HASTE MAKES WASTE: WTO, PILOT FREE TRADE ZONES AND FINANCIAL EXPERIMENTS

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ABSTRACT

While trade liberalization is the major objective that the world trade regime pursues in the long-run, the desirable pace and mode of liberalization for each economy may vary. This is particularly the case for financial liberalization, which involves plenty of prudential concerns such as control and management of systemic financial risks. In recent years, East Asia has seen a growing use of the "one-country-two-zone" approach ("OCTZ Approach") for experimenting with trade liberalization in a progressive manner. Notable instances include the Pilot Free Trade Zones in China (including Shanghai, Tianjin, Guangdong and Fujian), the National Strategic Special Zones in Japan, and the proposed Free Economic Pilot Zones in Taiwan. Such progressive liberalization, coupled with regulatory experiments, may be a more balanced and steady way to pursue financial liberalization while simultaneously satisfying regulatory needs.

The legal implications of the OCTZ Approach vis-a-vis the current WTO laws, however, remain understudied. In this paper, I focus on the WTO laws related to financial sectors and analyze the potential legal issues of the financial experiments in these zones. I argue that the principal legal risk lies in the anti-avoidance provision of the prudential exception contained in the Financial Annex. In particular, the

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interpretation of this provision is likely to refer to the principle of consistency as established by the current case law of Article XX chapeau of GATT 1994. If so, whenever a WTO Member adopts the OCTZ Approach, it might compromise the protection originally offered by the prudential exception to, and accordingly affect the WTO-consistency of, their already existing out-zone financial regulations. I argue that this is not a desirable result and propose both the interpretative approaches and rule-making approaches for addressing these legal concerns. This paper also offers an opportunity to rethink the principle of consistency and its expansive use under the current WTO case law.

"Haste does not bring success! How can an illness lasting for half a year be cured over one night?"

– Sima Guang, well-established Chinese historian (1019-1086)

INTRODUCTION

In recent years, the world has witnessed an increase of doubt in trade liberalization policy. Such doubt is not groundless. In theory, trade liberalization, in itself, is positive for an economy. In practice, institutional economists have cautioned that to reap the theoretical benefits of trade liberalization while controlling the accompanied negatives, an economy needs many prerequisite institutions in place. For instance, it may be necessary to have a robust court system to ensure contract enforcement and to protect property rights or a highly regulated financial market to finance trade activities.[1] Since the time to build up these institutions varies among different countries, the desired pace of liberalization varies. Moreover, because the countries possess different background institutions, there is no one-size-fits-all way of liberalization. Therefore, the desired mode of liberalization for each country also varies. Some unorthodox models of economic development, such as the well-studied East Asian model of development,[2] provide an alternative path

[1] For a discussion of what institutions promote high-quality growth, *see generally* DANI RODRIK, ONE ECONOMICS MANY RECIPES: GLOBALIZATION, INSTITUTIONS, AND ECONOMIC GROWTH 153-92 (2007). *See also* DOUGLAS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE (New York: Cambridge Univ. Press 1990).

[2] For instance, many studies discuss the East Asian model of economic development implemented in Japan, South Korea and Taiwan during the 1980s and argue that this model is unorthodox yet overall successful. *See, e.g.*, CHALMERS A. JOHNSON, MITI AND THE JAPANESE MIRACLE: THE GROWTH OF INDUSTRIAL POLICY, 1925–1975 (Stanford Univ. Press 1982); ALICE H. AMSDEN, ASIA'S NEXT GIANT: SOUTH KOREA AND LATE INDUSTRIALIZATION (1989); ROBERT WADE, GOVERNING THE MARKET: ECONOMIC THEORY AND THE ROLE OF GOVERNMENT IN EAST ASIAN INDUSTRIALIZATION (New York: Oxford Univ. Press 2004).

for economic growth.[3] In light of the above variables, it is perhaps unsurprising that the world has become cautious of trade liberalization.

