments to regulate and to develop new regulations. These agreements [1] also expressly allow the Parties to take prudential measures to ensure the stability of the financial system and to protect depositors; and [2] explicitly preserve the ability of a central bank or monetary authority to adopt measures pursuant to monetary and related credit policies or exchange rate policies. Because U.S. regulatory discretion is already protected by WTO rules, we do not see a need to propose any changes."

To our knowledge, neither the USTR, Treasury Department, or the WTO Secretariat have ever released a formal, comprehensive legal analysis of the GATS prudential measures defense (GATS Annex 2(a)) language on which such airy dismissals of this problem rely. When theses entities are confronted with questions about the conflict between GATS and financial regulation or the prudential provision's scope, they "reassure" or "cite" unofficial sources as suggesting there is nothing to be worried about.[3] In the following subsections, we refute USTR's arguments, and show that Senator Wyden's inquiry about changes needed to WTO rules deserves further consideration.

WIDE AGREEMENT ON WEAKNESS OF GATS PRUDENTIAL LANGUAGE

USTR's point number 1 refers to the GATS Annex on Financial Services Article 2(a), which reads:

> "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*" [italics added].

As the second sentence makes clear, prudential measures *are only allowed* under GATS rules *if they don't violate any of the GATS rules*, which are very expansive. Yet, a country would only need to employ this defense *if* its financial regulation were challenged in a trade tribunal as violating GATS rules. Similar restrictions on prudential measures are in place in a dozen bilateral trade and investment agreements negotiated by the Bush administration.[4]

USTR states that our trade agreements "also expressly allow the Parties to take prudential measures to ensure the stability of the financial system and to protect depositors." Yet, a comprehensive literature review spanning two decades of trade law publications conducted by Public Citizen found agreement that financial prudential measures are subject to dispute settlement, and could be ruled against. (To see our report detailing these findings, see http://www.citizen.org/documents/PrudentialMeasuresReportFINAL.pdf.)[5] Indeed, while analysts disagree about how the GATS prudential measure defense clause would operate if triggered as a defense, they all agree that it does not prohibit challenges of prudential measures, that it is at best confusing, and that a WTO tribunal would have the final say.

In fact, in a NAFTA tribunal hearing in a case brought against Mexico, which dealt with language similar to the GATS prudential measure defense clause, confirmed this point.[6] The target of the NAFTA challenge was a series of measures related to Mexico's bailout of its financial sector: Mexico deemed these "prudential" in nature, while a U.S. insurance firm, Fireman's Fund, claimed they constituted an indirect expropriation (among other violations) requiring compensation under NAFTA.

The Commission of Experts on Reforms of the International Monetary and Financial System was convened by the United Nations General Assembly president in the fall of 2008, in the early days of the financial crisis. It was chaired by Nobel Prize winner Joseph Stiglitz, with the participation of a host of distinguished academics, including former finance ministers and central bank heads from around the world. In September 2009, the Commission released a comprehensive report calling for changes to the global regulatory ceiling imposed by trade pacts like the World Trade Organization. Among the report's findings:

> "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."[7]
>
> "More broadly, all trade agreements need to be reviewed to ensure that they are consistent with the need for an inclusive and comprehensive international regulatory framework which is conducive to crisis prevention and management, counter-cyclical and prudential safeguards, development, and inclusive finance. Commitments and existing multilateral agreements (such as GATS) as well as regional trade agreements, which seek greater liberalization of financial flows and services, need to be critically reviewed in terms of their balance of payments effects, their impacts on macroeconomic stability, and the scope they provide for financial regulation. Macroeconomic stability, an efficient regulatory framework, and functioning institutions are necessary preconditions for liberalization of financial services and the capital account, not vice versa. Strategies and concepts of opening up developing economies need to include appropriate reforms and sequencing. This is of particular importance for small and vulnerable economies with weak institutional capacities. But there has to be a fundamental change in the presumptions that have guided efforts at liberalization. As noted in previous chapters, one of the lessons of the current crisis is that there should be no presumption that eventually there should be full liberalization. Rather, even the most advanced industrial countries require strong financial market regulations."[8]

Similar analytical conclusions – if contrary policy recommendations – came from the multinational corporation-dominated Emergency Committee for American Trade. In the group's comments on the GATS-based prudential language in the U.S. Model Bilateral Investment Treaty (BIT), they state that stronger prudential measures language – to allow for capital controls, for instance – would undermine the very policy-restricting purpose of the provision.[9]

MONETARY POLICY NOT PROTECTED FROM CHALLENGE

On USTR's second point related to monetary policy, this too is an obfuscation of reality. As Bart de Meester, a WTO expert and legal fellow with Belgium's Institute for International Law, concluded in a recent paper:

