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Working Paper on GATS Negotiations on Domestic Regulation:

# "Pre-established" Regulations & Financial Services

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This paper is a preliminary effort to identify issues for discussion and further analysis. It presents the views of the authors and does not represent Georgetown University or our collaborators. We will revise this paper as we receive comments; please send your comments or questions to Robert Stumberg at stumberg@law.geogetown.edu.

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## “Pre-established” Regulations & Financial Services

### *Abstract*

In March 2009, The Working Party on Domestic Regulation released a set of proposed disciplines. Among the draft’s many disciplines is a requirement that regulations be “pre-established.” But “pre-established” is literally a one-word discipline, and its ordinary meaning is ambiguous. In this paper, we examine several possible meanings of the “pre-established” discipline, drawing from sources such as the Chair’s statements, investment law, and the domestic regulatory practices of nations. By examining these sources, we come to several possible definitions of the “pre-established” discipline. These interpretations range from definitions that are consistent with many domestic regulatory systems to definitions that would be a substantial departure from the regulatory practice of most nations. Having laid out the possible meanings of “pre-established,” this paper will then discuss these meanings in the context of financial regulation. Many nations are in the process of updating their financial regulations in the wake of recent financial crisis. This paper asks whether certain types of re-regulation could be endangered by some interpretations of the “pre-established” disciplines. Finally, we conclude with several questions that trade delegators may wish to clarify before concluding negotiations on the “pre-established” discipline.

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# “Pre-established” Regulations & Financial Services


***Summary***

## CONTEXT

In March 2009, the Chair of the Working Party on Domestic Regulation (WPDR) released a “second revision” of proposed disciplines. This draft requires regulations to be “pre-established.”

***Ambiguity of “pre-established”***

“Pre-established” is an ambiguous term; it has been used only once before, in the GATS Accountancy Disciplines, but without any definition. The Oxford English Dictionary defines “establish” as “to institute or ordain *permanently* by enactment or agreement.” It defines “pre-establish” as “to establish beforehand.” The ambiguity arises in several alternate meanings of “before what”? The most basic alternatives are:

- Before government applies a change in regulations
- Before service suppliers rely on pre-existing licensing standards or procedures
- Before service suppliers rely on pre-existing law
    - Stable and predictable regulations
    - Foreseeable regulations

***Post-licensing focus – examples from regulation of financial services***

This paper focuses on regulation of financial services to provide examples of the post-licensing impact of a “pre-established” discipline.

***Purpose***

- Identify scenarios that might give rise to conflict
- Identify potential interpretations of “pre-established”
- Identify the impact that the “pre-established” provision may have on regulation of financial institutions

## MULTIPLE CHOICE DEFINITIONS

- ***Before government applies a change in regulations.*** This meaning would be consistent with the practice of most nations, which is that laws must not be applied retroactively.
- ***Before service suppliers rely on pre-existing licensing standards or procedures.*** This meaning would lock in licensing standard and procedures, once a supplier applies for a permit. It would limit the scope of “pre-established” so that it does not affect changes in the law that apply to post-licensing regulations. However, it would still not be consistent with the practice of most nations, which empower government to change licensing standards up to the point that government decides on a license.
- ***Before service suppliers rely on pre-existing law.*** This meaning would apply more broadly to any situation in which a service supplier makes an investment in reliance on existing regulations. This meaning could limit the ability of government to change regulations after a service supplier invests, at least as applied to that investment. If adopted, this meaning would be a major change in the practice of most nations. There are two versions of this meaning:
    - Stable and predictable regulations. This version would essentially grandfather investments made before a regulation is changed.
    - Foreseeable regulations. This version would enable government to apply changes of regulations to an investment if the change is foreseeable.

## ANALOGIES TO PRE-ESTABLISHED IN BITS CASES

***CMS and LG&E***

These cases arose in the context of a post-licensing scenario of conflict. Here, the government took measures that it considered necessary to staunch a *broad economic crisis*. Arbitration tribunals held that the Argentine government had failed to maintain a "stable and predictable" legal and business framework.

***Occidental v. Ecuador***

This case shows that even a marginal change in policy—and one that does not upset the premise of the investment—has been successfully challenged under investment law. What is more, the "stable and predictable" test in Occidental places the burden of proof on the government, not the investor. The arbitration tribunal interpreted the "fair and equitable treatment" provision to require "stability of legal and business framework," concluding that Ecuador had breached its obligations to maintain a "stable and predictable" legal and business framework.

***Saluka v. Czech Republic***

In Saluka, the Czech government, following a regime change, enacted stricter financial regulation provisions, causing Saluka to go into forced administration. Saluka brought a claim that the Czech government had violated the "fair and equitable treatment" provision of the Czech-Netherlands BIT. Specifically, they argued that the Czech government had not provided a "stable and predictable" regulatory environment. While the Czech government lost the "fair and equitable treatment" claim, the arbitration panel found that the Czech government had not violated a "stable and predictable" test. This case is particularly relevant because, in response to the *financial sector* crisis, many countries have recently re-regulated their financial institutions, often using regulations such as the increased capital requirements found used by the Czech government.

## GATS DISCIPLINES WITHIN BITS CLAIMS

The above cases explore the possibility that BITs law could be used in to inform the "pre-established" discipline. Conversely, could the "pre-established" discipline also influence international law for future BIT cases?

## ENDANGERED REGULATIONS

***High Capital Requirements***

In the wake of their financial crises, nations ranging from the United States to Germany to Chile have proposed raising their capital requirements**.** Under a broad interpretation of the "pre-established" provision, these sorts of changes to capital requirements could be challenged in the WTO

***Directed Lending***

Future "directed lending" policies could be jeopardized by a broad interpretation of the "pre-established" provision**.** Unlike capital requirements, "directed lending" is not a prudential measure

***Standards for Foreign Investment***

Standards provide differential treatment of some institutions based on upon whether they engage in cross border trade in financial services**.** Standards for foreign investment are prudential measures

***Competition and Antitrust Policy***

Antitrust regulations often discourage mergers and acquisitions in order to prevent large banks from becoming so big that they establish sufficient market power to reduce competition from smaller banks

***Regulation of Risky Trading Practices***

High-risk trading practices have emerged as a primary cause of the recent crisis. In particular, practices such as derivatives trading, in which highly specialized traders move vast sums of money around in transactions that are poorly understood by even the firm's executives. In order to rectify this situation, many regulations have been proposed that will allow the government to better regulate these practices. In whatever form these regulations take, they will be prudential measures that could be challenged as not "pre-established" if they are applied to pre-existing operations of a financial institution.

## CONCULSION

***Questions for the WPDR***

*Meaning of "pre-established."* There are several distinct meanings of "pre-established" as applied to financial regulation. Which of these meanings do negotiators intend to include? Which do they intend to exclude?

(a) Before government applies a change in the law.
(b) Before service suppliers rely on licensing standards or procedures.
(c) Before service suppliers rely on pre-existing law.