The need for cautious liberalization is even more acute in financial sectors.[4] After all, liberalization and efficiency are not the most important benchmarks for assessing financial systems. Rather, safety and soundness as well as financial stability matter more.[5] Financial liberalization without corresponding regulation and supervision could be a disaster. For example, the cause of the Asian Financial Crisis can arguably be attributed to the rushed and imprudent liberalization of capital accounts and financial sectors of the affected Asian economies.[6] The recent Global Financial Crisis further confirmed the pitfalls of financial liberalization absent adequate regulatory and governance regimes.[7] At this post-crisis moment, the world economy is more engaged in the debate between liberalism versus progressivism and experimentalism.[8]

In recent years, a new approach for implementing financial liberalization has emerged in several East Asian economies. I will refer to as the "one-country-two-zone" approach (hereinafter "OCTZ Approach").[9] The experiments in China have received the most attention,

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[3] For a summary of how East Asian countries and China used anomalies to overcome institutional restraints, see RODRIK, *supra* note 1, at 13–55.

[4] Defining what constitutes financial services has its ambiguity. For instance, the GATS Annex on Financial Service Paragraph 5(a) defines financial services as "any service of a financial nature offered by a financial service supplier of a Member", which appears to be tautological. It is generally recognized that financial services are mainly comprised of banking, securities and insurance services. J. Steven Jarreau, *Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer's Perspective*, 25 N.C.J. INT'L L. & COM. REG. 1, 8 (1999).

[5] For an illustration of different types of systemic risks in the financial system, *see generally* Hal S. Scott, *How to Improve Five Important Areas of Financial Regulation*, *in* RULES FOR GROWTH: PROMOTING INNOVATION AND GROWTH THROUGH LEGAL REFORM 114, 114–19 (Robert E. Litan ed., 2011).

[6] *See e.g.*, HA-JOON CHANG, THE EAST ASIAN DEVELOPMENT EXPERIENCE: THE MIRACLE, THE CRISIS AND THE FUTURE 208–14 (2006) (discussing how the capital account liberalization in South Korea led to the financial crisis there).

[7] For a summary of the causes of the Global Financial Crisis, *see* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011) at xvii–xxvii.

[8] ROBERTO MANGABEIRA UNGER, FREE TRADE REIMAGINED: THE WORLD DIVISION OF LABOR AND THE METHOD OF ECONOMICS (2007).

[9] To be sure, the meaning of this term as used throughout this paper is obviously distinct from the concept of "one country, two systems" as used to refer to the political relations of China with Hong Kong and Macao. Throughout this paper, the term "OCTZ Approach" simply refers to a zoning approach used by a country to experiment some economic liberalization measures in a

in particular the ambitious project, the Shanghai Pilot Free Trade Zone, (hereinafter "SH PFTZ")[10] which launched in 2013.[11] Reflecting a growing fashion of this approach, other economies, such as Japan[12] and Taiwan,[13] have also adopted or contemplated adopting similar projects. The OCTZ Approach is a zoning strategy within an economy, and accordingly a dual regime that aims to facilitate trade or financial liberalization reforms.[14] Its essential rationale is that pacing and downscaling liberalization experiments before national implementation is a better way to mitigate the certain economic, social, or political obstacles.[15] This rationale embodies a *haste creates waste* logic.

How this OCTZ Approach fits into the legal framework of the World Trade Organization (hereinafter "WTO") is so far understudied.[16] At first glance, the WTO appears to be receptive of this approach since no specific provisions directly address the issue. Relevant WTO covered agreements indeed contain a number of provisions implementing the so-called "non-discrimination principle," including the most-favoured-nation ("MFN") and national treatment principles.[17] These principles, however, only tackle discriminatory treatment against products or

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progressive manner, which bears no implication in international relations or public international law sense.

[10] Notice on Overall Plans for China (Shanghai) Pilot Free Trade Zones, (promulgated by State Council, Sep. 18, 2013, effective Sep. 18, 2013) ST. COUNCIL.

[11] *See, e.g.*, Shen Wei, *A Tale of Three Zones – Promises and Pitfalls of Three Financial Experimental Zones in China*, BANKING L.J. 399 (2014); Paul Kossof, *China's Pilot Free Trade Zone: Shanghai Free Trade Zone and the Potential Future of Free Trade Zones in Mainland China*, 1:7 INT'L J. L. & LEGAL JURIS. STUD. 4 (2014); Daqing Yao & John Walley, *The China (Shanghai) Free Trade Zones: Background, Developments, and Preliminary Assessment of Initial Impacts* (Nat'l Bureau of Econ. Res., Working Paper No. 20924, 2015).

[12] Japanese National Strategic Special Zones, 18 Sumitomo Mitsui Asset Mgmt. Mkt. Keyword (Oct. 21, 2014), http://www.smam-jp.com/documents/www/english/market_info/2014/10/22/SMAMMarketKeywordNo018.pdf (last visited Feb. 1, 2017).

