THE TPPA, FINANCIAL INSTABILITY & GOVERNMENTS' REGULATORY SPACE[#]

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The post-2007 global financial crisis exposed the chronic instability of a highly liberalised, deregulated and globally integrated financial system. The debate on the nature of these risks and the appropriate remedies is still embryonic. No one knows precisely how and where the next crisis will unfold or what actions national governments and international institutions will need to take.[1] In this fluid situation it is essential that governments retain the policy and regulatory space that will enable them to respond as they see appropriate to their situation.

In particular, the global financial crisis has sparked a timely rethink on the promotion of financial deregulation through multilateral and bilateral financial services and investment agreements,[2] and associated requirements for full capital account liberalisation.[3] The report of the UN-appointed a group of experts on the financial system, known as the Stiglitz Commission, explicitly criticised the narrow sectoral mindset of these agreements that ignores the associated risks:

> Unfortunately, while the GATS Financial Services Agreement provides the only significant regulatory framework for international financial services, it was not conceived and negotiated with these broader considerations in mind but rather was driven by sectoral interests. These special interests often do not realize (or care about) the vulnerabilities that these commitments impose on other aspects of their economy or the international economy. [4]

The Commission's final report in September 2009 recommended that:

> 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. … 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. [5]

The challenge arising out of the financial crisis coincides with a major reappraisal of international investment agreements. These agreements face a crisis of legitimacy as states' obligations to foreign investors and their obligations are seen to have an unacceptable chilling effect on regulations design to benefit the rest of society and the environment.[6] Strategies to rebalance these competing imperatives include new terminology and the broadening of objectives beyond the primacy of investor protection, yet the legal impact of these innovations depends on ad hoc arbitral interpretations; moreover, many old-style agreements still have force directly and indirectly most favoured treatment

[#] We are grateful for the assistance of Kevin Gallagher, Associate Professor of International Relations at Boston University, and Matthew Porterfield, Senior Fellow, Harrison Institute for Public Law, Georgetown University Law Centre, Washington DC, US and Sarah Anderson, Global Economy Project Director, Institute for Policy Studies, Washington DC, US and Todd Tucker, Public Citizen, Washington DC, US in preparing this paper.

clauses.[7] New responses to changing global financial dynamics, such as renewed support for various forms of capital controls or financial transactions taxes, add further uncertainty to this fluid legal environment.

The Trans-Pacific Partnership (TPPA) negotiations provide a critical opportunity to revisit the framework of trade and investment rules that govern financial services and investments and currency movements. Proponents of the TPPA aspire to a trade agreement that is fit for the 21st century. To achieve that goal, the agreement cannot perpetuate the flawed framework and policy and regulatory constraints that are currently imposed through the Financial Services Agreement in the General Agreement on Trade in Services (GATS)[8] and free trade agreements (FTAs), especially those premised on the North American Free Trade Agreement (NAFTA) model of US FTAs; instead, it needs to wind them back. In this uncertain and fluid environment, a TPPA should at the least exclude financial services, investment and currency controls from its scope and relieve its parties of their existing bilateral obligations to each other.

To date, the TPPA negotiations have taken the opposite approach. The process began as an expansion of the Trans-Pacific Economic Partnership Agreement or "P-4" between New Zealand, Chile, Singapore and Brunei to cover financial services and investment, with the US as a fifth party. These negotiations coincided with the onset of the global financial crisis, yet they followed the standard US FTA line. The draft texts that were developed have been carried into the TPPA process and reportedly form the basis for bracketed composite draft texts on financial services and investment that were compiled during the Auckland negotiations in December 2010. Those draft texts remain secret, but briefings confirm that there has been no reconsideration of the standard US FTA approach in light of the global financial crisis.

The secrecy surrounding the TPPA negotiations, including the refusal to release draft texts, increases the risk that governments will adopt obligations that carry unacceptable economic and social consequences. To provide a basis for independent experts to analyse the implications of a TPPA for financial stability a 'mock' text has been compiled from the existing US FTAs with Singapore, Chile, Peru and Australia.[9] The focus of this analysis is on financial regulation and the regulatory space that governments must regain and retain to pre-empt and respond to future crises. Other ways that a TPPA could restrict governments' ability to use common recovery measures, such as industry bailouts, to mitigate recession, job losses and social distress are not addressed here. Nor are the everyday socio-regulatory issues, such as community access to affordable credit, which financial services agreements raise.

CONTRIBUTORS TO FINANCIAL INSTABILITY

The global financial crisis has exposed systemic problems of concentration, contagion, excessive risk-taking and lack of transparency that result from deregulation and liberalisation of financial markets, foreign investment and capital flows. Financial services and investment agreements guarantee that governments will maintain the regulatory regime that has created those

conditions and fetter their ability to re-regulate. Key contributors to financial instability include:[10]

A core of powerful financial institutions became "too big to fail" as a result of decades of privatisations, foreign investment liberalisation, dismantling the firewalls between insurance, banking and securities activities, and facilitating national and international mergers and acquisitions.

The Wall St complex secured a light-handed deregulatory regime that hindered transparency, disguised conflicts of interest and rewarded recklessness. Governments competed to attract and maintain financial hubs by conceding to demands for self-regulation, coupled with private risk assessment by self-interested credit raters, investment advisers and analysts. This approach was legitimised through international standards, notably the Basel II rules.