> "The concept of 'service' in the GATS is a broad one and covers 'any service in any sector except services supplied in the exercise of governmental authority.' 'Financial Service' is defined in the Annex as 'any service of a financial nature offered by a financial service supplier of a Member' and a non-exhaustive list of financial services is provided. However, the Annex on Financial Services provides a more specific definition for the excluded services than the one in Article I GATS. The Annex excludes the following activities from the scope of the GATS: (i) activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies; (ii) activities forming part of a statutory system of social security or public retirement plan and (iii) other activities conducted by a public entity for the account or with the guarantee or using the financial resources of the Government. *Importantly, this does not mean that the measures taken by a central bank or monetary authority or other public entity are outside the scope of the GATS. Activities conducted by a central bank, monetary authority or any other public entity in pursuit of monetary or exchange rate policies are not considered 'services' within the scope of the GATS.* Hence, if a government adopts a measure that affects such activities, this measure cannot be scrutinised under the GATS. However, *if a central bank or monetary authority elaborates an assistance programme, this does not mean that such assistance programme is outside the scope of the GATS (provided it affects trade in services*)" (emphasis added)."[10]

Indeed, many U.S. monetary, credit or exchange rate policy could violate GATS Article XVI market access or Article XVII national treatment terms, and thus affect "trade in services." This possibility was noted in a memo by current Treasury Secretary Geithner in his early career at Treasury (as we detail below). And other WTO members are already scrutinizing the dozens of U.S. bailout measures for their GATS consistency,[11] while a wide range of policy experts on all sides of the trade debate are calling for WTO cases against China's exchange rate policy[12] – a key monetary measure by that country.

NO AGREEMENT ON DEFINITION OF "PRUDENTIAL"

Many policies that countries apply for prudential reasons may not be considered prudential by other countries or by WTO panels. The types of financial service regulations that have been considered "prudential" range from minimum capital requirements for depository institutions, to leverage restrictions, to various consumer protection policies, and beyond. Many countries' governments consider restrictions on capital inflows and outflows – both in crisis and non-crisis times – to be prudential in nature.[13] In the General Agreement on Tariffs and Trade (GATT) Uruguay Round debates, Mexico, India and many other developing countries' representatives stated that infant industry protection applied to promote the development of domestic financial sectors should be considered prudential in nature.[14] In the current re-regulation debate, there are far-ranging proposals for enhanced consumer protection measures, including the notion of adopting a precautionary principle approach for new financial instruments (i.e. the burden of proof is on the creator of a new financial product to show it is safe and useful to society and thus should be approved by government regulators).[15] Indeed, economists across the political spectrum – from the Keynesian Hyman Minsky to the former Federal Reserve economist John Boyd, a self described "laissez faire" economist – have advocated a variety of regulatory interventions to keep banks small and oriented towards community lending.[16]

How a WTO panel would rule on a challenge to such measures is unclear, but many governments and corporations have let it be known that they favor sharp limitations on which policies should be considered prudential.[17] Indeed, some pro-GATS scholars suggest that WTO panels should limit the definition of prudential measures to only Basel II-type requirements.[18] (Basel II refers to an agreement reached by central bankers from developed nations – under substantial industry influence – in 2004, which includes highly flawed notions of bank capital adequacy based on banks' own "internal risk models."[19]) The opening for such a low-road approach provided by the mere presence of WTO-style "disciplines" on domestic regulation can encourage a race to the bottom and lowest common denominator regulation.

DEEP CONCERNS OVER SCOPE OF CAPITAL CONTROL PROVISIONS

USTR did not answer Senator Wyden's inquiry about capital controls. However, the GATS includes disciplines on capital management techniques (noted by the Stiglitz Commission and detailed in another Public Citizen memo) that are especially worrisome. They could impair countries' ability to guarantee financial stability through transaction or speculation taxes, as the European Commission recently noted in a staff working paper on the topic:

> "the compatibility of such a levy with Article XI of the General Agreement on Trade in Services (GATS), which provides that WTO Members cannot apply any restrictions on international transfer and payments for current transactions relating to their specific commitments, would have to be further assessed. As the EU has taken specific commitments relating to financial transactions, including lending, deposits, securities and derivatives trading and these commitments relate to transactions with third countries, a currency transactions tax could constitute a breach of the EU's GATS obligations."[20]

There is significant concern that the GATS Annex 2(a) language would not provide any safe harbor for capital management techniques. This was the conclusion of two University of Zurich Law School scholars whose writings tend towards supportive of the current WTO regime, Rolf Weber (also a WTO panelist) and Christine Kaufmann in a recent study of the provisions:

> "The right of a member to issue or maintain such prudential regulation seems to find its limits in Article XI GATS. Indeed, paragraph 2 of the Annex on Financial Services underlines that the prudential carve-out should not be used to avoid commitments or obligations under the GATS Agreement. This sheds uncertainty on the relationship between the Annex on Financial Services and the GATS, in particular Article XI GATS. The issue is well illustrated by the current request from the EC to Chile to lift its requirement that a prior authorization by the Central Bank is necessary before profit repatriation to be allowed. Such restrictions are indeed considered by the EC to be in breach of Article XI… If this provision

is interpreted as prevailing over the prudential carve-out, it seems to prevent countries from taking prudential measures with respect to payment in transfers, in fact measures, which could be 'nevertheless very effective for dealing with financial stability.'"[21]

DIPLOMATIC RESTRAINT AS A SAFEGUARD AGAINST CHALLENGES OF FINANCIAL PRUDENTIAL MEASURES IS OVERSTATED

Another of the arguments embedded in claims that the WTO financial service provisions do not eliminate countries' prudential policy space is that, as a former U.S. regulator noted, only governments can bring WTO cases.[22] That is to say, governments would operate under some sort of diplomatic screening process that would result in certain fights not being picked because a government would take into consideration that an attack on another country's prudential regulation could later boomerang into an attack on that country's own policies.

