

# FEATURED ARTICLES

## Standard of Review for Jurisprudence on Prudential Measures

Byungsik Jung\*

I.	Introduction	49
II.	Good Faith Principle	50
	1. <i>Abuse of Discretion</i>	50
	2. <i>Criteria of Constraints on Discretion</i>	51
	3. <i>Application of a Good Faith Standard to Prudential Discretion</i>	51
III.	Standard of Review for Jurisprudence on Prudential Discretion	52
	1. <i>Prudential Objective</i>	52
	2. <i>Reasonable Relationship between Means and Ends</i>	53
	3. <i>Balance between Impaired Free Trade and Secured Prudential Interest</i>	54
IV.	Conclusion	55

### I. Introduction

The world is facing serious economic recession due to the financial crisis deriving from the United States in 2008. The U.S. financial supervisory authorities are now asked to strengthen prudential regulation of complex financial derivatives because loose financial supervision over financial derivatives is believed to be one of the main causes for this financial crisis. Prudential measures are financial actions that financial supervisory authorities may take for prudential reasons, such as consumer protection, soundness of financial institutions and stability of financial markets.<sup>1</sup> The financial services sector is heavily regulated by prudential measures because financial services are believed to be a very technical and sensitive area that is closely related to the integrity of the national economy.<sup>2</sup> Particularly, banks are subject to prudential regulations because of the pivotal position of banks in the financial system, especially in clearing and payment systems. The specialty of financial services caused international trade treaties to treat financial services in a different way than other services.<sup>3</sup> The General Agreement on Trade in Services (“GATS”) has a separate Annex on Financial Services and Understanding that provides special guidelines for the liberalization of financial services.<sup>4</sup> Most Free Trade Agreements (“FTAs”), including the North American Free Trade Agreement (“NAFTA”),

have independent chapters on financial services. For example, Chapter 14 of NAFTA prescribes cross-border trade and investment in financial services.<sup>5</sup> Furthermore, the technical sensitivity of financial services requires prudential supervision by a national financial authority, because a national financial authority is believed to have greater knowledge and expertise in domestic financial markets.<sup>6</sup> For this reason, the GATS Annex on Financial Services 2(a) prescribes “prudential carve-outs,” which give a host state wide discretion in regulating financial services for prudential reasons, such as consumer protection, soundness of financial institutions and stability of financial markets.<sup>7</sup> However, prudential measures can be used as non-tariff barriers if a clear standard of review for jurisprudence on prudential carve-outs is not established.<sup>8</sup> A non-tariff barrier in financial services can be a law, a regulation, an administrative rule, or a standard/requirement with the force and effect of law, other than a tax or duty, whose direct or indirect effect is to restrain or prohibit the entry of foreign financial services.<sup>9</sup> For example, a host state can require a foreign branch to have a certain amount of capital for the soundness of the branch. However, this capital requirement for the establishment of a branch may be considered a non-tariff barrier, because a branch, in general, conducts business based on the capital of a parent financial institution of a home state and thus does not need independent capital.

In order to draw a line between prudential measures qualifying as prudential carve-outs and trade barriers not falling within prudential carve-out exceptions, we need a standard of review for jurisprudence on prudential measures. A standard of review will be helpful in resolving disputes regarding prudential measures. As of now, a consensus on this issue has yet to be reached, but prudential measures are still subject to dispute settlement under the WTO.<sup>10</sup> Lazaros E. Panourgias argued that a prudential exception should be held up to a mere rationality test. He viewed that a prudential measure at issue does not have to be the least-restrictive measure. However, he insisted that application of the less-restrictive alternative test may be possible if objective factors sufficiently establish that the potential measure at issue is being used to avoid commitments of obligations under the GATS.<sup>11</sup> According to Panourgias, a host state's entry requirement is inconsistent with the GATS only if an alternative measure is less trade-restrictive and if the regulatory cost in opting for the less trade-restrictive alternative is not disproportionate to the trade benefits.<sup>12</sup>

Sydney J. Key viewed prudential measures as not subject to the least-restrictive principle, but prudential measures can be challenged under the anti-abuse of the prudential carve-out provision of the GATS.<sup>13</sup> Neither Panourgias nor Key, however, suggested detailed criteria for the identification of abuse of prudential discretion. The definition of prudential measures, the scope of prudential carve-outs, and the abuse of prudential discretion have not been tested under WTO jurisprudence.<sup>14</sup> The recent *Firemen* case at the International Center for Settlement of Investment Disputes ("ICSID") provided the tribunal with the chance to review a prudential measure where the complainant insisted that a prudential measure harmed the interest of a foreign investor.<sup>15</sup> However, the tribunal did not rule on the prudential measure on the grounds that no expropriation existed.<sup>16</sup> Due to the lack of cases on prudential measures, there are few scholars who specifically focus on jurisprudence on prudential measures. However, it is likely that the number of disputes on prudential measures will increase in the near future as cross-border trade and investment in financial services increase.<sup>17</sup> Some experts insist that certain functions of banks, such as being a backup source of liquidity, are no longer unique so that heavy banking regulations should, therefore, be deregulated.<sup>18</sup> This challenge against the belief in the specialty of financial services will also increase the number of disputes on prudential measures as parties can expect tribunals to grant less deference toward a state agency's determination.