Risks of transnational contagion intensified as banks and insurers operated through branches, agencies and representative offices, and poorly regulated cross-border e-finance. Unrestricted capital inflows and outflows enabled rapid circulation of speculative money flows and repatriation of capital to shore up parent banks, creating credit crises in host countries. The process of regulatory arbitrage and convergence around light touch regulation was intensified by special rights for the finance industry to be consulted over new regulation, self-regulatory bodies that relied on international standards set by their own industry, and mutual recognition arrangements across countries.

The shadow banking system traded highly leveraged, complex and opaque 'innovative' financial services and products in over-the-counter, cross-border transactions that were deliberately designed to evade national regulation and minimize transparency. High-risk, highly leveraged hedge funds, pension funds and private equity funds fuelled demand and speculative profits by investing heavily in these toxic products.

A TPPA is predicted to intensify the risk of financial instability and future crises. The form, coverage and rules projected in the mock TPPA text would intensify the risks and constraints arising from the GATS by:

- reiterating an expansive and open-ended definition of financial services and investments that includes operations and products at the core of the global financial crisis;[11]
- use of a negative list for market access and national treatment commitments on financial institutions and their investments;[12]
- broad application of rules to measures 'relating to' financial institutions, investors, investments and cross border transactions;[13]
- comprehensive capital account liberalisation that fosters speculation and hinders currency controls that may pre-empt and mitigate crises;[14]
- pre-commitment to allow supply of new financial services, including across the border;[15]
- unrestricted transactions with cross-border and offshore financial services suppliers and associated capital movements;

- limited and contestable exceptions, notably the prudential exception defence;[16]
- investor-state enforcement of minimum standards of treatment and expropriation when governments try to re-regulate foreign establishments, investments and capital movements;[17] and
- far-reaching MFN obligations that apply retrospectively, including cross fertilization with bilateral investment treaties.[18]

HIGH-RISK FINANCIAL INVESTMENT RULES

A number of controversial provisions of the investment chapter of US FTAs are imported into the chapter on financial services. In the mock TPPA text these include the definition of financial services[19] and investment,[20] minimum standards of treatment and expropriation provisions,[21] MFN rules,[22] transfers,[23] and the investor-state disputes mechanism.[24]

As noted earlier, the objectives, rules and arbitral interpretations of international investment agreements have become highly contentious, with debate centred on how to find a new balance between governments' competing objectives and responsibilities.[25] This debate is especially important in the TPPA context. The US uses the 2004 version of the US Model Bilateral Investment Treaty (BIT) as the basis for negotiating new international investment agreements. Significantly, President Obama made a pre-election commitment to make significant changes in the investment rules in trade agreements.[26] The Obama administration formed an advisory body of investment experts,[27] comprising a diverse group drawn from business, academia, labour, environmental NGOs and the legal profession, to review the Model BIT. As their September 2009 final report showed, the group was highly polarised.[28] Corporate representatives opposed virtually any changes to the existing model. Groups representing public interest organisations submitted a joint annex laying out recommendations for a significant overhaul, including the need for a stronger "prudential measures exception" to protect government actions that secure the stability of its financial system and safeguards for the use of capital controls to prevent or mitigate financial crisis.[29]

The original plan was to complete the model by the end of 2009. As of February 2011, the Obama administration was still consulting members of Congress to build consensus around a new model BIT. The outcome has the potential to significantly change the US position in the TPPA negotiations, for better or worse. Yet the text drafted in the US-P4 negotiations is apparently based on the 2004 US Model BIT; the mock TPPA text reflects that position.

'Investment' is broadly defined through a combination of the Financial Services and Investment chapters. The financial services rules apply to measures 'relating to' financial institutions of another Party, investors of another Party in financial institutions in another Party's territory, and the investments of those investors in such financial institutions.[30] (That section also applies to cross-border financial services transactions). In addition, rules on investment apply to other kinds of financial investments, such as bonds, debentures and other debt instruments, futures, options and other derivatives.[31] The investment rules cover

all assets that an investor owns directly or indirectly; one characteristic is the expectation of expected gain or profit, hence obligations regarding the treatment of an investment extend to the impact on gain or profit, as well as its value.

Application of the most-favoured nation (MFN) provision[32] to financial services and investments would have a highly unpredictable and dynamic ratcheting effect:

- BITS and financial services and investment chapters of FTAs that TPPA parties have with non-TPPA countries can become enforceable by other TPPA states and their financial investors. Many BITs especially have no prudential or other defence or safeguard mechanisms to allow financial regulation, and no interpretive note to restrict the scope of expropriation. For example, Vietnam has an old-style BIT with the United Kingdom that has no interpretive note on expropriation; investors from TPPA countries could be entitled to the same treatment under the MFN provision in a TPPA.
- Conversely, MFN provisions in such BITS and FTAs may entitle the non-TPPA countries and their financial investors benefit from any more favourable provisions in the TPPA. The Vietnam-UK BIT[33] guarantees investors treatment no less favourable than any other party's investors; that would entitle UK investors to any greater benefits conferred on investors under a TPPA.

It has also been argued that GATS commitments could become enforceable via an investor-to-state dispute settlement mechanism in a TPPA, where the MFN obligation[34] entitles financial institutions of the parties to any better treatment given to the commercial establishments of non-parties, including under the GATS.[35] That would only be directly relevant where negotiators want to reserve more regulatory space and claw back a commitment made in their GATS schedules. However, any new regulatory disciplines agreed under the GATS, which may go further than the financial services provisions in a TPPA, could also be imported through the MFN provision. The March 2010 chair's text[36] includes a requirement that domestic regulations be "pre-established", "objective", "relevant to the supply of services"; all are vague terms whose interpretation by an ad hoc arbitral panel in a TPPA would be impossible to predict with any certainty. Acceptance of other proposals made during the negotiations, such as a "necessity test" or restricting regulation to "legitimate" objectives, would certainly fall under the MFN provision, based on the mock text.