*Impact generally.* Which of these meanings would dramatically change the domestic practice of most nations? Have negotiators assessed the impact of these meanings on their own nation's practice?

*Impact of a discipline on financial regulation*
How would the different meanings of a "pre-established" discipline affect the following domestic practices, which regulators sometimes use both for prudential reasons such as responding to a financial crisis and for the purpose of encouraging development:

(a) High capital requirements
(b) Directed lending to certain sectors or regions
(c) Standards for foreign investment
(d) Competition and antitrust policy
(e) Regulation of risky trading practices

*Scenarios of conflict*

(a) What are specific examples where application of measures has not been "pre-established"? Without a concrete example, it is not possible to understand the problem that this discipline seeks to cure; nor it is possible to predict the impact of this discipline.
(b) Which countries are most likely to use "pre-established" to challenge changes to financial regulations? Which definitions of "pre-established" do these countries prefer?
(c) Do negotiators intend to adopt a discipline that foreign investors could use as evidence to strengthen their claims in BIT arbitrations?

# "Pre-established" Regulations & Financial Services

## I. Context

Following long negotiations, the Chair of the Working Party on Domestic Regulation (WPDR) released a "second revision" of proposed disciplines (March 2009).[1] These disciplines attempt to facilitate trade in services by ensuring that domestic regulations are not disguised restrictions that undermine trade commitments under the General Agreement on Trade in Services (GATS).[2]

The Chair's draft requires regulations to be "pre-established." This phrase has been inserted at the insistence of several nations that are enthusiastic champions of free trade. "Pre-established" is an ambiguous term. It was used in the WTO's 1998 Accountancy Standards, but otherwise has almost no history of use in international law.[3]

The Oxford English Dictionary defines "establish" as "to institute or ordain *permanently* by enactment or agreement."[4] It defines "pre-establish" as "to establish beforehand."[5] Likewise, the Merriam-Webster Dictionary defines "established" as "to institute (as a law) *permanently* by enactment or agreement."[6] Most governments presume that domestic regulations are "permanent," yet not in the sense that regulations are unchanging. To do so would restrict their capacity to amend their laws as circumstances require. This concern has generated questions by the WPDR chair as well as by trade commentators.[7]

The foremost problem is that "pre-established" is literally a one-word discipline, and its ordinary meaning is ambiguous. Its meaning, "to establish beforehand," would require a dispute panel to determine, before what? It could mean:

- ***Before government applies a change in regulations.*** This meaning would be consistent with the practice of most nations, which is that laws must not be applied retroactively.

- ***Before service suppliers rely on pre-existing licensing standards or procedures.*** This meaning would lock in licensing standard and procedures, once a supplier applies for a permit. It would limit the scope of "pre-established" so that it does not affect changes in the law that apply to post-licensing regulations. However, it would still not be consistent with the practice of most nations, which empower government to change licensing standards up to

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1 Working Party on Domestic Regulation, 'Disciplines on Domestic Regulation Pursuant to GATS Article VI:4', Room Document, 20 March 2009, *available at* http://www.tradeobservatory.org/library.cfm?refID=101417 (last viewed February 10, 2010) (hereinafter "The Draft"). Negotiations within the WPDR, since April 2007 in informal mode, are based on a draft text and subsequent revisions prepared by the WPDR Chair and circulated as a room document.

2 *GATS: 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).

3 Council on Trade in Services, Disciplines on Domestic Regulation in the Accountancy Sector, S/L/64, 17December 1998, ¶ 8.

4 *The New Shorter Oxford English Dictionary* 495 (2nd ed. 1993).

5 *The New Shorter Oxford English Dictionary* 334 (2nd ed. 1993).

6 *Merriam-Webster Online Dictionary* (Merriam-Webster Online. 26 January 2010), http://www.merriam-webster.com/dictionary/established.

7 Gould, Ellen and Andrew Pask, *New WTO Rules Could Threaten City Planning*, PLANETIZEN. July 10, 2008, http://www.planetizen.com/node/33910.

the point that government decides on a license.

- ***Before service suppliers rely on pre-existing law.*** This meaning would apply more broadly to any situation in which a service supplier makes an investment in reliance on existing regulations. This meaning could limit the ability of government to change regulations after a service supplier invests, at least as applied to that investment. If adopted, this meaning would be a major change in the practice of most nations. There are two versions of this meaning:
  - Stable and predictable regulations. This version would essentially grandfather investments made before a regulation is changed.
  - Foreseeable regulations. This version would enable government to apply changes of regulations to an investment if the change is foreseeable.

Shortly after taking office, the new chair of the WPDR sought to cure the ambiguity of "pre-established" (December 2009). She proposed that it apply to the situation of "applicants who are faced with changes to substantive requirements, and possibly procedures, while their application is being processed." In effect, the chair proposes to limit "pre-established" to licensing standards. Under the chair's definition, it is unclear whether the discipline would apply to post-licensing technical regulations, which govern operations of a licensed service supplier.

While not as far-reaching as the meaning of "before investing," the chair's definition of pre-established would nonetheless constrain the power and practice of most governments in situations like regulating public utilities, extraction industries, waste management, and financial institutions. Even if one supports her proposal, the issue remains as to whether her meaning would be explicitly stated in the discipline so as to limit its reach. If not, then it would remain one of several ambiguous possibilities.

This memo identifies questions that negotiators should address regarding a "pre-established" discipline. Since our time to scan for examples of potential impact is limited, we chose to focus on financial regulations for four reasons: 1) One-hundred and twenty nations (81 percent of WTO members) have at least one GATS commitment in the financial sector;[8] 2) following the financial crisis, there has been a global trend to strengthen the regulation of financial services; 3) the financial sector includes many services that are regulated after the point at which the supplier is licensed; and 4) the GATS understanding on financial services has provisions that relate to "pre-established," namely the standstill on scheduling new limits and the provision on new products.[9] A companion paper focuses on regulation of services at the stage of granting a license to use, develop or extract resources from land.[10]

The purpose of this paper is to: 1) identify scenarios that might give rise to conflict; 2) identify potential interpretations of "pre-established," and 3) identify the impact that the "pre-established" provision may have on regulation of financial institutions. Could a "pre-established" discipline deter countries from protecting their financial system against risky banking practices? Could it limit the capacity of countries to promote development?

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8 Adlung, Rudolf and Martin Roy, *Turning Hills into Mountains*, WTO STAFF WORKING PAPER ERSD-2005-01, (March 23, 2005).

9 *GATS: 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).

10 Kozonis, Loukas, *"Pre-Established" Regulations and Development Permits*, HARRISON INSTITUTE FOR PUBLIC LAW, (March 14, 2010).