The prudential carve-out provision of the GATS Annex on Financial Services 2(a) clearly states that a national authority has prudential discretion as long as the discretion is not abused. In other words, the sole ground of violation of the prudential carve-out provision is the abuse of discretion.

GATS Annex on Financial Services 2 (Domestic Regulation) (a):

Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform to provisions of the Agreement, *they shall not be used as measures of avoiding the Member's commitments or obligations under the Agreement* (emphasis added)

Therefore, understanding the standard of review on the abuse of discretion is a prerequisite to establish a standard of review on prudential discretion. There are various standards of review on the abuse of discretion, such as that of "good-faith" in administrative laws, "margin of appreciation" conducted by the European Court of Human Rights ("ECHR"), "proportionality" adopted by the European Court of Justice ("ECJ"), "state of necessity" in international investment laws, and a "necessity test" found in GATT Article XX and GATS Article XIV. Each standard of review, being applied in different subject matters, is conducted by a different tribunal. This paper will focus on a good faith principle and suggest that a good faith principle can be a standard of review for jurisprudence on prudential discretion. Furthermore, the paper will highlight the elements of prudential discretion that prudential measures should meet for not being abused. Particularly, this paper will prove that the least-restrictive principle does not apply to prudential discretion.

## II. Good Faith Principle

### 1. Abuse of Discretion

Discretion is the reasonable exercise of a power or a right. Discretion means the power to make a choice. A state exercises its discretion whenever the state is free to make a choice among possible options.<sup>19</sup> The exercise of discretion must be conducted in a good faith manner, because the right of every state under international laws is subject to the *pacta sunt servanda* rule.<sup>20</sup> *Pacta sunt servanda* means "every treaty in force is binding upon the parties to it and must be performed by them in good faith."<sup>21</sup> A good-faith principle requires that every right be exercised reasonably and fairly.<sup>22</sup> The exercise of discretion in an arbitrary, vague, or fanciful manner is an abuse of discretion.<sup>23</sup> According to the definition in Black's Law Dictionary, an arbitrary decision is one that "depends on individual discretion and is founded on prejudice or preference rather than on reason or fact."<sup>24</sup> If the exercise of discretion is arbitrary, capricious, or unreasonable, the discretion power is abused.<sup>25</sup> Arbitrariness has been described as "a willful disregard of due process of law, an act which shocks, or at least surprises,

a sense of judicial propriety.”<sup>26</sup> The expression of “arbitrary and capricious” is used as a synonym for “unreasonableness.”<sup>27</sup> The meaning of the two expressions is one and the same, because the key point is whether discretionary power has been abused.<sup>28</sup> Therefore, the words “unreasonable,” “not in good faith,” and “arbitrary” are variations on the term “abusive.”

The greatest injustice in the exercise of governmental power is likely to occur when government officers act with unreviewed discretionary power without the kind of procedural protection that the court customarily provides.<sup>29</sup> Therefore, those areas where decisions depend more upon discretion than upon rules and principles and where formal hearings and judicial review are mostly irrelevant are the areas that tend to be the most deficient in delivering justice to individuals in legal and governmental systems.<sup>30</sup>

Therefore, transparency is a key procedural discipline in preventing the abuse of discretion. Transparency in the implementation of measures requires the following: (i) reasonable notice before implementation; (ii) public availability to service suppliers making it easy to find and easy to read; (iii) specification of reasonable time periods for responding to applicants; (iv) information provided as to why an application was denied; and (v) information provided on procedures for review of administrative decisions.<sup>31</sup> Along these lines, Article III of the GATS requires a WTO-member country to publish all relevant measures affecting trade in services as well as to respond to all requests by any other WTO-member country.<sup>32</sup> In the same context, NAFTA Article 1411 also requires a host state to provide, in advance to all interested persons, all relevant measures in order to allow interested parties to make comments on the measures.<sup>33</sup>

## *2. Criteria of Constraints on Discretion*

The exercise of discretion is within the scope of judicial review.<sup>34</sup> Article 10(3) of the Federal Administrative Procedure Act of 1946 requires the court to set aside decisions that are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.<sup>35</sup> Tribunals check the following elements in determining whether there has been an abuse of discretion.

First, grounds for the exercise of discretion should be “for legitimate reasons.”<sup>36</sup> If the grounds are improper, the exercise of discretion is “in bad faith.”<sup>37</sup> Therefore, any exercise of a right for the purpose of evading either a rule of law or a contractual obligation constitutes an abuse of the right and shall be prohibited by law.<sup>38</sup> For example, the Home Secretary used his power of discretion to revoke a license under the Wireless Telegraphy Act of 1949 in order to impose a higher license fee.<sup>39</sup> The Court of Appeal held that it was a clear abuse of power, because the Home Secretary revoked the license without good reason.<sup>40</sup>

Second, there should be a reasonable relationship between

legitimate aims and legitimate means. If a rational relationship between the aims and the means is lacking, this may indicate an evidence of protective application, and thus, may suggest an abusive exercise of discretion right.<sup>41</sup> For example, it is unreasonable for a public authority to require a hotel to buy beer from the city as a condition for the hotel to receive a license, because the authority took into account an irrelevant element.<sup>42</sup>

Third, there should be a balance between the public interest secured by a legitimate purpose and the interest impaired by the exercise of discretion.<sup>43</sup> In other words, the discretionary power must be exercised in conformity with the spirit of the law and with regard to interests of others.<sup>44</sup> The rational basis of a good faith approach requires the national authority to check whether there was a threat to national security or public order that is sufficient to justify the measure taken.<sup>45</sup>