Financial investors of one TPPA Party may secure greatly expanded rights if they can combine TPPA provisions with more favourable treatment in an FTA with another Party. For example, Australian banks own 94% of New Zealand's banking sector.[37] They have full MFN and national treatment and rights to establish a commercial presence in the legal form of their choice under the services protocol to the Australia and New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) 1989, but that agreement currently has no formal investment chapter, hence no minimum standards and expropriation provisions, and no state- or investor-enforcement mechanism. A TPPA would vastly increase the leverage of Australian banks over New Zealand regulators.

Market access[38] and national treatment[39] rules could prevent important measures to restrict financial institutions becoming too big to fail and contagion. Governments are required to commit not to impose numeric

restrictions, including bans, on the number of financial institutions or their size, or caps or bans on financial services and products, in addition to the obligation to allow new financial services. Glass-Steagall-type of firewalls arguably breach these obligations. The need to take reservations to permit such measures may not be perceived at the time of the negotiations; an example is the concerns over institutions trading for their own account in derivatives. Financial regulators could not seek to increase effective legal responsibility and accountability by restricting or requiring a specific kind of legal entity, including a joint venture, require at least some of the senior executives to be nationals, or that a majority of directors are nationals or even residents of the host country.[40]

Governments may face a damages claim for a breach of minimum standards of treatment if it makes regulatory changes that contradict the basic expectations of an investor when the investment was made. The minimum standards provision explicitly includes "fair and equitable treatment" and "full protection and security" for investments. The provision, in particular the right to "fair and equitable treatment", has been repeatedly interpreted as conferring a right to a stable and predictable legal and business environment that does not frustrate an investor's legitimate expectations regarding the profitability or value of the investment.[41] The United Nations Conference on Trade and Development (UNCTAD) records that investors have invoked this provision much more in recent disputes than the investor protection through the expropriation clause.[42] Referring to the NAFTA-style approach, UNCTAD suggests the wording "could be broad enough to apply to virtually any adverse circumstance involving an investment".[43]

The minimum standard of treatment obligation applies directly to investments. It is incorporated indirectly into the Financial Services section through the Expropriation provision,[44] which sets the terms for permissible expropriation as compliance with the article on Minimum Standards of Treatment.[45] The interpretive Annex on Expropriation also refers explicitly to customary international law, which includes minimum standards of treatment.[46] It is difficult to predict whether an arbitral panel would agree that a measure that comes within the financial services chapter and falls short of direct or indirect expropriation could also violate the fair and equitable treatment and provide a separate cause of action.

If a tribunal interprets 'expropriation' to include the reduction of profits, many financial reregulation measures could be found to be expropriation. For regulation to constitute indirect expropriation it must interfere with a tangible or intangible property right or interest in an investment.[47] The expectation of profit is integral to the definition of a financial investment.[48] As the Stiglitz Commission notes: 'By definition, regulations reduce profits because they restrict potentially profitable actions.'[49]

The interpretive annex on expropriation gives no certainty that such regulations would be protected from investor-initiated claims. Assuming the regulatory action in question is interpreted as interfering with a property right or interest, a panel would need to consider the interpretive annex on expropriation. Whether an action constitutes indirect expropriation depends on a panel's determination on a case-by-case, fact-based inquiry. The first factor to be

considered under the mock TPPA text is the economic impact (on the investor) of the action, although adverse effect on the economic value of the investment is not determinative of itself. Other factors are the extent to which the action interferes with distinct, reasonable investment-backed expectations and the character of the government action.

There is a similar interpretive annex in the ASEAN Comprehensive Investment Agreement, and the Australia New Zealand ASEAN FTA (AANZFTA), but the wording is more restrictive.[50] An inquiry into a complaint must consider whether the action breaches the government's prior binding written commitment to the investor, as well as considering the government's objective and applying a proportionality test in relation to the public purpose. Given that Australia has accepted the standard US provision, it is unlikely that this wording would survive into a TPPA.

The Annex creates a strong presumption that protects non-discriminatory regulatory actions that are directed to 'legitimate public welfare objectives'.[51] However, the list of indicative objectives does not include financial or economic stability. An investor could argue that the prudential defence provides an equivalent and more appropriate protection for financial regulation; the inadequacies of that provision are discussed below.

Even where an expropriation claim falls within this interpretive annex, it does not apply to claims brought under the minimum standards of treatment.

Government responses to the financial crisis risk being challenged as expropriation or breach of fair and equitable treatment, with compensation to affected financial institutions. These measures are embryonic and evolving, and the likely arguments and outcomes are impossible to predict. For example, a number of recommendations of the Stiglitz Commission could become subject to a TPPA dispute if their impact was sufficiently significant.[52] These include restrictions on swaps and other derivative products and quantitative restrictions on the proportion of bank portfolios that can be allocated to sectors that are prone to speculative activity (eg real estate) and loan-to-value limits on mortgage lending, in terms of market access obligations and investment protections; limitations on bankers' bonuses, if employee remuneration is not also cut);[53] financial transaction taxes on banks to recoup the cost of bailouts;[54] or to provide a future fund for such bailouts; regulations to help consumers,[55] such as restrictions on abusive lending. Governments would have to rely on the inadequate prudential measures defence and the special provisions for taxation measures, discussed below.