This is a highly debatable notion, as most recently demonstrated with Panama's announcement that a major plank in its effort to be removed from tax haven watch lists is to launch WTO cases against countries that put them on such lists.[23] (Panama has previously commented in WTO sessions that countries that place limits on the financial service transactions of countries deemed tax havens are violating WTO rules.)[24] Some countries' whose economies are highly dependent on tax havens (such as Aruba, Liechtenstein, the Netherland Antilles and Switzerland) have taken deep commitments under the GATS Understanding on Commitments in Financial Services (an agreement that creates additional deregulatory obligations for WTO members that opted to take them).

In sum, countries whose economies revolve around offshore activities may conclude that the *real economic* costs of stoically suffering U.S. anti-tax haven measures outweigh the *theoretical diplomatic* benefits of keeping quiet at the WTO. Indeed, this is proven by the case of Antigua, which decided to prioritize its economic interests in offshore gambling revenue over predictable U.S. fury when it challenged U.S. Internet gambling measures at the WTO.

WTO FINANCIAL SERVICES PROVISIONS LOCK IN DEREGULATORY POLICIES

Former U.S. Treasury official Barry Newman, who went on to work at Bear Stearns, was unusually candid in his assessment of the benefits of NAFTA-style trade pacts. He told a 1993 congressional hearing on NAFTA financial services provisions that: "future Mexican governments may change, and they may not have the same attitudes of the current government. The benefit of NAFTA is that it will lock into an internationally legally binding and enforceable agreement the kinds of changes that the present government is seeking and that we are strongly encouraging so that it will be very much more difficult for future governments to pull back from what is now being developed in the context of the NAFTA."[25]

It would be difficult to find a clearer exposition of the real dangers associated with including legally binding limits on domestic financial service regulation in trade pacts. When the WTO financial services provisions were negotiated and implemented, there was a prevailing consensus that the shift to deregulation would be permanent. This consensus has been all but swept away after the 2007-09 financial meltdown, but the binding trade obligations remain. This situation is of special consideration with respect to the United States, because we have among the most expansive GATS financial service commitments, including in banking, insurance, securities, mutual funds, derivatives, and more.

WIDE CONSENSUS FOR CLARIFICATION OF GATS OBLIGATIONS

Even WTO defenders argue that renegotiation of the GATS rules on domestic prudential regulation of financial services would be useful. They acknowledge that leaving the definition of acceptable prudential measures up to a WTO panel risks the legitimacy of the entire system. As leading GATS proponents Pierre Sauvé and James Gillespie have written, there should be some "clarification of the boundaries of the 'prudential carve-out,'" and note that "it would be far better (in terms of regulatory legitimacy) for such a clarification to arise from a negotiated understanding among regulators than from a panel ruling (regardless of the degree of financial expertise panelists might have)."[26]

And the International Monetary Fund (IMF), which is generally in favor of increased trade in financial services, appears to agree. As Deborah Siegel, senior IMF counsel, has written, the GATS lacks clear definitions of what types of capital controls the agreement restricts, and could result in a situation where IMF-approved or IMF-allowed policies could be GATS violations. She states: "Leaving issues of the Fund / WTO relationship to the WTO's dispute settlement panels effectively amounts to allocating the conduct of international relations to judges; experience shows that the judicial process alone cannot properly ensure coordination between international organizations."[27]

Thus, both WTO critics and defenders share an interest in renegotiating the space for prudential policies in the GATS.

ALTERNATIVE GATS FRAMEWORKS FOR PRUDENTIAL MEASURES POSSIBLE

When thinking of how to reformulate a balanced prudential carve-out that truly protects reregulation, legislators need not delve into any radical tomes.

In the Uruguay Round negotiations, there were several alternative proposals for a WTO financial services prudential exception that would have more fully protected financial stability policies, but these were rejected in favor of the current GATS language.

In June 1990, Felipe Jaramillo, the Colombian diplomat in charge of the Uruguay Round services negotiations, proposed five options for a carve-out provision that could protect countries' financial stability measures. Each of these options would have entailed more policy space than what the United States and other developed country governments desired and eventually obtained in the WTO text. According to the negotiators' meeting minutes (the only record we have of this debate), the options…

> "ranged from narrow to broad in scope. The first option provided for a prudential carve-out limited to a qualified national treatment provision. The second option was broader, permitting all 'reasonable' prudential and fiduciary measures. Option three was a variation of option two, enumerating examples of permissible measures. Option four provided for an unqualified right to take such measures. Option five aimed at defining as precisely as

possible the prudential actions that would be permitted, so as to reduce legal uncertainties."[28]

Similarly, the negotiating history of the Uruguay Round showed that countries contemplated – and ultimately rejected – versions of the text that would have allowed countries to maintain capital controls. The chair of the Uruguay Round Working Group on Financial Services had outlined four negotiating options:

> "The latter paper listed four options relating to payments and transfers matters, ranging from the obligation to freely permit all payments and transfers related to the provision of financial services which were liberalized under the agreement (option 1) to the 'no obligation' option (option 4). An intermediate option (option 2) would permit restrictions on current payments that were in conformity with the regulations of the IMF, as well as restrictions on capital account transaction that were necessary because of severe balance-of-payments problems. Option 3 would combine a grandfathering of existing restrictions on payments and transfers with option 2, applicable to new restrictions."[29]

Option 3 or 4 would have provided more policy space than the resulting Option 2 of the final GATS text, and yielded rules consistent with the IMF Articles. Yet the European Commission, for one, noted that it was precisely *because* the IMF Articles of Agreement contained "no direct obligations applied to restrictions on capital movements" that these new disciplines were needed. The EC worried that "Restrictions on payments and transfers could be imposed for reasons other than current account/balance of payments difficulties, such as monetary policy concerns, particularly in foreign exchange and/or capital markets, disturbances in the conduct of monetary and exchange rate policies, etc." and wanted to ensure that any such restrictions should be "monitored against the backdrop of agreed disciplines" and "should be limited in nature and time."[30]

In September 1990, the Malaysian delegation circulated a proposal for a GATS structure that was also endorsed by Indonesia, Thailand, Nepal, Sri Lanka, Korea, the Philippines, and Singapore to the members of the GATT "Working Group on Financial Services including Insurance." The maintenance of prudential measures was a theme throughout,[31] and the prudential carve-out itself read:

> "(v) Domestic regulation (prudential regulation)
>
> Compliance of the MFTS and sectoral annotations on financial services should not impinge on a supervisory authority's right to:
>
> (a) Exercise adequate and proper supervision over the foreign financial institutions operating in its country;
> (b) Implement rules and regulations to ensure that foreign financial institutions maintain sound and prudent practices and policies;
> (c) Take necessary action for the protection of depositors and investors; and
> (d) Allow flexibility to governments to impose measures for maintenance of stability in the financial system.

Measures taken for prudential reasons should not be subject to any dispute settlement procedure."[32]

FOIA DOCUMENTS SHOW EVEN GEITHNER THOUGHT MORE POLICY SPACE WAS NEEDED

Even the U.S. government had advanced GATS proposals more protective of policy space. As documents released to Public Citizen under FOIA indicate, as early as April 1990, an under-30 year old Treasury Department official named Timothy Geithner raised the possibility that Glass-Steagall firewalls, state level regulations, and other prudential measures could be challenged under the new global rules… if the rules were insufficiently deferential to national regulators.[33] The GATS draft that the first Bush administration had tabled by that time was less expansive than the final product: it defined market access and national treatment narrowly to target only overtly discriminatory conduct.[34]

What a difference a few years can make. By December 1991, the WTO financial services terms would be completed, and would include, for covered sectors: a ban on regulatory bans, even non-discriminatory ones (i.e. simply forbidding a hazardous activity in a covered sector); a ban on size limits on banks or other financial service providers; a ban on measures to stem capital floods and flights; and a ban on non-discriminatory measures that that inadvertently "modify the conditions of competition in favor of services or service suppliers" in the domestic market. (The first three examples refer to the GATS Market Access Article XVI obligations; the last example refers to the National Treatment Article XVII obligations.)

The Bush and Clinton administrations agreed to conform a vast array of U.S. financial services to these rules, and would further commit to the "the Understanding on Commitments in Financial Services," an incredibly pro-deregulation additional agreement. The Understanding includes a "standstill" provision which binds the United States from creating new regulations (or reversing past deregulation) in a variety of ways. They would also commit to allow in "new financial services" – no matter their risk level. Geithner, who had originally worried about the compatibility of GATS with non-discriminatory regulations, was dispatched to sell the more intrusive version of the GATS. A November 24, 1997 document obtained through FOIA show that Geithner was urging his then-boss, Deputy Treasury Secretary Larry Summers, to call Goldman Sachs and other corporations to gauge support for the GATS talks.[35]

LOOKING FORWARD

The WTO threat to financial services reregulation – both at home and abroad – is far from a hypothetical concern, as the European Commission report citing the conflict between GATS and a financial transaction tax noted above shows. And, as the final WTO Appellate Body ruling reaffirmed in the *US – Measures Affecting the Cross-border Supply of Gambling & Betting Services* case (Antigua's successful challenge of the U.S. ban on internet gambling), both regulatory bans and cross-border financial flow restrictions are prohibited by the GATS. In the case, the U.S. prohibition on both U.S. *and* foreign gambling companies against offering online gambling to U.S. consumers was found to be a "zero quota" and thus violate GATS market access requirements.[36] In the case, Antigua also alleged that

> "the United States maintains measures that restrict international money transfers and payments relating to the cross-border supply of gambling and betting services. In particular, Antigua points to the laws of the state of New York that render contracts that are based on wagers or bets void as well as an example of an 'enforcement measure' taken by the New York Attorney General against a financial intermediary that provides Internet payment services. In Antigua's view, the purpose of these measures is to prevent foreign suppliers of gambling and betting services from offering their services on a cross-border basis. Antigua argues that, therefore, these measures violate Article XI:1 of the GATS."