## II. Multiple Choice Definitions

Unless negotiators in the WPDR choose to make it clear, the meaning of "pre-established" will remain ambiguous. The term "pre-established" has precious little history in international law. As explained by the chair, the term has only been used one time before (without a definition), in the WTO's 1998 disciplines on domestic regulation for the accountancy sector.[11] As mentioned above, the Oxford English Dictionary defines "pre-establish" as "to establish beforehand."[12] This raises the question, "before what?"

The above discussion presents two distinct meanings of "pre-established," before regulating or before investing. The Chair's interpretation is one way to implement the latter; it focuses on pre-licensing changes in the law. A broader way to implement the "before investing" definition has been adopted by arbitrators in disputes under bilateral investment treaties (BITs), some of which focus on post-licensing changes in the law. This section attempts to distill the range of possible meanings that could apply.

### *A. Before government applies a change in regulations (not retroactive)*

Many nations have what might be described as a "retroactivity" principle for new regulations.[13] The principle of "non-retroactivity" is an ancient one, with roots in Roman and Canon law.[14] Having come to the Americas through the work of Spanish Jesuit priest Francisco Suárez, it permeates the legal systems of both developed and developing nations.[15] This principle forms a fundamental part of the legal systems of many nations; the principle of "non-retroactivity" exists, in some form, in legal systems as diverse as those of Russia, Japan, Argentina, India, the United States, and South Africa.[16]

If the WPDR were to adopt the "not retroactive" definition, "pre-established" would refer to the period before regulators apply a measure to a licensed entity. In other words, new regulations should affect future rather than past actions, with many countries having a presumption that new laws and regulations have only a future effect unless the text of the statute explicitly states otherwise.[17] This may not be the intent of some proponents of the "pre-established" provision, but it is the practice of many nations.[18]

If the WPDR does not adopt this definition, then the other (and probably more likely) meanings would be a significant change in the practice of many nations, much of which is established in domestic constitutional law.[19]

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11 *WTO adopts disciplines on domestic regulation for the accountancy sector*, WTO NEWS, (Dec. 14, 1998), http://www.wto.org/english/news_e/pres98_e/pr118_e.htm.

12 *The New Shorter Oxford English Dictionary*, 2nd ed. (334).

13 *See generally*, Geoffrey C. Weien, *Retroactive Rulemaking*, 30 HARVARD JOURNAL OF LAW AND PUBLIC POLICY 749, 751-52 (2007).

14 Rev. Basil M. Frison, *The Retroactivity of Law An Historical Synopsis and Commentary* 29-39 (Washington, DC, Catholic University of America Press: 1946).

15 *Id*. at 7-11.

16 Sampford, Charles, *Retrospectivity and the Rule of Law*, 9-22 (Oxford: Oxford University Press, 2006).

17 *See, e.g.* Landgraf v. USI Film Prods., 511 U.S. 244, 265 (1994).

18 *Id*. at 268.

19 *See* Ann Woolhandler, Public Rights, Private Rights and Statutory Retroactivity, 94 Geo. L.J. 1015, 1019-1022 (2006); *see generally*, Peter Wittenborg Time When Statutes Take Effect, Crocker's Notes on Common Forms Volume II, Chapter 24 (Real Estate Bar Association for Massachusetts). Similar principles apply in common law systems outside of the United

### B. *Before a service supplier relies on pre-existing licensing standards and procedures (after application and before a decision)*

This test reflects the Chair's interpretation. Under this test, governments could not alter a licensing requirement after a service supplier applies for a license and use the changed requirement to prevent the applicant from obtaining a license. For example, requirements and standards can be changed, but government cannot apply a change while a financial institution waits for its application to be processed.

Such a test would provide a more restrictive interpretation of "pre-established." Unlike the above test, this test could deter governments from drafting from drafting new financial regulations. Rather, this test would mean that new applications for licensing and permits cannot be denied because of a rule change that occurred after the application was made.

It is important to note that the chair's definition should take the "pre-established" discipline out of Article 11. Article 11 comes under the General Provisions section of the Disciplines. The chair's definition, on the other hand, refers to licensing requirements and procedures. As such, if the chair's definition is accepted, it would stand to reason that the "pre-established" discipline should fall under Section VI on Licensing Procedures, rather than Section III on General Provisions.

Focusing only on licensing requirements and procedures may avoid conflicts with respect to technical standards, which apply to post-licensing situations including prudential regulations. But there are still questions as to how broadly it could be interpreted. For example, what would be the standards for approving "permission" to acquire another institution, or "permission" to open a new branch? The Chair's Agenda states that this discipline is meant to apply to "applicants who are faced with changes to substantive requirements, and possibly procedures, while their application is being processed."[20] Does the "pre-established" discipline apply to these "permissions" as well?

### C. *Before a service supplier relies on existing law ("stable and predictable" or "foreseeable" regulations)*

In several BITs cases, the arbitration tribunal found that changes in government policy constituted a breach of the "stable and predictable framework" because those changes upset investors' "reliance on existing law."[21] This definition is fairly restrictive on government's ability to change regulations, particularly in a post-license environment such as regulation of existing financial institutions.

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States. *See generally* John Prebble, Rebecca Prebble, Catherine Vidler Smith, Retrospective Legislation: Reliance, the Public Interest, Principles of Interpretation and the Special Case of Anti-Avoidance Legislation, 22 N.Z.U. L. Rev. 271 (2006).

20 *Annotated Agenda by the Chairperson*, INFORMAL MEETING OF THE WORKING PARTY ON DOMESTIC REGULATION, December 8, 2009.

21 *See* Leila Bruton, Constantine Partasides and Elizabeth Snodgrass, *Recent Developments in Investment Treaty Arbitration*, THE EUROPEAN & MIDDLE EASTERN ARBITRATION REVIEW, (2008), *available at* http://www.globalarbitrationreview.com/reviews/3/sections/5/chapters/69/recent-developments-investment-treaty-arbitration/. *See also LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, Para. 35-38, (Oct. 3, 2006) http://ita.law.uvic.ca/documents/LGEArgentinaLiability.pdf; and *CMS Gas Transmission Co. v. Argentine Republic*, ICSID Case No. ARB/01/8, Award, Para. 77 (May 12, 2005), *available at* http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC687_En&caseId=C4. *Cf., PSEG Global Inc. v. Republic of Turkey*, Award, Case No. ARB/02/5, par. 13 (ICSID (W. Bank) 2007); *MTD Equity Sdn. Bhd. v. Chile*, Case No. ARB/01/7 (ICSID (W. Bank) 2004), par. 1 & 80, *available at* http://www.asil.org/ilib/MTDvChile.pdf.

If applied to interpreting a "pre-established" discipline, this definition could limit government's capacity to respond to future financial crises. Under this definition, many of the proposed measures to combat the financial crisis would upset reliance on "pre-established" regulatory standards. Increased capital requirements, restrictions on interest rates, and portfolio requirements are all prudential measure that, if changed, could disrupt the "stable and predictable framework" that foreign banks or investment funds relied upon in making their initial investments. Prudential regulations are thought to be protected by the "prudential exception" in GATS law; whether the "prudential exception" protects prudential measures as much as is commonly believed is topic that we will cover later in this paper.