Investors have already used investor-state disputes powers to sue governments for the financial regulations they imposed to deal with financial crises. All but one of 27 of pending BIT cases against Argentina at the International Centre for Settlement of Investment Disputes relate to its financial crisis. The claims argue either that the measures to delink from the dollar or to staunch capital flight constituted indirect expropriation, violated investors' expectations from the pre-crisis era, or were a prohibited restriction on free transfers.[56] Specific to TPPA parties, a foreign investor sued the Malaysian Government under an equivalent provision in a BIT for its use of capital controls to deal with its 1998 financial crisis.[57] These capital controls are widely

recognised to have spared Malaysia the worst of the financial crisis. The current economic crisis could give rise to more investor-to-state cases.[58] For example, failure to bail out banks equally has already resulted in host governments being liable.[59]

CONSTRAINTS ON CAPITAL CONTROLS & SOVEREIGN DEBT RESTRUCTURING

The “transfers” provision requires governments to permit all transfers relating to a covered investment to be made “freely and without delay into and out of its territory”;[60] the equivalent applies for transfers and payments for cross-border financial services.[61] In effect, these rules promote capital account liberalisation between the parties, regardless of the implications for financial stability.[62]

Prohibiting capital controls conflicts with contemporary economic thinking. In addition to the Stiglitz Commission, successive reports from the International Monetary Fund (IMF) have concluded that capital controls are a legitimate policy tool for preventing and mitigating crises,[63] a view echoed by the Asian Development Bank[64] and United Nations.[65] In January 2011, 250 international economists, including a Nobel Prize winner, former IMF economists and other prominent experts, provoked a vigorous exchange of views when they wrote to the US Government expressing concern over the extent to which US trade and investment treaties restricted the use of capital controls and calling for governments to be permitted to deploy capital controls without being subject to investor claims, as part of a broader menu of policy options to prevent and mitigate financial crises.[66]

The lack of safeguard mechanisms contrasts with the trade and investment agreements of virtually every other major capital exporter.[67] The absence of any right in US FTAs to allow capital controls on inflows and outflows to prevent or mitigate crises, even in balance of payments emergencies, has drawn criticism from senior legal counsel for the IMF, among others.[68]

Financial speculation taxes to stem hot money flows could be challenged for violating investors’ rights to transfer investments “freely and without delay”.[69] Financial transaction taxes are increasingly considered a viable means to curb speculation and generate revenue for emergency bailouts, economic recovery programmes and other urgent needs. Taxation measures are subject to expropriation obligations, but under special conditions that require prior consultation between the tax authorities of both parties; a claim can proceed where they agree the measure constitutes expropriation or there is no agreement. There are no similar restrictions on complaints that taxation measures breach the transfer provisions.

The variety of forms of capital controls that have recently been employed potentially involve market access and national treatment issues, such as taxes on selected investments, restrictions on the domestic uses of foreign currency loans or on investments in financial products based on the duration or nature of the instrument, and quotas on the proportion of derivatives contracts held relative to capital.[70]

Governments seeking to stabilize capital flows are vulnerable to investor-initiated disputes because exceptions are inadequate. Special dispute

resolution annexes in US FTAs with Singapore, Peru, and Chile have an extended "cooling off" period before investors may file claims relating to "transfer" provisions,[71] and the amount of damages related to certain types of capital controls is limited in the Chile and Peru FTAs to reduction in the value of the transfers. However, restrictions on investor disputes for transfers still place undue restrictions on the authority to use capital controls and do not apply where claims relate to other provisions, such as national treatment.[72]

Governments using sovereign debt restructuring (SDR) as a post-crisis recovery strategy may face investor-initiated claims for damages. SDR is increasingly viewed as a valid alternative, or complement, to IMF- or taxpayer-financed bailouts at times of debt crises. In the mock TPPA text, sovereign debt is defined as an "investment".[73] Restructuring, by definition, reduces the value of a sovereign bond and could be seen as a violation of not only the transfers provisions, but also of "fair and equitable treatment"[74] and constitute an "expropriation." By filing investor-state claims under a TPPA, bondholders can thereby circumvent official restructuring processes.[75]

Vulnerability to claims over sovereign debt restructuring:[76] Debt-related claims during a restructuring are not permitted in the Peru FTA; the Chile US FTA has a more comprehensive exclusion. Both versions are inadequate, as they do not apply where the measures violate national treatment or most favoured nation provisions; a nation in crisis may be justified in giving domestic bondholders priority under a sovereign debt restructuring to protect the banking system or ensure fulfillment of wage and pension commitments.

INADEQUACIES OF THE PRUDENTIAL MEASURE DEFENCE

The "prudential measures" defence[77] does not provide member governments with adequate policy space to respond to future financial crises and pursue other legitimate regulatory objectives. The prudential defence only applies to financial services and not to financial investments that fall outside its scope.[78] Assuming that capital controls are considered to be in pursuit of monetary and related credit policies or exchange rate policies, they are excluded from the prudential provision as it relates to financial services.[79] Further, the language of the text excludes from its protection some important non-prudential areas of regulatory policy.

The text fails to specify either the degree of nexus required between regulatory measures and their prudential objectives or the standard for determining when a Party will be found to be improperly using the measure to avoid its obligations under the agreement.