## *3. Application of a Good Faith Standard to Prudential Discretion*

A good faith standard can be applicable to prudential discretion, because prudential measures are conducted by the discretion of a national financial supervisory authority. Prudential issues require highly complex and technical knowledge of, and expertise in, circumstances and conditions that judicial organs in general do not appreciate.<sup>46</sup> Prudential discretion should be granted with wide deference from tribunals, because a national financial supervisory authority has expertise on domestic financial issues and is in a better position to know surrounding facts than international tribunals do.<sup>47</sup> Prudential regulations should also meet a good faith standard, because the laws of a state are presumed to meet the requirements of international laws, and a fundamental principle of international law is the good faith standard.<sup>48</sup> It is generally accepted that the GATS did not intend to authorize unreasonable action; instead, they are considered *ultra vires* and void.<sup>49</sup> In fact, the prudential carve-out provision of the GATS Annex on Financial Services 2(a) clearly states that prudential measures shall not be used as a means to avoid obligations and commitments of the GATS. The exercise of discretion to avoid obligations and commitments is a clear abuse of discretion.<sup>50</sup> Therefore, prudential measures must be taken for the purpose of prudential reasons, such as consumer protection, soundness of financial institution, and stability of financial markets. There must be a reasonable relationship between the measure taken for prudential reasons and the prudential purposes.<sup>51</sup> There must also be a balance between the impaired free trade and the secured sovereign right of a state to regulate for the prudential purpose.<sup>52</sup>

Some scholars argue that the U.S. *Chevron* reasoning cannot be sustained in the context of WTO panel proceedings because of the following reasons: (i) The traditional deference under U.S. administrative law is not transferable to the WTO

panel system, because the panels have built up expertise; (ii) Article 17.6(ii) of the Anti-Dumping (“AD”) Agreement directs WTO panels to clarify the AD Agreement “in accordance with customary rule of interpretation of public international law.” Articles 31 and 32 of the Vienna Convention on the Law of Treaties (“VCLT”) aim to resolve any lack of clarity in order to arrive at one single interpretation; (iii) Article 17.6(ii) of the AD agreement uses the word “permissible,” which may be interpreted differently from the term “reasonable” as construed under the U.S. law.<sup>53</sup>

However, the U.S. *Chevron* doctrine does apply to the carve-out provision of the GATS because of the following reasons. First, the panels need to rely on the determination of a host state in order to decide whether a measure at issue falls within the prudential carve-out provision, because the provision itself does not define the meaning of a prudential measure. Instead, the provision provides non-exhaustive lists of prudential reasons: consumer protection, soundness of financial institution, and stability of financial markets. An additional list of prudential reasons may be provided by a national authority rather than by the panels, because each country needs different prudential measure to address its individual circumstance. Second, the panels do not have sufficient expertise to determine what a prudential reason is, because there has yet to be a single case on prudential measures under the WTO Dispute Settlement Bodies (“DSB”). Even though the DSB would be able to select financial experts as panelists, the financial experts cannot be in a better position than a national financial authority in determining whether a measure at issue is a prudential measure or not.<sup>54</sup> Third, with regard to a single interpretation of WTO laws, Articles 31 and 32 of the VCLT do not prevent the panels from relying on a national authority’s interpretation of prudential reasons. Moreover, Article 17.6(ii) of AD agreement<sup>55</sup> even manifests the necessity of the panels’ deference to a national authority’s interpretation. In fact, WTO panels and the Appellate Body have applied the general principle of international law, including the principle of good faith to a national authority’s interpretation.<sup>56</sup>

### III. Standard of Review for Jurisprudence on Prudential Discretion

The sole standard of review for prudential discretion is a good faith principle, because a national financial authority deserves a wide latitude of discretion when it comes to prudential measures. Such latitude is appropriate, because: (1) a national financial authority has direct knowledge of its society’s needs, which puts it, in principle, in a better position than international tribunals to appreciate what is “in the public interest”<sup>57</sup>; (ii) prudential issues require highly complex and technical knowledge of, and expertise in, circumstances and conditions that tribunals in general do not sufficiently

appreciate<sup>58</sup>; (iii) a lack of consensus among states tends to strengthen the tribunals’ deference to a national financial supervisory authority.

Under a good faith principle, prudential discretion must meet the following criteria: (i) a measure at issue must be taken for a substantial prudential objective; (ii) there must be reasonable relationship between a measure at issue and the prudential objective; (iii) there must be a balance between the infringed right of a foreign financial supplier and the secured prudential interest. This balance test does not necessarily require a least-restrictive measure, since prudential discretion is not subject to the least-restrictive principle.