In *Saluka v. Czech Republic*, which is examined in greater depth below, the tribunal refined the "stable and predictable" test. The tribunal found that, given the evolving circumstances in the Czech Republic, Saluka should indeed have been aware that new regulations were forthcoming, thus concluding that Saluka's "expectations" had not been "reasonable."[22]

This "reasonable expectations" test gives government more operating room than the "stable and predictable framework" test. At the time of its investment, an institution should reasonably expect that a government will re-regulate a financial institution in the event of a financial crisis. Still, this seems like a highly subjective question to leave in the hands of a WTO dispute panel.

- What new regulations will be "foreseeable"? This adds a substantive dimension to the time dimension of analysis. For example, in *Saluka*, the arbitrators saw that changes in prudential measures (capital requirements) were forseseeable to investors who purchased a privatized bank during a time of upheaval in lending markets.
- Will the burden of proof be placed upon the government or the investor? Since these decisions are only made after the fact, governments may have an impossible task in deciphering what regulations that the WTO would find "foreseeable."

Thus, while a "foreseeable" test leaves more latitude for government regulation than the "stable and predictable framework" test, there may still be governments that oppose this definition. This definition would perhaps be a substantial change in the way that GATS treats non-prudential regulations.

These tests are broadly similar in a non-prudential context, however, and these tests are far and away the most likely to restrict the regulatory space of domestic governments. The primary difference between the two tests is that under the "stable and predictable" test, the government is responsible for showing that the change in regulation is reasonable, while under the "foreseeable" test, the burden of proof lies with the foreign party. Nevertheless, either test under this definition would mean a substantial departure from the current practices of most nations.

## III. Analogies to "Pre-Established" in BITs cases

How will the term "pre-established" be interpreted in WTO law? The logical starting point is the ordinary meaning above, which defines "pre-established" as "to establish beforehand." But if pre-established means "to establish beforehand," then the next question is to ask, "before what?" The WPDR chair's interpretation suggests one possibility, which is that "pre-established" addresses a situation in which applicants are faced with changes in procedure or requirements while their applications are being processed. But, unless explicitly adopted, there is little evidence to suggest that the Chair's interpretation would be adopted by WTO dispute panels. Unless the chair's interpretation is explicitly adopted, there

22 Saluka at 348-60.

are several other alternatives, which would lead WTO dispute panels to expand the scope of legal context in order to resolve this ambiguity. One source is the interpretation of customary international law by arbitrators in investment disputes.

The WTO's Appellate Body has relied on Article 31 of the Vienna Convention on Treaties in stating that "relevant rules of international law… in the relation between parties" shall be taken into account in interpreting treaties.[23] Since Bilateral Investment Treaties (BITs) provide rules that govern the "relation between parties, investment disputes may be a logical place to look for interpretive guidance. The BITs that WTO panels interpret provide similar coverage of investment and investors; they provide a similar type of protection related to the timing of regulations; and academics have called for the harmonizing of international law.[24] What is more, it seems that the "pre-established" argument has arisen in BIT disputes several times. Several of these cases have turned on whether or not a country provided a "stable and predictable framework" for investment.

A WTO panel may decide that the "stable and predictable framework" test (discussed below) is a principle of "customary" international law and that it should therefore be applied to a "pre-established" claim. It is, of course, difficult to know just when a principle becomes a part of "customary" international law, but such a scenario should not be dismissed without further examination. To explore the link between BIT law and WTO law, we examine three such cases below.

### *A. CMS and LG&E*

In a context outside of permits, tribunals have used a "stable and predictable" standard in judging whether changed financial regulations violate investment law. In the 1990s, CMS and LG&E filed arbitration claims that (among other things) the Argentine government's actions violated the "fair and equitable treatment" clause of the U.S.-Argentina BIT.[25] The companies argued that, under the "stable and predictable" standard, Argentina has failed to meet the "basic expectations" that were taken into account when the companies made their investment.[26] In both cases, the tribunal concluded that "the stability of the legal and business framework" is an essential element of "fair and equitable treatment."[27] The tribunals held that, by changing its tariff rates, the Argentine government had failed to maintain a "stable and predictable" legal and business framework.[28] Both tribunals concluded that Argentina had violated the "fair and equitable treatment" provision of the U.S.-Argentina BIT.[29]

To be clear, CMS and LG&E did not challenge the kinds of domestic regulations that would be covered by a "pre-established" discipline. Nor do they deal with financial services. Yet we start with these cases because they arise (a) in the context of a post-licensing scenario of conflict, in which (b) the government is taking measures that it considers necessary to staunch a financial crisis. Moreover, these cases have been widely cited by subsequent arbitration panels for the principle that governments have an obligation to provide foreign companies with a "stable legal and business framework," upon which the

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23 *Understanding on Rules and Procedures Governing the Settlement of Disputes*, WTO ANALYTICAL INDEX, http://www.wto.org/english/res_e/booksp_e/analytic_index_e/dsu_01_e.htm.

24 Luc Thévenoz, *Intermediated Securities. Legal Risk, and the International Harmonisation of Commercial Law*, 170 DUKE LAW SCHOOL LEGAL STUDIES 79 (Sept. 1, 2007), http://ssrn.com/abstract=1008859.

25 *LG&E v. Argentine Republic* at 35-38; and *CMS Gas Transmission Co. v. Argentine Republic* at 77.

26 *Id*. at 100-05; and at 77-80.

27 *Id*. at 119-20; and at 83-85.

28 *Id*.

29 *Id*.

companies rely when making their investment.[30] It is easy to imagine how a case could arise under similar circumstances in the financial sector. Does this set a precedent that will concern regulators?

### *B. Occidental v. Ecuador*

Occidental involved a change by Ecuador's government in the interpretation of its tax code, rather than a financial regulation, but its conflict is analogous to scenarios that could arise under the proposed "pre-established" discipline. In response to the changed interpretation of the tax code, Occidental commenced arbitration proceedings under the U.S.-Ecuador BIT on November 11, 2002, claiming that Ecuador had breached BIT guarantees, among these that Ecuador had breached its obligation of "fair and equitable treatment."[31] The arbitration tribunal interpreted the "fair and equitable treatment" provision to require "stability of legal and business framework."[32] The tribunal concluded that the Ecuadorian government had substantially changed the framework under which Occidental had invested in Ecuador.[33] It therefore concluded that Ecuador had breached its obligations to maintain a "stable and predictable" legal and business framework.[34]

Occidental claimed that, by changing a policy that it had legitimately relied upon, the Ecuadorian government frustrated its "legitimate expectations" on the basis of which Occidental's investment had been made.[35] A "pre-established" discipline under GATS could be interpreted in line with the argument made by Occidental. And a "pre-established" test might well be stricter than a "stable and predictable" test. Under the "stable and predictable" test, regulations can be changed, but not in an "unpredictable" way.[36] This case shows that even a marginal change in policy—and one that does not upset the premise of the investment—has been successfully challenged under investment law. What is more, it is informative that in both Occidental and the CMS and LG&E cases, the tribunals placed the burden of proof on the government, not the investor. All this raises the question of what types of changes might be "predictable." Is any change in government "unpredictable"?