There are several areas of ambiguity in the prudential measures provision. Some guidance on its likely interpretation by future dispute settlement panels or arbitral tribunals can be gained from the analysis of how WTO dispute panels have interpreted analogous exceptions in Article XX of the General Agreement on Tariffs and Trade (GATT) and Article XIV of the GATS. Under this approach, the analysis would focus on two questions: 1) Is the financial service regulation "provisionally justified" as falling within the scope of the prudential

measures defence; and if so, is it applied in a manner that does not inappropriately circumvent the Party's obligations under the TPPA?[80]

Is the measure provisionally justified as a prudential measure? This question involves two elements.

First, was the measure designed to achieve prudential objectives? The text of the Article indicates that the defence applies to measures aimed at protecting individual financial institutions, their investors and depositors, and the "integrity and stability of the financial system."[81] Significantly, this appears to exclude certain types of financial services regulations such as directed lending requirements and other regulations of financial products for non-prudential reasons (e.g., restrictions on food-based derivatives to limit food price volatility.)[82] It is debatable whether the defence extends to measures that arguably have mixed objectives. For example, a WTO Secretariat note cast doubt on whether Glass-Steagall type firewalls would be allowed under the prudential defence, given that the US viewed them as prudential, but European countries perceived them as having non-prudential elements.[83]

Second, in order to be provisionally justified, even measures that are intended to achieve prudential objectives would need to have some requisite degree of nexus with their prudential objectives. Under GATT Article XX, for example, some types of measure are merely required to be "related to" their objectives, whereas others are required to meet the more stringent standard that they be "necessary" to achieve their objectives.[84] The prudential measures language does not specify the required degree of nexus. Presumably some evidence of risk is required, with the burden of proof on the regulating state. That raises particular problems where governments with to impose more restrictive precautionary regulations on 'new financial services' that are, by definition, novel and permitted by domestic law, often because they are designed to evade existing regulation. For example, a government seeking to regulate cross-border over the counter collateralized debt obligations during the mid-2000s would have been unable to demonstrate a risk that justified regulation because the toxicity of CDOs only became widely accepted once the financial crisis was underway.

If provisionally justified, is the measure nonetheless impermissible because it is applied in a manner that inappropriately circumvents the party's obligations under the TPPA? The second sentence of the prudential measures defence states that when prudential measures "do not conform to the provisions of this Agreement . . . they shall not be used as a means of avoiding the Party's commitments or obligations under such provisions." This provision could be subject to a range of interpretations. On one end of the spectrum, it could be interpreted literally, which would render the prudential measures language effectively self-cancelling.[85] Under this approach, a measure that was inconsistent with a party's obligations under the agreement (such as a market access commitment) would be impermissible, thereby rendering the prudential measures defence effectively meaningless.

At the other the other end of the spectrum, it could be interpreted in a manner similar to the chapeau (introductory paragraph) of Article XX of GATT, which states that measures that are otherwise within the scope of an exception

may not be used "as a means of arbitrary or unjustifiable discrimination . . . or a disguised restriction on international trade." The NAFTA provision has been interpreted as permitting tribunals to review financial measures to determine whether they are "reasonable" or "arbitrary".[86]

The Prudential Measures provision is really a defence, not an exception or a carveout, and its acceptance will depend on the interpretation of a dispute panel. Given these limitations and uncertainties, governments cannot presume the provision will protect measures that they deem to be essential to maintain financial stability and for financial and economic recovery in the face of a crisis. It is important to recall that the risks under investor-state disputes are much higher than where only states can enforce the agreement, because investors will sue if they can make money and they can claim multi-million dollars in compensation; states may be deterred from bringing a case by broader political considerations and are limited to reversal of to measure or retaliatory measures as the remedy.

RECOMMENDATIONS

A TPPA should not restrict a government's authority to regulate the financial sector and financial transactions, use capital controls and restructure sovereign debt to prevent and mitigate financial crises. This analysis indicates that a TPPA text that was fit for the 21st century would:

1. explicitly extend the self-judging exclusion of measures adopted by a Party for essential security interests[87] to include measures a government considers necessary with respect to the maintenance or restoration of its essential financial and related security interests.

2. restrict the definition of "financial service" to core traditional banking and insurance services.[88]

3. exclude from the definition of "investment" any short-term investment and sovereign debt.[89]

4. ensure that financial services, financial investment and transfers are not subject to investor-initiated disputes. Any state-to-state dispute settlement procedures should only be available after a consultation process.

Ultimately, however, the only effective way to provide the necessary regulatory space to governments is to exclude coverage of financial services, financial investment and currency movements from a TPPA in a way that also rescinds any existing obligations between the parties that exceed those undertaken through the GATS 1994, pending their review as recommended by the Stiglitz Commission.

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[1] In the 2008 Lowy Lecture former Australian Reserve Bank Governor Ian Macfarlane contextualised the current crisis as one of eight that has occurred in just over a decade. Four of those were banking crises. Macfarlane concluded that, even though other crises had much more severe impacts on Australia, from an international perspective the depth and contagion of the GFC has clearly invalidated the model of a deregulated financial system that has operated in recent decades. Ian Macfarlane, 'Australia and the International Financial Crisis', 2008 Lowy Lecture, Sydney, 3 December 2008.