The WTO panel ruled that:

> "Article XI has not, as yet, been the subject of interpretation or application by either panels or the Appellate Body. In light of this and taking into account the limited facts and arguments submitted by the parties with respect to Antigua's claim under Article XI, we believe that there is not sufficient material on record to enable us to undertake a meaningful analysis of this provision and its specific application to the facts of this case … However, the Panel wants to emphasize that Article XI plays a crucial role in securing the value of specific commitments undertaken by Members under the GATS. Indeed, *the value of specific commitments on market access and national treatment would be seriously impaired if Members could restrict international transfers and payment for service transactions in scheduled sectors. In ensuring, inter alia, that services suppliers can receive payments due under services contracts covered by a Member's specific commitment, Article XI is an indispensable complement to GATS disciplines on market access and national treatment" [italics added].*[37]

The existing GATS restrictions on financial services regulation could become yet more intrusive on domestic policy space if the current WTO Doha Round agenda is completed. The pre-crisis demands by the Bush administration for further financial service commitments under the current deregulatory rules remain on the table as the U.S. position.

Indeed, USTR has actively pressed other countries to make deeper deregulatory commitments in financial services… despite the financial crisis proving the deregulation model misguided. The United States remains a signatory to a Doha Round plurilateral request on financial services offered in 2005 that includes a demand for all WTO countries to submit additional financial sectors to the GATS regulatory constraints. Geneva-based WTO negotiators from several other countries have reported to us that more financial service sector commitments, including those that extend beyond the plurilateral request, are among the top demands made to them by USTR officials in 2009 and 2010 during discussions of U.S. expectations for concluding the Doha Round. As *Inside U.S. Trade* reported in October 2009,

> "The U.S. has made clear that, under this new approach [on sectoral service offers], existing plurilateral requests would still remain on the table, sources said… In an Oct. 12 speech at a services business conference in Washington, USTR Ron Kirk highlighted that the U.S. needs further concessions on services from key trading partners. 'But we believe that the biggest gains for the global economy are likely to derive from the multilateral services

> liberalization, and the offers on the table, frankly, in the services sector just aren't there,' he said."[38]

And in the March "2010 Trade Policy Agenda," USTR wrote that "improved packages in services (providing new market access in key infrastructure services sectors such as financial services …)" is key to moving Doha forward.[39] Second, a GATS "Working Party on Domestic Regulation" continues to work out text in Geneva that would impose additional disciplines on permissible domestic regulations. In these talks, some countries are pushing hard to force the United States to accept a "necessity test" for *all types* of domestic regulation, not only the types of policies covered by the market access, national treatment and Understanding provisions noted above.

As a top U.S. legal scholar noted in a World Bank publication, "From a U.S. perspective, this test immediately appears to be overbroad… The main thrust of the U.S. approach is to ferret out discrimination, and not to independently impose requirements for the most open or efficient markets."[40]

Awaiting adoption as part of the Doha Round is also new WTO "*Disciplines on Domestic Regulation in the Accountancy Sector,"* which include the necessity test. The fallen Arthur Andersen firm (of Enron accounting scandal fame) helpfully revealed to the *New York Times* their role in devising these rules, which could undermine legitimate domestic regulations in that key sector.[41] All sorts of conflict-of-interest and other accounting rules that have significant impact on multinational corporations could be deemed to fail the necessary test.

In sum, USTR's answer to the Senate Finance Committee in March that they are not proposing any changes to WTO rules is extremely worrisome – and based on misleading analysis. A congressional request that USTR provide its full legal analysis of these rules could foster the needed debate about what modifications to existing WTO rules and current Doha Round proposal are required.

The concerns expressed by the European Commission, the UN Stiglitz Commission and others show that a reworking of the prudential measures language is necessary. The negotiating history points to several alternative GATS provisions that would be more protective of policy space. As well, the bipartisan Trade Reform Accountability Development and Employment (TRADE) Act states that investment provisions of future trade deals should "allow each country that is a party to the trade agreement to place prudential restrictions on speculative capital to reduce global financial instability and trade volatility." This bill – cosponsored by a majority of House Democrats, committee chairs, and subcommittee chairs across a range of caucuses, and by nine Senators – provides a roadmap that has already achieved wide consensus in Congress.

Finally, as Public Citizen has studied the question of the GATS prudential measures defense provision and reviewed the alternatives under past discussion, we developed a proposed alternative provision that could provide more meaningful safeguards, while also hedging against abuse:

> *"2. Domestic Regulation: (a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from adopting or maintaining measures relating to financial services it employs for prudential reasons, including for the protection of consumers, 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. For greater certainty, if a Party invokes this provision in the context of consultations or an arbitral proceeding initiated under the Dispute Settlement Understanding, the exception shall apply unless the Party initiating a dispute can demonstrate that the measure is not intended to protect consumers, investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or is not intended to ensure the integrity and stability of the financial system."

We look forward to continuing the conversation with you about how Congress can conduct more oversight over the little-known but very important GATS and FTA provisions that can pose conflicts with financial reregulation at home and abroad.

ENDNOTES

[1] Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, September 2009 Report, at 38-39. Available at: http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf., at 104-105.

[2] For simplicity, references in the paper to the GATS conflict with regulations refer to conflicts with respect to covered sectors.