In many licensing processes, regulators must interpret licensing requirements based on the facts of a case, often after a hearing or other forms of public participation. It is common for regulators to grant a license, but only if the service supplier complies with conditions that are designed to mitigate adverse impacts on the environment, the community or other parties. *Occidental* illustrates the risk that regulatory interpretations or conditions could be challenged as not "pre-established."

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30 *PSEG Global Inc. v. Republic of Turkey*, Award, Case No. ARB/02/5, par. 13 (ICSID (W. Bank) 2007); *MTD Equity Sdn. Bhd. v. Chile*, Case No. ARB/01/7 (ICSID (W. Bank) 2004), par. 1 & 80, *available at* http://www.asil.org/ilib/MTDvChile.pdf.

31 *Occidental Exploration & Production Co. v. Republic of Ecuador*, (London Court of International Arbitration Administered Case No. UN 3467), Final Award, para. 179-80, (July 1, 2004) http://ita.law.uvic.ca/documents/Oxy-EcuadorFinalAward_001.pdf.

32 *Id*. at 183.

33 *Id*. at 184.

34 *Id*. at 187.

35 *Id*. at 180-81.

36 *Id*. at 180-83.

### *C. Saluka v. Czech Republic*

The Saluka arbitration arose out of the failed privatization of the Czech Republic's third largest bank, IPB.[37] In response to the Czech financial crisis in 1997, the government decided to revamp its banking system, both privatizing its major banks and improving its financial regulations.[38]

In 1998, the government sold a controlling block of IPB shares to Saluka, a Dutch company. While the bank's performance improved considerably under Saluka's management, the IPB still lacked sufficient operating capital and was burdened by a large amount of non-performing loans.[39]

In 1999 and 2000, the Czech government continued to privatize state-owned banks and began to update its financial regulations. In updating these financial regulations, the Czech government increased the capital requirements on banks. After it repeatedly failed to comply with more stringent capital requirements, in June 2000, the Czech National Bank put IPB under forced administration and then sold it to another banking group.[40] Saluka lost managerial control over the bank, as well as several million dollars that it had invested, and the IPB shares it held were rendered worthless.[41]

In July 2001, Saluka commenced arbitration proceedings under the Netherlands-Czech Republic BIT.[42] Saluka alleged that, through an "unpredictable" increase in capital requirements, the Czech Republic had frustrated Saluka's "legitimate expectations."[43] On the basis of this claim, Saluka argued that the Czech Republic had deprived the company of its investment unlawfully (under BIT law) and without just compensation.[44]

One factor for evaluating the "fair and equitable treatment" clause was whether the Czech Republic had failed to ensure a predictable and transparent framework for investment.[45] The tribunal set out this test: Did the government frustrate Saluka's "legitimate expectations regarding the treatment of IPB without reasonable justification."[46] The tribunal then set out a three-pronged test for whether the Czech Republic had frustrated Saluka's "legitimate expectations": 1) whether Saluka had a basis for expecting that there would be no future change in the government's policy towards the financial sector's problems; 2) whether Saluka was reasonable in expecting that the government would not introduce stricter financial regulations that would negatively affect IPB; and 3) whether Saluka should have been aware of the "longstanding shortcomings of the Czech legal system" and could not have reasonably expected these shortcomings to be fixed quickly.[47] The tribunal found all of Saluka's "expectations" to

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37 *Saluka Investments BV v. The Czech Republic* at 32-163.

38 *Id*. at 28-35.

39 *Id*. at 42-66.

40 *Id*. at 136-63.

41 *Id*. at 160-63.

42 *Id*. at 164-67.

43 *Id*. at 349.

44 *Id*.

45 *Id*. at 349-51.

46 *Id*.

47 *Id*. at 348-60

have been unreasonable,[48] and therefore it did not touch on whether the Czech Republic had failed to ensure a predictable framework.[49]

The Saluka case perhaps distinguishes an important difference between prudential regulation of financial institutions and other types of regulation. For example, in the CMS and Occidental cases, investors succeeded in challenging in the law or its interpretation, in part because the burden of proof for justifying the new regulations was placed on the government. In Saluka, the investor challenged a change in a prudential financial regulation, but the BIT tribunal held that a) the investor must carry the burden of proof that its reliance on the regulations was reasonable, and b) the test is whether or not the change in prudential measures is reasonable in light of the circumstances.

It is worth noting that, despite winning the "stable and predictable" argument in this case, the Czech government lost the "fair and equitable treatment" claim brought by Saluka.[50] Thus, while the tribunal gave the government more deference here in the case of a prudential regulation, in the end, the Czech government was held to have violated the "fair and equitable treatment" clause of the BIT and lost overall lawsuit.[51]

It is also worth noting how the government objective of preserving a stable financial system compares to the investor's objective of maintaining a "stable and predictable" regulatory environment. In the financial sector, the purpose of the government's policy change here was to preserve stability. This objective was directly related to managing risk within regulated banks, rather than maintaining the stability in the economy as a whole as was the case in CMS and LG&E. The evidence from these BITs cases indicates that different standards apply to prudential regulation of financial institution than apply to other types of re-regulation. How will the "pre-established" provision affect new regulations that are intended to protect financial stability? Even though the government won this case, could the very fact that this case was brought have a chilling effect on financial regulation?

There are three main points that one can draw from *Saluka*. First, without explicit clarification—such as the WPDR Chair's interpretation—the "pre-established" discipline would apply to post-license changes in domestic regulation. Such a situation is not without precedent, as can be seen in the above cases. Second, without clarification, the "pre-established" discipline could apply to any disruption of a "stable and predictable" regulatory environment upon which an investor has relied, regardless whether that disruption is necessary to stabilize the financial system or the economy as a whole. Finally, the *Saluka* case raises the question of whether reliance on pre-existing regulations is "reasonable" or "foreseeable."[52] In so doing, the *Saluka* panel placed the burden of proof on the investor, at least in the context of prudential financial regulations. Such deference might not apply to non-prudential regulations, as illustrated in the Occidental case.[53]

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48 It is worth noting that, while the Czech government won the "legitimate expectations" issue in this case, the government lost the overall claim. The tribunal found that the Czech Republic's conduct towards Saluka in respect of Saluka's investment was unfair and in violation of the "fair and equitable" treatment clause of Czech Republic-Netherlands BIT.

49 *Saluka Investments BV v. The Czech Republic* at 348-60.