[2] United Nations, *Report of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, 21 September 2009*, [Stiglitz Report]; Cornford, Andrew (2008) *The WTO Negotiations on Financial Services: Current Issues and Future Directions,* Discussion Paper no 172, June 2004, Geneva: UNCTAD, UNCTAD/OSG/DP/2004/6; Raghavan, Chakravarthi (2009) 'Financial Services, the WTO and Initiatives for Global Financial Reform', Report to the Intergovernmental Group of 24, http://www.iatp.org/tradeobservatory/library.cfm (accessed 10 February 2010); Gallagher, Kevin P. (2010) *Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements,* G-24 Discussion Paper No. 58, April 2010

[3] Most significantly, the International Monetary Fund, previously a stalwart champion for light-handed financial sector regulation and full capital account liberalisation, has published a number of documents that identify flaws in the model. J. D. Ostry, *et al*, (2010) *Capital Inflows: The Role of Controls*, International Monetary Fund Research Department, SPN/10/04, 19 February 2010; Ourada Merrouche and Erland Nier, (2010) 'What Caused the Global Financial Crisis?—Evidence on the Drivers of Financial Imbalances 1999-2007', IMF Working Paper WP/10/265, December 2010

[4] Stiglitz Report, p. 103

[5] Stiglitz report, p.104

[6] Spears, Suzanne (2010) 'The Quest for Policy Space in a New Generation of International Investment Agreements', *Journal of International Economic Law,* 13(4) 1037-1075

[7]Sweeney Samuelson, Emily and Ebere, Solomon, *Could a Foreign Investor Use GATS Disciplines in a BIT Claim*?, Working Paper on GATS Negotiations on Domestic Regulation, discussion draft 19 May 2010

[8] The GATS rules and commitments on financial services are spread across four main documents, collectively known as the Financial Services Agreement. The first is the basic GATS text. The second is the Fifth Protocol to the GATS that contains the final schedules of commitments on financial services and came into effect in March 1999. A third Annex on Financial Services incorporates a comprehensive definition of financial services into the legal text, alongside provision for prudential measures. The most far-reaching component is the Understanding on Commitments in Financial Services that was designed by OECD members as a model template; the Understanding does not have legal status unless adopted by a WTO member in its schedule.

[9] http://web.me.com/jane_kelsey/Jane/TPPA.html

[10] A number of published accounts of the crisis identify some or all of these common elements see: Tett, Gillian (2009) *Fool's Gold. How unrestrained greed, corrupted a dream, shattered global markets and unleashed a catastrophe*; Boyes, R. (2009) *Meltdown Iceland. How the Global Financial Crisis Bankrupted an Entire Country,* Bloomsbury Books, London; McDonald, Larry (2009), *A Colossal Failure of Common Sense. The Incredible Inside Story of the Collapse of Lehman Brothers,* Edbury Press*;* Cable, Vince (2009) *The Storm. The World Economic Crisis and What it Means*, Altantic Books, London; Stiglitz, Joseph (2010) *Freefall. Free Markets and the Sinking of the Global Economy,* Allen Lane, London; Roubini, Nouriel and Mihm, Stephen (2010) *Crisis Economics. A Crash Course in the Future of Finance*, Allen Lane, London.

[11] The definition in Article 21 reiterates the non-exclusive definition of financial services in the GATS Annex supplemented by the definition of "investment" in Article 22 that includes enterprises, equity in an enterprise, bonds, debentures and other debt instruments.

[12] Article 9 provides for two schedules of non-conforming measures: one imposes a standstill on existing measures; the second permits new measures in specified sectors, subsectors or activities. However, these reservations do not apply to 'new financial services' under Article 6. M. Roy, J.

Marchetti and H. Lim (2006) *Services Liberalisation in the New Generation of Preferential Trade Agreements (PTAs): How Much Further than the GATS?*, WTO Staff Working Paper, Economic Research and Statistics Division, p. 54
http://www.wto.org/english/res_e/reser_e/ersd200607e.pdf (accessed 7 October 2009)

[13] Article 1.1. It is debatable whether "relating to" is broader or narrower than the term "affecting" used in Article 1(a) of the Annex on Financial Services in the GATS.

[14] The Financial Services chapter imports the Transfers and Payments provision in the Cross-border Services Chapter and the Transfers Article from the Investment Chapter. Unlike the GATS, these obligations apply irrespective of whether sectoral commitments have been made.

[15] Article 6 goes further than Paragraph 7 of the GATS Understanding on Financial Services, which applies only to services supplied by financial institutions, by including cross-border supply of services. Article 9:2, which reserves the right to regulate aspects of financial services, does not extend to new financial services.

[16] Article 10

[17] See below

[18] Article 3.

[19] Article 21

[20] Article 22

[21] Articles 23 and 24

[22] Article 3

[23] Article 25

[24] Article 20

[25] For a discussion of various actual and proposed changes on traditional bilateral investment treaties see Spears, Suzanne (2010) 'The Quest for Policy Space in a New Generation of International Investment Agreements', *Journal of International Economic Law,* 13(4) 1037-1075

[26] Wallach, Lori (2010) 'US Politics and the TPPA' in Kelsey, Jane (ed) *No Ordinary Deal. Unmasking the Trans-pacific Partnership Free Trade Agreement*, Bridget Williams Books, Auckland, p.54

[27] The formal name of this body was the Investment Subcommittee of the US State Department's Advisory Committee on International Economic Policy (ACIEP).