#### 1. Prudential Objective

There should be a measure for prudential objectives. Prudential measures include the following objectives: (i) to protect investors to help build their confidence in the market; (ii) to ensure that the market is fair, efficient, and transparent; (iii) to reduce system risk; (iv) to protect financial services businesses from malpractice (e.g., money laundering); and (v) to maintain the consumer’s confidence in the financial system.<sup>59</sup> If the objective of the measure is, for example, solely for the prevention of entry of foreign financial suppliers, the measure does not qualify as a prudential carve-out. A measure is arbitrary only when the measure has no objective and no reasonable justification of its failure to pursue a legitimate aim.<sup>60</sup> In other words, if a national authority acts upon an irrelevant motive, it is unreasonable, and thus, is an abuse of discretion. The prudential carve-out provision of the GATS requires a prudential objective when it states clearly that a prudential measure is a measure taken “for” prudential reasons. In order to interpret the meaning of “for,” we have to look to the ordinary meaning of the word “for” in context and in light of the object and purpose of the GATS Annex on Financial Services 2(a), in accordance with Article 31(1) of the VCLT.<sup>61</sup>

The word “for” means “with the object or purpose of” or “in order to obtain.”<sup>62</sup> It is unreasonable to suppose that the word “for” has the same meaning as the word “necessary” as it appears in the GATS Article XIV, because the terms and their contexts are different.<sup>63</sup> The word “for” is a subjective expression whereas the word “necessary” is an objective expression.<sup>64</sup> The term “necessary” refers to a range of degrees of necessity between “indispensable” and “making a contribution to.”<sup>65</sup> Whether a measure is “indispensable” or “making a contribution to” the ends is assessed objectively by third parties. However, the terms “with object or purpose of” and “in order to obtain” focuses on the subjective intention of a national authority. It does not take into account whether a measure meets or is likely to meet the end to be pursued. The purpose of the national authority is critical in determining whether a measure is prudential or not.<sup>66</sup> The subjectivity of the term “for” is supported by use of the term “reasons” in the

expression “for prudential reasons.”

GATS Annex on Financial Services 2 (Domestic Regulation)(a) provides:

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 to provisions of the Agreement, they shall not be used as measures of avoiding the Member’s commitments or obligations under the Agreement (emphasis added)

The word “reason” ordinarily means “motive for an action.”<sup>67</sup> “Motive” also has a subjective meaning. The combination of the words “purpose” and “motive” strengthens the fact that prudential measures rely on a national authority’s policy objective.<sup>68</sup> The preamble of the GATS also recognizes the right of a Member to introduce new regulations in order to meet national policy objectives.<sup>69</sup> Historically, the prudential carve-out provision was created to secure the discretion of national financial regulators, and thus, the WTO DSB was expected to grant a wider deference to the subjective determinations of a national financial authority.<sup>70</sup> Therefore, a restriction on a new banking license, for example, may have prudential connotations so long as the national authority is seeking to prevent excessive competition in the financial sector in order to reduce systemic risk. However, the restriction may not qualify as a prudential measure if its objective is to solely restrict entry of foreign financial suppliers.

A problem arises when a measure has both a prudential objective and a trade restrictive objective. The national authority’s objective does not have to be “purely” prudential because the national authority can pursue multiple policy objectives with a single measure. For example, a commercial presence requirement is used not only for financial supervision but also for tax purposes.<sup>71</sup> The existence of foreign financial suppliers’ subsidiaries or branches in a host state makes it easier for a national authority to supervise or tax them than when a cross-border trade is conducted via the Internet without commercial presence in a host state. In sum, a national authority’s action will be lawful as long as prudential motives behind the act at issue are dominant, even though some incidental advantage may be gained from some irrelevant motives.<sup>72</sup>

However, a prudential objective cannot be a “supplementary” one; otherwise, most non-tariff barriers, including quantitative market access limitations and discriminative measures, can be justified as prudential carve-outs, which would effectively invalidate the GATS. Therefore, prudential objective of a policy should be at least a “substantial”

one. Under this substantial criterion, when a foreign investor’s license is rebuked on both prudential and non-prudential grounds, as long as the prudential purpose is a substantial one, the non-prudential grounds will not vitiate that rebuke.<sup>73</sup> The decision as to whether the prudential objective is substantial or supplementary relies on the individual facts and circumstances of each case.

## 2. Reasonable Relationship between Means and Ends

There must be reasonable relationship between a measure taken for prudential reasons and the prudential objective. If a measure at issue is not reasonably related to the prudential objective, exercise of the measure is an abuse of prudential discretion.<sup>74</sup> The relationship between the means and the ends should be close and genuine.<sup>75</sup> A national financial authority may grant a license to a foreign financial supplier based on whatever conditions the national authority believes to be necessary. However, such conditions are invalid unless they are “fairly and reasonably” related to the prudential objective.<sup>76</sup> If a financial supervisory authority considers elements that even a reasonable person could not expect to be within the discretionary power of the authority, the measure cannot be prudential because the authority’s discretion is unreasonable.<sup>77</sup> In other words, taking an irrelevant consideration into account indicates a lack of good faith.<sup>78</sup> For example, the Federal Reserve may consider the following relevant elements in approving the opening of a branch or agency by a foreign bank in the U.S.:

- (i) Whether the home country allows the proposed establishment of an agency in the U.S.;
- (ii) Whether managerial human resources of the applicant foreign bank are capable in engaging international banking;
- (iii) Whether the foreign bank has given the Federal Reserve adequate information;
- (iv) What the *relative* size of the foreign bank is in its home country.<sup>79</sup>