50 *Id*. at 361-95.

51 *Id*.

52 *Id*.

53 *Occidental* at 179-83.

## IV. GATS Disciplines in a BIT Claim

Having explored the possible effects of BIT law on the "pre-established" discipline, it is also worth taking a moment to consider the opposite possibility: that the "pre-established" discipline could influence international law for future BIT cases. If interpreted broadly, the "pre-established" provision could create a standard of "customary" international law whereby foreign investors would expect a certain level of stability in their investments.

Already, investors have argued that "stable and predictable" standard has been clarified in international law.[54] If the "pre-established" provision were a part of international law, investors such as Saluka might attempt to use it to strengthen their own BIT claims, arguing that the "pre-established" discipline provides a standard for interpreting the "stable and predictable" provision in BIT law. Just as WTO treaty law is informed by international law, BIT law may be affected by GATS provisions such as the "pre-established" discipline. If "pre-established" is not clearly defined, the plain meaning of the discipline might be used to inform BIT claims of investors seeking to prove a violation of this "stable and predictable" regulatory environment.

## V. The "Prudential Exception"

Article 2 of the Financial Services Annex to the GATS states that:

> "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."[55]

This "prudential exception," as it has become known, was supposed to protect the capacity of government to respond to crises and other exigent circumstances. Defenders of the "prudential exception" argue that "there is no reason to believe" that any of the actions taken "in response to the financial crisis are inconsistent" with trade commitments.[56] Indeed, the WTO Secretariat's recent Background Note on Financial Services refers to this provision as a "prudential carve-out." The Note goes on to interpret the prudential language as an "exception," and it makes no mention of alternative interpretations.[57]

This interpretation relies heavily on the first sentence of the above paragraph, while giving short shrift to the second sentence. But, as other commentators have pointed out, the second sentence of the

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[54] *Glamis Gold Ltd v. The United States of America* (UNCITRAL), Final Award of June 6, 2009 http://www.state.gov/documents/organization/125798.pdf (Para. 348-60).

[55] *GATS: General Agreement on Trade in Services, Apr. 15, 1994, Annex on Financial Service*, 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).

[56] *Hearing on Confirmation of Mr. Ronald Kirk to be Unites States Trade Representative,* 111th Cong. 70 (2009) (Question 18 from Sen. Stabenow, answer from Mr. Kirk).

[57] WTO, "Financial Services," *Background Note by the Secretariat*, S/C/W/312 and S/FIN/W/73, Feb 3, 2010.

"prudential exception" contains a "significant loophole."[58] The exception provided in the first sentence appears to be withdrawn in the second sentence, where the agreement states that prudential measures "shall not be used as a means of avoiding the Member's commitments or obligations." In this view, the "prudential exception" appears to be "self-canceling."[59]

Analysis of these competing views of the GATS "prudential exception" is beyond the scope of this paper. For present purposes, the three essential points are that, first, the "prudential language in the GATS annex is not a "carve-out" as some have called it. It clearly does not exclude "prudential" measures from the GATS. Second, whether it functions as a "prudential exception" is an open question, since it provides no guidance or test as do exceptions to GATS rules. If it is not as strong as its defenders believe, even prudential regulations could be challenged "where they do not conform with provisions of the Agreement." And third, whatever the value of the prudential language for safeguarding measures, it extends no protection to financial regulations that are not prudential in nature.

This last point is of particular importance. For the purposes of this discussion, it is important to remember that the "prudential exception" is not all-encompassing. Even assuming a viable and strong "prudential exception," there are still important financial regulatory measures that are not prudential in nature and, therefore, would not be covered by the "prudential exception." The following section presents several examples of proposed financial regulations, some of which are prudential and some of which are not prudential but are nevertheless important to economic development.

## VI. Scenarios for Conflict Under a "Pre-Established" Discipline

The above cases show scenarios in which a government changed laws upon which a foreign investor had relied, thus opening the door for an investor to bring a claim under a BIT. Once codified, a "pre-established" discipline would enable governments to bring similar claims under GATS. If the "pre-established" discipline is interpreted in a manner similar to the "stable and predictable framework" interpretation of BIT obligations, countries could be in violation of GATS law if they change certain regulations. At what point is an investor's reliance on pre-existing law no longer reasonable? The following are examples of financial regulations that have a significant impact on the profitability of an investment. If a government strengthens them, their application to existing financial service suppliers could be impeded by a broad interpretation of the "pre-established" discipline.

### *A. High Capital Requirements*

Some experts believe that low capital requirements were a major cause of the financial crisis.[60] Low capital requirements allowed banks to become overly leveraged, placing financial systems in a precarious situation.[61] When the economy slowed, risky investments were lost, and banks did not have the capital necessary to cover their losses.[62]

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58 Bart De Meester, *Testing European Prudential Conditions for Banking Mergers in the Light of Most Favoured Nation in the GATS*, 11 J. INT'L. ECON. L. 609, 644 (2008); Joel P. Trachtman, *Transatlantic Regulatory Cooperation from a Trade Perspective: A Case Study in Accounting Standards*, in TRANSATLANTIC REGULATORY COOPERATION: LEGAL PROBLEMS AND POLITICAL PROSPECTS 223, 237 (George A. Bermann *et al*., eds., 2000).

59 *Id*. *See also* Todd Tucker and Lori Wallach, No Meaningful Safeguards for Prudential Measures in World Trade Organization's Financial Service Deregulation Agreements (Public Citizen, September 2009) 5, 17.

60 Robert Pozen, *Too Big to Save?* 129-30 (Hoboken, NY: Wiley) (2010).

61 *Id*. at 131.

62 *Id*.

Before the 2008 financial collapse, capital requirements caused tension between developing and developed nations. The European Union demanded that several emerging Asian countries lower their capital requirements in order to improve market access for European banks.[63] In 2006, the European Union assailed China for having "much higher than minimum capital requirements in most other countries" and asserted that China's requirements act as a protectionist measure.[64] But China was vindicated during the latest financial crisis when its banks proved more stable than their Western counterparts.

In the wake of their financial crises, nations ranging from the United States to Germany to Chile have proposed raising their capital requirements:

- Chile had high capital adequacy requirements prior to the crisis, helping its banks to weather the financial storm. Nevertheless Chile has "tightened and clarified" these requirements in order to guard against future financial instability.[65]
- Germany's coalition government has already released a draft policy that will ensure that capital requirements for German banks are greatly strengthened.[66]
- In the United States, the "Dodd Bill," currently under consideration in Congress, has provisions that would raise capital requirements, particularly for banks deemed "too big to fail.[67] The United States also hopes to rally support for international agreement on such capital standards.[68]

Under a broad interpretation of the "pre-established" discipline, these sorts of changes to capital requirements could be challenged in the WTO to the extent that they apply to the pre-existing capital base. As noted above, governments are already claiming that higher capital requirements are protected by the "prudential exception," but the prudential language defers to obligations under GATS. In other words, the broader the meaning of "pre-established," the narrower the scope of the prudential exception. This circular and unpredictable meaning of prudential language in GATS increases the need to clarify which version of "pre-established" the WPDR intends to adopt. Increased capital requirements, such as those in the Saluka case, are meant to increase financial stability, not to act as disguised protections against foreign banks. But so long as "pre-established" is open to mean, before investing (reliance on pre-existing law), the discipline could be used to challenge an increase in capital requirements.