[3] See WTO, "Financial Services," Background Note by the Secretariat, S/C/W/312 and S/FIN/W/73, Feb 3, 2010 for a clear example. For an analysis, see Todd Tucker, "That's All They've Got?": What Latest WTO Secretariat Paper on Financial Crisis Does and Does Not Say About GATS Disciplines on Financial Regulation," Public Citizen Memorandum, March 15, 2010, Available at: http://www.citizen.org/documents/That%27sAllTheyGot.pdf. On the response from Treasury, see discussion in comments section of Sarah Anderson, "Memo to U.S.: Only Fools Rush In," *Guardian.Co.Uk,* March 21, 2010, Available at: http://www.guardian.co.uk/commentisfree/cifamerica/2010/mar/18/china-usforeignpolicy

[4] The GATS' Annex on Financial Services provision on domestic regulation provided the basis for the 2004 Model U.S. Bilateral Investment Treaty's (BIT) provision on prudential regulation, which was contained in BITs with Rwanda and Uruguay. Similar language was also contained in U.S. "Free Trade Agreements" (FTAs) with Australia, Bahrain, Central America, Chile, Morocco, Oman, Singapore, and agreements signed by President George W. Bush but not approved by Congress with Colombia, Korea, and Panama. Many of these deals allow not only governments, but also private investors, to bring cases against prudential measures. Under these FTA "investor-state" enforcement provisions, foreign investors can directly demand cash compensation from governments in foreign tribunals – in addition to the pacts being enforceable by government-to-government dispute settlement tribunals.

[5] Todd Tucker and Lori Wallach, "No Meaningful Safeguards for Prudential Measures in World Trade Organization's Financial Service Deregulation Agreements," Public Citizen Report, September 2009. Available at: http://www.citizen.org/documents/PrudentialMeasuresReportFINAL.pdf.

[6] In the NAFTA "Fireman's Fund" challenge of a financial stability measure, a tribunal ruled that even this more robust exception would not necessarily be sufficient to protect a NAFTA signatory country's prudential measure. The target of the challenge was a series of measures related to Mexico's bailout of its financial sector: Mexico deemed these "prudential" in nature, while Fireman's Fund claimed they constituted an indirect expropriation (among other violations) requiring compensation under NAFTA. The tribunal cited writings by the U.S. Treasury Department official who negotiated the NAFTA financial services chapter as support for the conclusion that investors can challenge prudential measures as expropriations, and that tribunals in investor-state cases can decide *whether* challenged measures qualify for the prudential exception. That is to say that even under the more expansive NAFTA language the tribunals, not the governments, get to determine whether a measure is deemed prudential. See International Centre for Settlement of Investment Disputes, Additional Facility, Fireman's Fund Insurance Company (Claimant) and The United Mexican States (Respondent), Award Before the Arbitral Tribunal constituted under Chapter Eleven of the North American Free Trade Agreement (NAFTA), ICSID Case No. ARB(AF)/02/01, July 17, 2006, at 59, 73-77, 95, and 103. Available at: http://www.naftaclaims.com/Disputes/Mexico/Fireman/FiremansFund-Mexico-Final_Award.pdf

[7] Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, September 2009 Report at 82. Available at: http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf

[8] Ibid at 104-105.

[9] As ECAT's submission during the State Department's 2009 Model BIT review said, "In addition, Article 20.1 provides governments the ability to take measures that would otherwise be contrary to the BIT for 'prudential reasons or to ensure the integrity and stability of the financial system.' Additional flexibility is simply not needed and would have highly negative effects on U.S. investors and their U.S.-based operations. Indeed, to adopt the proposals made would be to deny investors the very protection that they need at the time that they most need it. Including such provisions would increase substantially the risk for foreign investors, chilling, rather than promoting, the very investment that many developing countries are seeking. Incorporating provisions to permit capital controls would also have a severely negative effect on U.S. investors compared to many of their counterparts from Europe and beyond, that benefit from strong free transfer provisions, without capital control or balance of payment exceptions, in their countries' BITs. Creating a greater exception in the U.S. Model BIT would mean U.S. investors can be discriminated against compared to their foreign competitors." See Written Statement of the Emergency Committee For American Trade Concerning The Administration's Review Of The Model Bilateral Investment Treaty (BIT), July 31, 2009, at 19. Available at: http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480a0247a

[10] Bart de Meester, "The Global Financial Crisis and Government Support for Banks: What Role for GATS?" Leuven Center for Global Governance Studies, Working Paper 32, December 2009, at 8.

[11] This work is ongoing in the WTO General Council and Committee on Trade in Financial Services. See WTO, "Discussion Document by Argentina, India and South Africa on the Financial Crisis and Related Matters," WTO Document, Sept. 17, 2009.

[12] See March 12 interventions by Nobel Prize Winner Paul Krugman, pro-"free trade" analyst Fred Bergsten, and labor-affiliated economist Rob Scott. Available at : http://www.epi.org/resources/event_20100312/

[13] "Communication from Colombia," GATT Document MTN.TNC/W/67, Feb. 11, 1991, and "Communication from Colombia," GATT Document MTN.TNC/W/68, Feb. 20, 1991.