Furthermore, the Federal Reserve may consider another element to be subject to its approval as it deems necessary.<sup>80</sup> However, the Federal Reserve cannot require irrelevant conditions. For example, if the Federal Reserve requires a foreign branch to employ a U.S. citizen as the senior manager of the branch as a condition of receiving a license, this requirement would not qualify as prudential measure, because the U.S. citizenship requirement is not reasonably related to the soundness of the foreign branch. It is not the citizenship but the capability of the senior managers that is related to the soundness of a financial institution. For this reason, NAFTA Article 1408 (Senior Management and Boards of Directors) prevents citizenship requirement for senior managerial and other essential personnel.<sup>81</sup>

A measure at issue is deemed to have a reasonable relationship with a prudential objective if the measure itself has the typical prudential characteristics, such as consumer protection, safety and soundness of financial institutions, and stability of financial markets. International standards, such as the BIS ratio,<sup>82</sup> are believed to be reasonably related to prudential reasons, since the BIS ratio was made for the soundness of financial institutions. In the same context, existence of equivalent measures in other states may enhance the legitimacy of a prudential measure that is otherwise impugned.<sup>83</sup> For this reason, if a home state does not adopt the Basel accords,<sup>84</sup> a host state may legitimately discriminate against the establishment of a branch by the bank of the home state, because the host state may have a reasonable concern with the soundness of the foreign parent bank.<sup>85</sup>

A measure taken by a host state might not be a prudential measure because of the lack of a reasonable relationship. For example, lending requirements to a certain sector or geographical area are, arguably, not reasonably related to a prudential objective.<sup>86</sup> The rationale of this lending requirement derives from the concept that credit markets are local in nature.<sup>87</sup> Since banks use money from these areas, these banks should also be required to lend and invest in these areas instead of funneling the money out.<sup>88</sup> However, credit markets today are no longer local, but have become, instead, inter-local, thanks to the development of transportation and communication.<sup>89</sup> Furthermore, social welfare is not the banking sector's obligation; it is the government's responsibility to assist less competitive sectors and geographical areas. Therefore, the lending source for local areas should be the tax revenue of the nation rather than the money of depositors. For this reason, it is understandable why there is no international standard on lending requirements.

### *3. Balance between Impaired Free Trade and Secured Prudential Interest*

There must be a balance between the infringement of free trade and the national interest that is secured by exercise of prudential measure.<sup>90</sup> The GATS preamble paragraph four requires a balance between the increase of free trade and the sovereign right of a nation to regulate for legitimate purposes.<sup>91</sup> The WTO panels' general objective is to find a balance between the Members' interests in protecting their sovereignty and the general interest in free trade. International standards, such as the Basel accords, provide a yardstick for the adequacy or excessiveness of national prudential regulations.<sup>92</sup> Some scholars argue that the international standard for capital requirements would be a least trade restrictive alternative, as the international standards would equally address the relevant financial stability concerns of a host regulator.<sup>93</sup> In other words, the host country's extra capital requirements, more than that of any international standard, would be in contravention of

the GATS principles because the extra capital requirement would be more trade restrictive than necessary.<sup>94</sup>

However, existence of a relevant international standard does not necessarily mean that the international standard is a least-restrictive alternative; a balance test must be administered that would take into account the host state's circumstances. For example, extra capital requirements that exceed international standard requirements can be reasonable in a host state where deposit insurance is not established, because sufficient capital requirements can substitute for absence of deposit insurance.

Furthermore, a least-restrictive principle is not applicable to prudential discretion because of the following reasons. First of all, the prudential carve-out provision of the GATS does not contain the word "necessary" from which a least-restrictive principle derives. Without exception, all provisions of the GATS that are subject to a least-restrictive principle contain the word "necessary." For example, GATS Article VI (Domestic Regulation)<sup>95</sup> requires a least-restrictive principle when it states that domestic regulations "shall not be more burdensome than necessary." Domestic regulations are standards or criteria for the authorization, licensing or certification of services suppliers.<sup>96</sup> Under a least-restrictive principle, domestic regulations must not have a less restrictive alternative to achieve the same objective.<sup>97</sup>

The GATS Article XII (Restrictions to Safeguard the Balance of Payments) also requires a least-restrictive principle by prescribing that restrictions on trade in services, including payments or transfers for transactions, shall avoid unnecessary damage and shall not exceed necessary restrictions.<sup>98</sup>

GATS Article XII, which derives from the self-preservation principle of customary international law — the basis for the state of necessity defense of International Law Commission (ILC) Article 25 and Non Precluded Measure of BITs — is also subject to a least-restrictive principle.<sup>99</sup>

The GATS Article XIV (General Exceptions) incorporates a least-restrictive principle as one of two prongs of its necessity test in which a measure at issue must be necessary to achieve legitimate objectives.<sup>100</sup>

On the other hand, Lazaros E Panourgias believes that the word "reasonable" is related to the least-restrictive principle.<sup>101</sup> He argues that application of the least-restrictive principle to prudential measures is likely to be more applicable under NAFTA, because Article 1410(1) required that prudential measures be "reasonable."<sup>102</sup> However, it should be noted that it is the word "necessary" — not "reasonable" — that indicates a least-restrictive principle. The word "reasonable" is just another way of expressing "a good-faith principle," because a good-faith principle requires a reasonable relationship between the ends and the means. For this reason, both prudential carve-out provisions under Article 1410 of NAFTA and the GATS Annex on Financial Services 2(a) are the same, even though Article 1410 of NAFTA contains the additional term "reasonable" in its measure. Therefore, the prudential

exceptions under NAFTA are also not subject to a least-restrictive principle, because NAFTA Article 1410(1) does not contain the word “necessary.”