[28] http://www.state.gov/e/eeb/rls/othr/2009/131098.htm

[29] http://www.state.gov/e/eeb/rls/othr/2009/131118.htm#b

[30] Article 1.1

[31] Article 22 (a) to (d)

[32] Article 3

[33] Article 3.1 of the Bilateral Investment Treaty between the United Kingdom and Vietnam 2002

[34] Article 3 of the mock text reads: Each Party shall accord to investors of another Party, financial institutions of another Party, investments of investors in financial institutions, and cross-border financial service suppliers of another Party treatment no less favourable than that it accords to the investors, financial institutions, investments of investors in financial institutions, and cross-border financial service suppliers of a non-Party, in like circumstances.

[35] Sweeney Samuelson, Emily and Ebere, Solomon, *Could a Foreign Investor Use GATS Disciplines in a BIT Claim*?, Working Paper on GATS Negotiations on Domestic Regulation, discussion draft, 19 May 2010

[36] WTO, Working Party on Domestic Regulation, Disciplines on Domestic Regulation Pursuant to GATS Article VI:4, Annotated Text, Informal Note by the Chairperson, Room Document (March 14, 2010), which is an annotation of the March 2009 Chair's text (Room Document, 20 March 2009, Working Party on Domestic Regulation, - DRAFT -, DISCIPLINES on domestic regulation pursuant to GATS article VI:4, Second Revision, *Informal Note by the Chairman)*

[37] *Report of the Parliamentary Inquiry into Banking*, November 2009,
http://www.issues.co.nz/library_images/bankinquiry/report_of_the_parliamentary_banking_inquiry.pdf

[38] Article 4

[39] Article 2

[40] Article 8.

[41] Eg *Tecmed v Mexico*, *Enron v Argentina*, *CMS and PSEG v Turkey*, http://www.unctad.org/en/docs/iteiia20073_en.pdf, http://www.unctad.org/en/docs/iteiia20083_en.pdf, *Occidental Exploration & Production Co. v Ecuador,* 191 UNCITRAL Arb, 1 July 2004.

[42] UNCTAD (2009), 'Latest Developments in Investor-State Dispute Settlement'*, IIA Monitor no. 1* at 6, http://www.unctad.org/en/docs/iteiia20073_en.pdf

[43] UNCTAD (2007), *Investor-State Dispute Settlement and Impact on Investment Rule Making,* at 75 http://www.unctad.org/en/docs/iteiia20073_en.pdf

[44] Article 24.1 based on the US-Peru, US-Chile and US-Singapore FTAs.

[45] Article 23

[46] Investment Annex 1: Expropriation. A comprehensive contemporary analysis of the minimum standards obligation that disputes its status as customary international law can be found in Porterfield, Matthew. 'State Practice and the (Purported) Obligation under Customary Law to Provide Compensation for Regulatory Expropriations', forthcoming

[47] Investment Annex 1: Expropriation para 2.

[48] Article 22

[49] http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf

[50] Investment Annex 1: Expropriation in the draft TPPA text notes these differences.

[51] Investment Annex 1: Expropriation para 4(b)

[52] http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf

[53] Taxes on bankers' bonuses have also been implemented, see for example those imposed by the United Kingdom, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8xEsjTikfm8, which notes that it will reduce profits. France imposed a similar tax, see for example, http://www.guardian.co.uk/environment/2009/dec/11/tax-climate-aid-brown-sarkozy. These taxes on bankers' bonuses could be imposed to recoup the cost of bailing out banks (since banks continued to pay bonuses even when they made losses, for example the Royal Bank of Scotland made a loss of £3.6bn ($5.5bn) in 2009, but will pay £1.3bn in bonuses to staff, http://news.bbc.co.uk/2/hi/business/8534694.stm), or to realign incentives to try and prevent bankers from making risky investments such as those that caused the current financial crisis (eg US bill, see http://abcnews.go.com/Politics/story?id=8213911&page=1).

[54] In the US, the banking industry has already threatened to bring a legal challenge (under US law) against such a tax, see for example http://www.nytimes.com/2010/01/18/business/18bank.html. For a discussion on the various tax options see Alexander, Kern, 'International Regulatory Reform and Financial Taxes', *Journal of International Economic Law*, 13(3) 893-901; see also the view of the European Commission staff in EC 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

[55] Eg the US's proposed reduction in credit card fees in order to help consumers has already caused lost profits for banks, see for example http://dealbook.blogs.nytimes.com/2010/07/16/banks-seek-to-keep-profits-as-new-oversight-rules-loom/ and http://money.cnn.com/2010/02/17/news/companies/credit_card_rules/.

[56]Peterson, Luke Eric, 'Argentina by the numbers: where things stand with investment treaty claims arising out of the Argentine financial crisis', *Investment Arbitration Reporter*, Vol. 4, No. 2, 1 February 2011

[57] *Philippe Gruslin v Government of Malaysia,* ICSID. Case No. ARB/99/3. The investor lost on a point of jurisdiction.