[14] "Communication from Mexico: Test of the Applicability Of Concepts, Principles And Rules To The Financial Services Sector," GATT Document MTN.GNS/W/71, Sept. 15, 1989; "Communication from Cameroon, China, Egypt, India, Kenya, Nigeria and Tanzania," GATT Document MTN.GNS/W/101, May 4, 1990.

[15] The UK's top financial regulator advocated a variation on this theme, for instance. George Packer, "Call to curb London from UK watchdog," *Financial Times,* Aug. 27, 2009.

[16] For Minsky's recommendations, see Hyman P, Minsky, *Stabilizing an Unstable Economy,* (New York: McGraw Hill, 2008), at 355 and 367-368. For Boyd's remarks, see video of a forum at the Economic Policy Institute from Sept. 9, 2009. Available at: http://www.epi.org/publications/entry/event20090909/.

[17] Aaditya Mattoo, "Financial Services and the World Trade Organization," World Bank Research Working Paper 2184, September 1999. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=629174

[18] Christine Kaufmann and Rolf Weber, "Reconciling Liberalized Trade in Financial Services and Domestic Regulation," in Kern Alexander and Mads Andenas (eds.), *The World Trade Organization and Trade in Services,* (Amsterdam: Martinus Nijhoff Publishers, 2008). See also Bart de Meester, "Testing the European Prudential Conditions for Banking Mergers in the Light of Most Favored Nation in the GATS," Leuven Centre for Global Governance Studies, Working Paper 10, January 2008; Mamiko Yokoi-Arai, "GATS' Prudential Carve Out in Financial Services and its Relation with Prudential Regulation," *International and Comparative Law Quarterly,* 2009.

[19] Daniel Tarullo, *Banking on Basel: The Future of International Financial Regulation,* (Washington, D.C.: Peterson Institute for International Economics, 2008).

[20] European Commission staff working document, "Innovative financing at a global level," SEC(2010) 409 final, April 1, 2010. Available at: http://ec.europa.eu/economy_finance/articles/international/2010-04-06-global_innovative_financing_en.htm

[21] Christine Kaufmann and Rolf Weber, "Reconciling Liberalized Trade in Financial Services and Domestic Regulation," in Kern Alexander and Mads Andenas (eds.), *The World Trade Organization and Trade in Services,* (Amsterdam: Martinus Nijhoff Publishers, 2008), at 424. On Weber and Kaufmann's background, see: http://www.nccr-trade.org/people/kaufmann/ and http://www.nccr-trade.org/people/weber/

[22] "Disagreement over whether a particular measure falls within the prudential carve-out is subject to WTO dispute settlement procedures and thus potentially to determination by a dispute settlement panel. Most regulators, however, do not appear to be particularly concerned about this possibility. For one thing, prudential issues are dealt with intensively in other fora, as discussed in the following section, so there is some basis for assuming that certain types of rules will

always be considered prudential. Moreover, if a country was concerned that a particular measure might not be generally accepted as prudential in the future, it listed that measure as an exception in its schedule of commitments. Another very important reason for the apparent lack of concern is that only governments--not private parties--may bring claims to dispute settlement in the WTO; and, in the absence of a truly egregious action, governments may prefer to respect each other's ability to determine which rules may be prudential." See Sydney J. Key, "Trade Liberalization and Prudential Regulation: The International Framework for Financial Services," *International Affairs,* 75: 1, January 1999, at 67-68.

[23] "Panamá protegerá sus servicios internacionales y financieros," *Xinhua Spanish,* Aug. 6, 2009. Available at: http://spanish.peopledaily.com.cn/31617/6720014.html; "Panama to accuse Ecuador of discriminatory trade practices before WTO," *BBC,* Sept. 18, 2009.

[24] Council for Trade in Services, "Report of the Meeting Held on 9 July 2001," WTO S/C/M/54, Released Aug. 27, 2001. In this meeting, the Panamanian delegation's intervention focused on how GATS exceptions would not apply to OECD measures on harmful tax havens, because Panama does not have any double taxation treaties (which is one of the GATS exceptions). In regards to the other exception, on the "the imposition or collection of direct taxes in respect to services or service supplier of other members," the Panamanian delegation said: "It was difficult to imagine how the Panamanian tax regime could have an impact on the ability of other jurisdictions to impose and collect taxes on Panamanian services or suppliers that required the application of discriminatory measures, measures distinct to those used in the cases of other suppliers other than nationality."

[25] Comments of Barry Newman, Hearing before the House Committee on Banking, Finance and Urban Affairs, "Financial Services Chapter of NAFTA," Serial Number 103-71, Sept. 28, 1993, at 45. See also: http://mitsloan.mit.edu/alumni/clubs/newyork/files/news_apr04.pdf

[26] See Pierre Sauvé and James Gillespie, "Financial Services and the GATS 2000 Round," *Brookings-Wharton Papers on Financial Services*, 2000.

[27] Deborah Siegel, "Legal Aspects Of The IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements," *American Journal of International Law,* July 2002.

[28] "Working Group on Financial Services Including Insurance, "Note on the Meeting of 11-13 June 1990," GATT Document MTN.GNS/FIN/1, July 5, 1990, at 23.