#### IV. Conclusion

The financial crisis triggered financial supervisory authorities to increase regulation regarding financial derivatives. The U.S. authorities declared to tighten regulation on exotic financial instruments. The Europeans are pushing for the establishment of a single European clearing house for credit derivatives. The Basel Committee on Banking Supervision plans to increase capital reserve requirements and demand better disclosure on complex securities. In introducing new regulation pertaining to derivatives, financial authorities can use considerable discretion because of their expertise and specialty of financial services. However, it does not necessarily mean that the prudential discretion is not subject to judicial review. A good-faith test still applies to the prudential discretion. New financial derivative regulation should substantially aim at consumer protection, the soundness of financial institutions, or the stability of financial markets. Regulation of complex derivatives must be reasonably related to prudential objectives. The consensus that credit derivatives are at the heart of financial crisis would be good evidence for the existence of a reasonable relationship between the regulation of financial derivatives and the stability of financial markets. Additionally, there must be a fair balance between the infringed free trade and the secured prudential objectives. However, the financial derivatives measure does not have to be the least-restrictive measure, because prudential discretion is not subject to necessity test.

---

\* Byungsik Jung has been working for the Free Trade Agreement (“FTA”) Implementation and Planning Team as director of the Customs Bureau in the Korean Ministry of Strategy and Finance (formerly MOFE) since August 1, 2009. Mr. Jung was a senior trade advisor at Bryan Cave LLP from July 2008 to July 2009. Mr. Jung specialized in international trade law at American University Washington College of Law with the support of the Hubert Humphrey Fellowship. He also holds a Master of Laws from Georgetown University Law Center, where he concentrated in securities and financial regulations. Mr. Jung obtained his Doctor of Juridical Science degree from American University Washington College of Law and his dissertation suggested a standard of review for jurisprudence on prudential measures. Prior to attending law school and joining the firm, Mr. Jung was a Korean government officer in the Ministry of Finance and Economy for 10 years. Mr. Jung successfully conducted financial service negotiations as a government negotiator under the World Trade Organization and various FTA negotiations. His e-mail address is:

byungsikjung@yahoo.com.

1 Lazaros E Panourgias, *Banking Regulation and World Trade Law: GATS, EU and ‘Prudential’ Institution Building*, at 9-14 (2006); See the GATS Annex on Financial Services 2(a).

2 WTO Background note by the Secretariat, *Financial Services*, S/C/W/72, at 9 (Dec. 2, 1998 WTO).

3 Regarding specialty of financial services, see Corrigan, *Are Banks Special?*, Federal Reserve Bank of Minneapolis 1982 Annual Report.

4 See General Agreement on Trade in Services, available at [http://www.wto.org/english/docs\\_e/legal\\_e/26-gats\\_01\\_e.htm](http://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm).

5 NAFTA Chapter 14, Article 1401 (Scope and Coverage), available at <http://www.nafta-sec-alena.org/en/view.aspx?x=343&mtpiID=145>.

6 Matthias Oesch, *Standard of Review in WTO Dispute Resolution*, Oxford University Press, at 57 (2003).

7 Sydney J. Key, Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology Committee on Financial Services, U.S. House of Representatives: *Increasing Efficiency and Economic Growth Through Trade in Financial Services*, at 2, Nov. 15, 2005, available at <http://bulk.resource.org/gpo.gov/hearings/109h/26757.pdf>.

8 *Id.*

9 Raj K. Bhala, *Foreign Bank Regulation After BCCI*, 48 (Carolina Academic Press 1994).

10 Wendy Dobson and Pierre Jacquet, *Financial Services Liberalization in the WTO*, 76-77 (Peterson Institute 1998).

11 Panourgias, *supra* note 1, at 80.

12 *Id.* at 86.

13 The DOHA Round and Financial Service Negotiation, Sydney J. Key, 36 (AEI Press 2003).

14 *Id.*

15 Fireman’s fund insurance company v. the United Mexican States, ICSID case No. ARB(AF)/02/01.

16 *Id.*

17 C. Christopher Parlin, *Current Developments Regarding the WTO Financial Services Agreement*, at 9, available at <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/parlin.pdf>.

18 See Jonathan Macey and Geoffrey Miller, *Banking Law and Regulation*, 86-89 (Little Brown & Co. Law & Business 1997); See also Aspinwall, *On the “specialness” of Banking*, 7 Issues in Bank Reg. at 16 (1983).

19 See Kenneth Culp Davis, *Discretionary Justice in Europe and America*, 4 (University of Illinois Press 1977).

20 Barry E. Carter, Phillip R. Trimble, Allen S. Seiner, *International Law* (5th edition), p.102-03 (Aspen Law & Business Publishers 2001).

21 *Id.*

22 Anglo-Norwegian Fisheries case, ICJ report 116, at 142

(1951).

23 See William Wade and Christopher Forsyth, *Administration law*, 387 (Oxford: Clarendon Press 1994).

24 CMS Gas Transmission Company v. Argentine Republic (Case ARB/01/8), Award, para 291, May 12, 2005.

25 Wade and Forsyth, *supra* note 23, at 391-92.

26 LG&E International Inc. v. Argentine Republic, ICSID Case No. ARB/02/01, para 157, Oct. 3, 2006; ICSID review-*Foreign Investment Law Journal* 203, 242.