Hypothetically, a change in capital requirements would be "pre-established" if the change applies only to newly chartered banks. This prospect frames the question for existing institutions: To what extent would a "pre-established" discipline grandfather an existing bank in terms of its capital base and its

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[63] Vicky Cann, *Taking the Credit: How Financial Services Liberalisation Fails the Poor*, 18-21 (World Development Movement) (March 2009).

[64] *Communication from the European Communities - Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China*, WTO DOCUMENT S/FIN/W/52, 11 OCTOBER 2006.

[65] J.F. Hornbeck, *Financial Regulation and Oversight: Latin American Financial Crises and Reform Lessons from Chile*, U.S. CONGRESSIONAL RESEARCH SERVICE (R40751; Aug 11, 2009), available at http://assets.opencrs.com/rpts/R40751_20090811.pdf.

[66] Noah Barkin, *Berlin eyes stronger bank capital requirements*, REUTERS, Oct. 9, 2009 http://in.reuters.com/article/fundsNews/idINBAT00319720091009.

[67] *Financial Reform Legislation Draft Bill*, UNITED STATES SENATE, Para. 605 & 615 (Accessed on March 29, 2010) http://banking.senate.gov/public/_files/AYO09D44_xml.pdf; Eric Dash, *White House to Propose Big Reserves at Banks*, NEW YORK TIMES, Sept. 2, 2009 http://www.nytimes.com/2009/09/03/business/03bank.html?_r=1; Stephen Labaton, *Bill Seeks to Shift Rescue Costs to Big Banks*, NEW YORK TIMES, Oct. 27, 2009 http://www.nytimes.com/2009/10/28/us/politics/28regulate.html.

[68] *Id*.

pre-existing operations, as compared with future stock sales, expanded deposit base, new branches, new products, etc.

### *B. Directed Lending to Certain Sectors or Regions*

Proponents of microfinance argue that the right to credit is a human right. But whether or not credit is a human right, it is often "the last hope left to those faced with absolute poverty."[69] Yet the poor are not the only group that government has aided in securing credit. Many governments have enacted "directed lending" regulations, in which the government implements regulations directing banks to make a certain percentage of their loans to disadvantaged groups.[70] Such policies can help to further the development of a nation's rural and agricultural sectors.[71] As farmers and entrepreneurs gain access to credit, they are better able to compete in the domestic market. In recent years, developing country governments from Nepal to Bolivia have pursued policies that encourage directed lending.[72]

A recent study in India shows that foreign banks are much less likely to give loans to rural areas and small businesses.[73] These foreign banks focus their lending on big businesses and rich individuals in cities—the most profitable group to lend to—thereby leaving the rural areas and small businesses without sufficient access to credit.[74]

Directed lending requires banks, especially foreign banks, to work harder in order to manage risk in sectors or regions with which they are not familiar. This imposes a cost in terms of time, expertise and risk of default. By changing regulations so that banks are directed to lend money to disadvantaged rural groups, "directed lending" policies change the technical standards that banks must follow.[75] Consequently, if a country strengthens or expands directed lending regulations, the change in regulations could be challenged as not "pre-established" so long as the discipline is open to mean, before investing (reliance on pre-existing law).

Unlike capital requirements, directed lending is not a prudential measure and therefore would not be protected by the "prudential exception." Directed lending promotes development. Consequently, a "pre-established" discipline could be particularly restrictive to developing countries. Developing countries often evolve at a more rapid pace then developed countries. Such rapid changes necessitate evolving policies to keep pace with the changes conditions; the "pre-established" discipline could therefore have a larger impact on developing countries.

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[69] *Vision*. YUNUS CENTER. (Accessed on Nov. 25, 2009) http://www.muhammadyunus.org/About-Professor-Yunus/about-professor-yunus-vision/.

[70] *National Treatment for Foreign-Controlled Enterprises*, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, (OECD Publishing: 2005), 121.

[71] Agricultural Finance Corporation Act, *Cap. 323 of the Laws of Kenya* (accessed Feb 2010 from http://www.kenyalaw.org/kenyalaw/klr_app/frames.php).

[72] D.K. Dhakal and H.K. Panthi, *Institutional Arrangements on Micro-Credit Operations in Nepal*, SAARC FINANCE SEMINAR ON MICRO CREDIT OPERATIONS, Dec. 21, 2002 http://www.bangladesh-bank.org/seminar/cpnepal.html; Sergio Navajas and Mark Schreiner, *Apex Organizations and the Growth of Microfinance in Bolivia*, OHIO STATE UNIVERSITY, May 1998 http://www.microfinance.com/English/Papers/Bolivia_Apex.pdf.

[73] Kavaljit Singh and Myriam Vander Stichele, *Rethinking Liberalisation of Banking Services Under the India-EU Free Trade Agreement*, 3-6 (Amsterdam: The Netherlands, SOMO) (Sept 2009).

[74] *Id*.

[75] The Draft at ¶¶ 40-41.

Hypothetically, a change in directed lending regulations would be "pre-established" if the change applies only to newly chartered banks. This prospect frames the question for existing institutions: To what extent would a "pre-established" discipline grandfather an existing bank in terms of its capital base and its pre-existing operations, as compared with future stock sales, expanded deposit base, new branches, new products, etc.

### *C. Standards for Foreign Investment*

Investment standards are another aspect of financial regulation that has stirred up tension over trade issues. The United States and China have quarreled over China's foreign investment standards, which provide that only firms with sufficient assets can invest in overseas funds or equities.[76] China responded by stating that the requirements are non-discriminatory and that they are "necessary to protect against excessive risk for overseas investment."[77] This is an interesting point because it shows that standards for foreign investment are prudential measures, but they nevertheless provide differential treatment of some institutions based on upon whether they engage in cross-border trade in financial services.

### *D. Competition and Antitrust Policy*

Antitrust regulations also have the capacity to provoke trade disputes, especially as they involve financial institutions. Large foreign financial institutions dominate the financial sector of many nations.[78] Regulations that constrain the expansion of these large foreign banks often encourage more competition from smaller domestic start-up banks and institutions.[79]

In addition to antitrust regulations that encourage competition from the bottom-up, there are top-down antitrust regulations that are meant to improve the stability of the economy. A prominent example is the recently proposed "Volcker Rule," in which U.S. banks would be prohibited from acquiring another bank if the merged company would have more than 10 percent of the liabilities in the financial system.[80] This rule, in a trimmed down form, has been in place since 1994.[81] But the original rule limited the calculation of 10 percent to counting the amount of deposits of the merged institution.[82] The Volcker Rule has proposed expanding this "10 percent of all deposits" rule to include other assets and liabilities such as non-deposit funding in the hope that this measure will further restrict growth and mergers between large banks.[83] Such regulations discourage mergers and acquisitions in order to prevent large banks from becoming so big that they establish sufficient market power to reduce competition from

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76 *Communication from the United States - Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China*, WTO DOCUMENT S/FIN/W/53, 18 October 2006.