[29] Group of Negotiations on Services, "Note on the Meeting of 12-13 July 1990," Working Group on Financial Services Including Insurance, GATT Document MTN.GNS/FIN/2, Aug. 10, 1990. Available at: http://sul-derivatives.stanford.edu/derivative?CSNID=92110082&mediaType=application/pdf. Accessed March 1, 2010.

[30] Ibid.

[31] Among the key provisions related to prudential measures:
"(i) Scope and definition
(a) Financial services shall cover transactions as contained in Article I of MFTS. However, countries should have the right to prohibit the provision of a financial service on prudential grounds.
(b) Countries may choose to limit coverage of financial services which, on the effective date of the MFTS, are governed by a legal framework involving governmental regulation…

"(iii) Most Favoured Nation Treatment
As defined in Article III of the MFTS, but subject to:
(a) Prudential need to limit concentration of foreign service providers from any one country; and
(b) The MFTS and sectoral annotations on financial services should not prohibit the establishment of regional cooperation agreements to promote additional liberalisation among countries which share similar cultural and economic systems, such as the SEACEN countries…

"(iv) Transparency
(a) The need for transparency is recognised but this should be limited only to the publication of laws and regulations relevant to financial services sector. Countries should not be required to publish administrative guidelines and other decisions taken as this is an onerous requirement. In some cases, such decisions are conveyed orally to the financial institutions and the publication of such decisions would, therefore, be cumbersome and impractical.

(b) Measures taken for prudential reasons or to effect monetary policies should be made available at the discretion of the supervisory authorities and only after the threat to stability has been overcome or the objective of the policies achieved.

(c) The need to achieve transparency in the financial services sector should not compromise a supervisory authority's right to reject individual applicants without disclosing the reasons for the rejection…

“(vii) Market access
Application of Article XVI of the MFTS for financial services should be qualified as follows:
(a) Countries should be free to choose one or all of the modes of delivery to effect liberalisation of financial services, based on prudential, monetary policy or balance of payments considerations.
(b) Commercial presence
Granting market access through commercial presence should be subject to several criteria in order to meet the needs of developing economies. These include: Right to establish "presence" cannot be automatic; In admitting foreign institutions, supervisory authorities should be allowed to adopt selective admission criteria based on prudential considerations; The right of supervisory authorities to determine the mode of entry i.e. via the setting up of new financial institutions or the acquisition of domestic institutions should be respected; The judgement of supervisory authorities on the number of financial institutions that an economy can effectively support should be respected; and Rejection of applications to establish a commercial presence by a supervisory authority on prudential grounds should not be subject to review.
(c) Cross-border
Market access through cross-border trade may be subject to payment restrictions as may be allowed by the International Monetary Fund; and Countries should be allowed to limit the degree of liberalisation of cross-border financial services (e.g. retail banking), taking into account prudential, monetary policy or balance of payments considerations.”

Under the National Treatment article, a provision reads: “National treatment should not preempt a country's right to impose conditions on the operations of foreign institutions to take into account: The unique circumstances of individual countries, e.g. countries which have a high foreign content in their domestic banking industry; The level of development and competitiveness of the domestic institutions vis-a-vis foreign institutions. In this regard, the need for a core of strong indigenous financial institutions which pursue policies consistent with the national objectives should be recognized.”

[32] “Communication from the Delegation of Malaysia,” GATT Document MTN.GNS/FIN/W/3, Sept. 12, 1990.
[33] Timothy Geithner, “Uruguay Round / Financial Services: U.S. Measures in the Banking and Securities Sectors,” Treasury Department Memo, April 20, 1990. On file with Public Citizen.
[34] See United States, “Agreement on Trade in Services,” GATT Document MTN.GNS/W/75, Oct. 17, 1989. Available at: http://sul-derivatives.stanford.edu/derivative?CSNID=92080100&mediaType=application/pdf
[35] Memorandum from Assistant Treasury Secretary Timothy Geithner to Deputy Treasury Secretary Larry Summers on the GATS, Nov. 24, 1997. On file with Public Citizen.
[36] See, “United States - Measures Affecting the Cross-Border Supply of Gambling and Betting Services - AB-2005-1 - Report of the Appellate Body,” WTO Document WT/DS285/AB/R, July 4, 2005, at 88.
[37] See WTO, “United States – Measures Affecting The Cross-Border Supply of Gambling and Betting Services,” Report of the Panel, WTO Document WT/DS285/R, Nov. 10, 2004 at 232-233.
[38] Jamie Strawbridge, “U.S. Floats New Approach For Services Liberalization In Doha Round,” *Inside U.S. Trade,* Oct. 16, 2009.
[39] USTR, “The President’s 2010 Trade Policy Agenda,” at 4.
[40] David W. Leebron, “Regulatory Discrimination in Domestic United States Law: A Model for the GATS?,” in Aaditya Mattoo and Pierre Sauvé (eds.), *Domestic Regulation and Services Trade Liberalization*, (Oxford: OUP/World Bank, 2003), at 51 and 53.
[41] On the involvement of Arthur Andersen, see Patricia J. Arnold, “Disciplining domestic regulation: the World Trade Organization and the market for professional services,” *Accounting, Organizations and Society*, 30: 4, May 2005; and Anthony DePalma, “WTO Pact Would Set Global Accounting Rules,” *The New York Times,* March 1, 2002.