27 Wade and Forsyth, *supra* note 23, at 391-92.

28 *Id.*

29 Kenneth Culp Davis, *supra* note 19, at 3.

30 *Id.*

31 An Introduction about The General Agreement on Trade in Services, at 18, March 29, 2006, available at [http://www.wto.org/english/tratop\\_e/serv\\_e/serv\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/serv_e.htm).

32 See GATS Article III (Transparency).

33 See NAFTA Article 1411. (Transparency).

34 Wade and Forsyth, *supra* note 23, at 392

35 *Id.*

36 *Id.* at 439.

37 *Id.*

38 Anglo-Norwegian Fisheries case, ICJ report 116, at 142 (1951).

39 Congreve v. Secretary of State for the Home Office Q.B. 629 (1976).

40 *Id.*

41 U.S.-Taxes on Automobiles, WTO Panel report, para 7.148, WTO Appellate Body Report, para 72.

42 R.V. Birmingham Licensing Planning Committee ex P. Kennedy 2 Q.B. 140 (1972).

43 See Bhala, *supra* note 9, at 256.

44 B. Cheng, *General Principles of Law as Applied by International Courts and Tribunals*, 122 (Grotius Cambridge, 1987).

45 William W. Burke-White and Andreas Vonstaden, *Investment Protection in Extraordinary Times: the Interpretation and Application of Non-Precluded Measures Provision in Bilateral Investment Treaties*, 52-53 (University of Pennsylvania Law School 2007), available at [http://lsr.nellco.org/cgi/viewcontent.cgi?article=1156&context=upenn\\_wps](http://lsr.nellco.org/cgi/viewcontent.cgi?article=1156&context=upenn_wps).

46 Sporrong and Lonroth v. Sweden, European Court of Human Rights, 23 Sep. 1982, A52, para. 69.

47 Oesch, *supra* note 6, at 234; See Argentine Republic, ICSID case, No. ARB/02/8, Award, para 273 (Feb 6, 2007); S.D Mayers, Inc. c. Canada, UNCITRAL/NAFTA Arbitration, partial award of 13 November 2000, at 263; Jahn and others v. Germany, Judgement, Strasbourg, 30 June, 2005, at 91 (2005).

48 Alwyn V. Freeman, *International Responsibility of State for Denial of Justice*, 74 (Longmans, Green & Co. 1970)

49 Wade and Forsyth, *supra* note 25, at 381.

50 Anglo-Norwegian Fisheries case (1951), ICJ report 116,

at 142.

51 WTO Appellate Body report, *United States-import prohibition of certain shrimp and shrimp products*, WT/DS58/AB/R, at 35, Oct. 12 1998.

52 See Bhala, *supra* note 9, at 256.

53 *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 843 (1984); see also Oesch, *supra* note 6, at 174.

54 The GATS Annex on Financial Services provide:

Dispute Settlement Panels for disputes on prudential issues and other financial matters shall have the necessary expertise relevant to the specific financial service under dispute.

55 Article 17.6 of the Agreement on Implementation of Article VI of the GATT (Anti-dumping) provide:

In examining the matter referred to in paragraph 5:

(ii) the panel shall interpret the relevant provisions of the Agreement in accordance with customary rules of interpretation of public international law. Where the panel finds that a relevant provision of the Agreement admits of more than one permissible interpretation, the panel shall find the authorities' measure to be in conformity with the Agreement if it rests upon one of those permissible interpretations.

56 US-Shrimps, WTO Appellate Body Report, WT/DS58/AB/R, para. 158, Oct. 12, 1998; US-Foreign sales corporations, WTO Appellate Body Report, WT/DS108/AB/R, para. 166, Feb. 24, 2000.

57 James and others v. UK, European Court of Human Rights, A98, para 46, Feb. 21, 1986.

58 Sporrong and Lonroth v. Sweden, European Court of Human Rights, 23 Sep. 1982, A52, para. 69.

59 Kenneth Kaoma Mwenda, *Legal Aspect of Financial Services Regulation and the Concept of a Unified Regulator*, 3 (World Bank 2006), available at [http://siteresources.worldbank.org/INTAFRISUMAFTPS/Resources/Legal\\_Aspects\\_of\\_Financial\\_Sces\\_Regulations.pdf](http://siteresources.worldbank.org/INTAFRISUMAFTPS/Resources/Legal_Aspects_of_Financial_Sces_Regulations.pdf).

60 See Rasmussen v. Denmark, European Court of Human Rights, A87, Nov. 28 1984.

61 WTO Appellate Body Report, *Korea-Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, WT/DS/161/AB/R, WT/SD169/AB/R, at 48, Dec. 11, 2000.

62 See American Heritage dictionary.

63 See WTO Appellate Body Report, *United States-Gasoline*, at 17-18, Apr. 29, 1996. In this case, the Appellate Body viewed that each paragraph of GATT Article XX has a different degree of connection between the measures and the state policy sought to be realized because each paragraph uses different terms: "necessary" in paragraphs (a), (b) and (d); "essential" in paragraph (j); "relating to" in paragraphs (c), (e) and (g); "for the protection of" in paragraph (f); "in pursuance of" in paragraph (h); and "involving" in paragraph (i).