77 *Id*.

78 J. Soedradjad Djiwandono, *Indonesian Financial Crisis Ten Years After: An Insider's View*, LESSONS FROM THE ASIAN FINANCIAL CRISIS, (ed.) Richard Carney, New York, Routledge: 2009 (67-78).

79 *Id*.

80 Sewell Chan, *White House Offers Bill to Restrict Big Banks' Actions*, NEW YORK TIMES, March 3, 2010, (*available at* http://www.nytimes.com/2010/03/04/business/04regulate.html?scp=1&sq=bill%20offered%20to%20restrict%20big%20banks&st=cse).

81 *Market Share Caps*, NEW RULES PROJECT, (*available at*: http://www.newrules.org/banking/rules/market-share-caps).

82 Nicholas Johnston and Julianna Goldman, *Obama Calls for Limiting Size, Risk-Taking of Financial Firms*, BLOOMBERG, January 22, 2010, *available at*: http://www.bloomberg.com/apps/news?pid=20601087&sid=aGwoMdcKbVFk).

83 *Id*.

smaller banks.[84] Will the "pre-established" discipline subject nations to trade sanctions if they apply such regulatory changes to existing financial institutions?

### *E. Regulation of Risky Trading Practices*

High-risk trading practices have emerged as a primary cause of the recent crisis.[85] In particular, practices such as derivatives trading, in which highly specialized traders move vast sums of money around in transactions that are poorly understood by even the firm's executives.[86] Warren Buffet has characterized derivatives as "financial weapons of mass destruction."[87] Some of these practices are particularly harmful to developing countries, with hedge funds and private equity funds destabilizing the financial systems of small economies through speculative and leverage activities.[88]

In order to rectify this situation, many regulations have been proposed that will allow the government to better regulate these practices.[89] Such regulations take many forms; some would attempt to regulate the complex derivate trading directly.[90] The Dodd Bill on financial regulation, under consideration in the U.S. Congress, would regulate several derivative-trading practices, most significantly, by requiring derivative trading to be done through open and transparent markets in the future.[91] Likewise, European Union parties have proposed new EU regulations on hedge funds and private equity that curb "over-the-counter" derivative trading by obliging all derivatives to be traded on regulated and standardized trading platforms.[92]

Other policymakers have suggested alternative measures, such as dividing financial institutions into two distinct classes, each subject to different regulations.[93] But whatever form these regulations take, they will be prudential measures that could be challenged as not "pre-established" if they are applied to pre-existing operations of a financial institution.

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84 Pozen at 13-25.

85 Andrew Ross Sorkin, *Too Big to Fail*, 373-484 (New York, NY: Penguin Group) (2009).

86 *Id*. at 79-133.

87 *Buffet Warns on Investment 'Time Bomb'*, BBC NEWS, March 4, 2003, http://news.bbc.co.uk/2/hi/2817995.stm.

87 Myriam Vander Stichele, *Financial Regulation in the European Union*, CENTRE FOR RESEARCH ON MULTINATIONAL CORPORATIONS, 45-47, http://somo.nl/publications-en/Publication_3198.

89 Erik F. Gerding, *Deregulation Pas de Deux: Dual Regulatory Classes of Financial Institutions and the Path to Financial Crisis in Sweden and the United States*, 3-6 (Draft of Feb 5, 2010), http://ssrn.com/abstract=1548753; Pozen at 26-50.

90 Pozen at 26-50.

91 *Financial Reform Legislation Draft Bill*, UNITED STATES SENATE, Para. 714 (Accessed on March 29, 2010) http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

92 Myriam Vander Stichele, *An Oversight of Selected Financial Reforms on the EU Agenda*, CENTRE FOR RESEARCH ON MULTINATIONAL CORPORATIONS, 21-26, http://somo.nl/publications-en/Publication_3221.

93 Gerding at 6-10.

## VII. Conclusion

### A. *Overview of the Possible Meanings of "Pre-Established"*

Can the "pre-established" provision be defined in a clearer and more explicit way? The meaning of the "pre-established" discipline need not be ambiguous. WPDR negotiations are ongoing, meaning that governments and trade negotiators have a ready forum to discuss the ultimate meaning of "pre-established."

| Multiple meanings of "pre-established" | Stage of the licensing process | | |
|---|---|---|---|
| | 1 Before application | 2 After application & before approval | 3 Before renewal |
| 1. Before government applies a change in the law (not retroactive). New regulations should affect only future and not past actions. | | Point of approval | Point of renewal |
| 2. Before service suppliers rely on pre-existing licensing standards or procedures (proposed by the WPDR chair). Government could not change standards or procedures after application and before a decision. | X | X | |
| 3. Before service suppliers rely on pre-existing law.<br>a. Stable and predictable regulations. This version would essentially grandfather investments made before a regulation is changed.<br>b. Foreseeable regulations. This version would enable government to apply changes of regulations to an investment if the change is foreseeable. | X | X | X |

### B. *Questions for the WPDR*

2. *Meaning of "pre-established."* There are several distinct meanings of "pre-established" as applied to financial regulation. Which of these meanings do negotiators intend to include? Which do they intend to exclude?
   (a) Before government applies a change in the law.
   (b) Before service suppliers rely on licensing standards or procedures.
   (c) Before service suppliers rely on pre-existing law.

3. *Impact generally.* Which of these meanings would dramatically change the domestic practice of most nations? Have negotiators assessed the impact of these meanings on their own nation's practice?

4. *Impact of a discipline on financial regulation*
   How would the different meanings of a "pre-established" discipline affect the following

domestic practices, which regulators sometimes use both for prudential reasons such as responding to a financial crisis and for the purpose of encouraging development:

(a) High capital requirements
(b) Directed lending to certain sectors or regions
(c) Standards for foreign investment
(d) Competition and antitrust policy
(e) Regulation of risky trading practices

5. *Scenarios of conflict*
   (a) What are specific examples where application of measures has not been "pre-established"? Without a concrete example, it is not possible to understand the problem that this discipline seeks to cure; nor it is possible to predict the impact of this discipline.
   (b) Which countries are most likely to use "pre-established" to challenge changes to financial regulations? Which definitions of "pre-established" do these countries prefer?
   (c) Do negotiators intend to adopt a discipline that foreign investors could use as evidence to strengthen their claims in BIT arbitrations?