[58] See for example http://kluwerarbitrationblog.com/blog/2009/02/05/whither-the-new-financial-crisis-claims/#more-231

[59]See for example *Saluka Investments BV (The Netherlands) v The Czech Republic*: http://www.pca-cpa.org/upload/files/SAL-CZ%20Partial%20Award%20170306.pdf

[60] Article 25

[61] Article 26

[62] Anderson, Sarah. Policy Handcuffs in the Financial Crisis, Institute for Policy Studies, February 2009. Available at: http://www.ips-dc.org/files/329/Policy%20Handcuffs%20in%20the%20Financial%20Crisis.pdf; and Comments on

the U.S. Model Bilateral Investment Treaty before the U.S. State Department and USTR, July 17, 2009. Available at: http://www.ips-dc.org/files/1366/IPS%20comments%20on%20Model%20Bilateral%20Investment%20Treaty.pdf

[63] J. D. Ostry, *et al*, *Capital Inflows: The Role of Controls*, International Monetary Fund Research Department, SPN/10/04, 19 February 2010; Ourada Merrouche and Erland Nier, 'What Caused the Global Financial Crisis?—Evidence on the Drivers of Financial Imbalances 1999-2007', IMF Working Paper WP/10/265, December 2010

[64] ADB, *Asia Capital Markets Monitor,* May 2010, p.3

[65] UNESCAP, 'Theme Topic for the Sixty-Sixth Session: "Addressing Challenges in the Achievement of the Millennium Development Goals; Promoting a Stable and Supportive Financial System; and Green Growth or Environmentally Sustainable Economic Growth, Including Through Technology and Financing", Sixty-Sixth Session, 13-19 May 2010, Incheon, Republic of Korea', E/ESCAP/66/26, 14 April 2010

[66] Letter to Secretary of State Hillary Rodham Clinton, Secretary to the Treasury Tim Geithner and US Trade Representative Ron Kirk from Ricardo Hausmann, Dani Rodrik, Joseph Stiglitz, Arvind Subramaniam and 246 others, 31 January 2011; Letter to Secretary of State Hillary Rodham Clinton and others from John Endean, President, American Business Conference and 17 others, 7 February 2011; Gallagher, Kevin and Anderson, Sarah, 'Corporate Lobby Groups Issue Weak Attack on Economists Who Support Capital Control Flexibility', Institute of Policy Studies/Global Development and Environmental Institution at Tufts University, 10 February 2011

[67] Gallagher, Kevin P (2010). Policy space to Prevent and Mitigate Financial Crises, UNCTAD-G-24 Discussion Paper #58, Geneva: UNCTAD.
Available at: http://www.ase.tufts.edu/gdae/Pubs/rp/KGCapControlsG-24.pdf

[68] Siegel, Deborah (2004) 'Using Free Trade Agreements to Control Capital Account Restrictions: Summary of Remarks on the Relationship to the Mandate of the IMF', *ILSA Journal of International and Comparative Law*, 10: 297-304

[69] European Commission staff noted this conflict in EC 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

[70] Gallagher, Kevin P. (2010) *Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements,* G-24 Discussion Paper No. 58, April 2010;

[71] Transfers Annex 1: Special Dispute Settlement Provisions

[72] The Peru-US FTA excludes claims based on market access and national treatment from this special process.

[73] Article 22(c)

[74] Explicitly in relation to 'investments' and potentially through indirect application to financial services, as discussed earlier.

[75] For example, Italian bondholders sued Argentina to recoup the full value of their original bonds. Michael Waibel, 'Opening Pandora's Box: Sovereign Bonds in International Arbitration', *American Journal of International Law,* v 101, n4, October 2007, pp. 711-759

[76] Investment Annex 3: Public Debt

[77] Article 10

[78] As defined in Article 1. For a discussion of the implications of the limitations of the scope of the prudential defence see http://worldtradelaw.typepad.com/ielpblog/2011/01/applicability-of-the-nafta-prudential-carveout-to-capital-controls.html

[79] Article 10.2. For an exploration of the legal argument see Trachtman, Joel, 'Applicability of the NAFTA "Prudential Carveout" to Capital Controls',
http://worldtradelaw.typepad.com/ielpblog/2011/01/applicability-of-the-nafta-prudential-carveout-to-capital-controls.html

[80] See, e.g., Appellate Body Report, *United States—Import Prohibition of Certain Shrimp and Shrimp Products*, ¶ 118 WT/DS58/AB/R (Nov. 6, 1998) (describing sequence of analysis under Article XX of GATT).

[81]*See TPPA Composite Financial Services Text from Existing U.S. FTAs with TPP Parties,* Article 10(1)

[82] WTO Special Studies No. 1, *Opening Markets in Financial Services and the Role of the GATS* at 3

(1997) (discussing non-prudential regulation of financial services). *See also* Olivier de Schutter, United Nations Special Rapporteur on the Right to Food, *Food Commodities Speculation and Food Price Crises—Regulation to reduce the risks of price volatility* (Briefing Note 02 September 2010) (discussing need for regulation of derivatives based on food commodities in order to address increases in price and volatility).

[83]WTO, *Background Note by the Secretariat: Financial Services*, S/C/W/72, 2 December 1998, footnote 44

[84] See, e.g., GATT art. XX(b) (measures "necessary to protect human, animal or plant life or health"); and GATT art. XX(g) (measures "related to the conservation of exhaustible natural resources . . . ."). The equivalent provision in the EU's template for financial services contains an explicit 'necessity' test; see Articles 7.38 and 8.4 of the EU-Korea FTA.

[85] see http://citizen.typepad.com/eyesontrade/2011/02/dont-abuse-me-the-prudential-quandary.html

[86] *Fireman's Fund Insurance v United Mexican States*, ICSID Case No. ARB(AF)/02/01 (Award of 17 July 2006), paras 166-68

[87] Article 27

[88] Restricting the coverage to Article 21 (a), (f), (f) and (h).

[89]Remove from Article 22 paragraphs (c) and (d) and require a minimum holding period for stocks, shares and equities under paragraph (b).

15 February 2011