64 U.S.-Shrimp case, *supra* note 51, at 49-50.

65 *Id.*

66 Key, *supra* note 7, at 2 (stating, “[a]n allegedly prudential measure that violates a country’s obligations or commitments under the GATS might be challenged on the grounds that “its purpose” is really trade restrictive rather than prudential.” (emphasis added)

67 See American heritage dictionary.

68 Kern Alexander, *The World Trade Organization and Financial Stability: The Balance between Liberalization and Regulation in the GATS*, 25 (Cambridge University 2003) available at <http://www-cfap.jbs.cam.ac.uk/publications/files/CERFWP5.pdf> (stating that compared with other general exceptions in the GATS which have an objective necessity standard, the prudential carve-out is flexible and, to some extent, subjective).

69 See Preamble of GATS, available at [http://www.wto.org/english/docs\\_e/legal\\_e/26-gats\\_01\\_e.htm](http://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm), (Recognizing the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives).

70 Sydney J. Key, *Trade liberalization and prudential regulation: the international framework for financial services*, 75 *International Affairs* 61, 67 (1999).

71 Developing countries are reluctant to open cross-border financial trades because of the concern that cross-border trade might replace foreign branches or subsidiaries in their territories which are important tax resources for developing countries.

72 Wade and Forsyth, *supra* note 23, at 436.

73 Hanks v. Minister of Housing and Local Government, 1 Q.B. 999 (1963).

74 See Rasmussen v. Denmark, European Court of Human Rights, A87, Nov. 28 1984.

75 U.S.-Shrimp, WTO Appellate Body Report, WT/DS58/AB/R, at 35, Oct. 12, 1998.

76 See Pyx Granite Co. Ltd. v. Ministry of Housing and Local Government, Q.B. 544, at 572 (1958) (affirmed in 1960, AC 260).

77 Jurgen Schwarze, *European Administrative Law*, 680 (Boyon 1992).

78 *Cannock Chase DC v. Kelly*, 36 P&CR 219 (Cal. Ct. App. 1978).

79 Bhala, *supra* note 9, at 145-152.; 12 U.S.C. Section 3105 (d)(3)(A)-(D), Regulation K, 12 C.F.R. Section 211. 25(c)(2) (i)-(vi).

80 12 U.S.C. § 3105(c)(5).

81 NAFTA Article 1408 provides: “1. No Party may require financial institutions of another Party to engage individuals of any particular nationality as senior managerial or other essential personnel.”

82 BIS ratio gives an indication of the solvency of a bank. It gives the ration between the risk-bearing capital and the risk-weighted assets.

83 See Yutaka Arai-Takahashi, *The Margin of Appreciation*

*Doctrine and the Principle of Proportionality in the Jurisprudence of the ECHR*, 215 (Intersentia 2002).

84 Refers to banking supervisions, laws and regulations.

85 Panourgias, *supra* note 1, at 93.

86 WTO Background note by the Secretariat, *Financial Services*, S/C/W/72, at 11 (2 December 1998) (stating that “Non-prudential regulatory measures such as lending requirements to certain sectors or geographical regions, restrictions on interest rates or fees and commissions, and requirements to provide certain services may exist”).

87 Macey, *supra* note 18, at. 193-194.

88 *Id.*

89 *Id.*

90 Oesch, *supra* note 6, at 31.

91 See Bhala, *supra* note 9, at 256.

92 Panourgias, *supra* note 1, at 214.

93 *Id.* at 67.

94 *Id.*

95 GATS Article VI (Domestic Regulation) provide:

1. In sectors where specific commitments are undertaken, each Member shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.

4. With a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, the Council for Trade in Services shall, through appropriate bodies it may establish, develop any necessary disciplines. Such disciplines shall aim to ensure that such requirements are, inter alia:

- (a) based on objective and transparent criteria, such as competence and the ability to supply the service;
- (b) *not more burdensome than necessary* to ensure the quality of the service; (emphasis added)

96 See the GATS Article VI (Domestic regulation) 1.

97 WTO Council for Trade in Services, *Article VI:4 of the GATS*, *supra* note 289, at 6. Secretariat distinguished the necessity test of Article XIV (general exception) from the necessity test of Article VI (domestic regulation) in terms that domestic measure should be non discriminatory and the list of policy objectives in domestic measures are non exhaustive one. However, it viewed that both Article VI and XIV require “legitimate objective” and “no effective alternative means.”

98 GATS Article XII (Restrictions to Safeguard the Balance of Payments) provide:

1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments

of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, inter alia, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

2. The restrictions referred to in paragraph 1:

- (a) shall not discriminate among Members;
- (b) shall be consistent with the Articles of Agreement of the International Monetary Fund;
- (c) shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;
- (d) shall not exceed those necessary to deal with the circumstances described in paragraph 1;

99 ILC Article 25 states:

1. Necessity may not be invoked by a state as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that state unless the act: (a) is the only means for the state to safeguard an essential interest against a grave and imminent peril; and (b) does not seriously impair an essential interest of the state or states towards which the obligation exists, or of the international community as a whole.

Article XI of the U.S.-Argentina BIT provides:

“This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.”

100 GATS Article XIV (General Exceptions) states:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures;

necessary to protect public morals or to maintain public order;

necessary to protect human, animal or plant life or health;

necessary to secure compliance with laws or regulations...

101 Panourgias, *supra* note 1, at 80.

102 *Id.*