[13] Draft of the Special Act for Free Economic Pilot Zones, http://www.fepz.org.tw/en_news_content.aspx?MN= 1288 (last visited Feb. 1, 2017) (Taiwan).

[14] *See infra* Part II.B.1 & 2.

[15] *See infra* Part II.B.3.

[16] For instance, while Shanghai Pilot Free Trade Zone has attracted plenty eyes, few studies have discussed its implications with the world trade regime. For a relatively relevant discussion, *see generally* Jie Huang, *Challenges and Solutions for the China–US BIT Negotiations: Insights from the Recent Development of FTZs in China*, 18 J. INT'L ECON. L. 307 (2015).

[17] *See e.g.*,General Agreement on Tariffs and Trade, Jul.1986; *see* also General Agreement on Tariffs and Trade, arts. I & III, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT]; Agreement on Technical Barriers to Trade, 1994, Art. 2.1 [hereinafter TBT Agreement]; General Agreement on Trade in Services, arts. II & XVII, Apr. 15, 1994, 1869 U.N.T.S. 183 [hereinafter GATS]

services that originate from foreign WTO Members (hereinafter "Members").[18] The OCTZ Approach is not inconsistent with these principles because the different treatment accorded to in-zone and out-zone businesses is not based on the origin of the products or services.

The legal risks of the OCTZ Approach under the WTO are subtler. Specifically, WTO laws are likely to impede the OCTZ Approach through the recently developed case-law principle, which I refer to as "the principle of consistency." This principle, derived from Article XX chapeau of GATT 1994,[19] came from the Appellate Body Report in *Brazil–Tyres*.[20] Any trade restrictive measure that fails to observe this principle will lose the public policy defense under GATT Article XX and will be found WTO-inconsistent.[21] This indirectly obligates Members to refrain from adopting inconsistent rules for the same regulatory subject matter.[22] Extending this rationale to financial sectors, I argue that the principle of consistency is likely to compromise a Member's safeguard under the "prudential exception" as granted under Paragraph 2(a) of the GATS Annex on Financial Services.[23] In my view, this is not a desirable outcome, and therefore calls for certain interpretative or rule-making efforts to find room for the OCTZ Approach under the WTO laws.

In the following sections, I seek to elucidate the following issues: first, is it desirable to have a world trade regime, which supports the OCTZ Approach? Second, do the current WTO laws support it? Third, what are the potential legal hurdles under the current WTO laws? Finally, how should the world trade regime integrate the OCTZ Approach? In Part II, I will discuss the theoretical bases and practices of the OCTZ Approach. I will reference economic theories to provide

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[18] *See generally* PETER VAN DEN BOSSCHE & WERNER ZDOUC, THE LAW AND POLICY OF THE WORLD TRADE ORGANIZATION: TEXT, CASES AND MATERIALS 315–417 (2013).

[19] GATT, *supra* note 17, at Art. XX.

[20] Appellate Body Report, Brazil – Measures Affecting Imports of Retreaded Tyres, WTO Doc. WT/DS332/AB/R (Dec. 3, 2007) [hereinafter *Brazil–Tyres*].

[21] *Id.* at ¶¶ 224–27.

[22] *Id.*

[23] Paragraph 2(a) of the GATS Annex on Financial Services reads:

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

rationales for the experimental economic and financial policies. Then I will brief how China's SH PFTZs, together with other similar projects around the world, put these theories into practice. In Part III, I will discuss how the current WTO laws deal with the OCTZ Approach. I will outline the WTO obligations related to financial services, mostly those from General Agreement on Trade in Services (hereinafter "GATS") and its Annex on Financial Service (hereinafter "Financial Annex"). With the major focus on the prudential exception as contained in the Financial Annex, I will elaborate on how the recently developed "principle of consistency" hinders the use of the OCTZ Approach. In light of this unreasonable result, in Part IV, I will propose avenues for rescuing the OCTZ Approach under the current WTO laws. In principle, I will proffer a number of interpretative approaches that help soften the prudential exception and therefore secure some room for the OCTZ Approach. In addition, I will suggest some rule-making approaches. Part V will conclude this paper. Through my analysis, I anticipate that this paper will highlight some important aspects of international finance under the WTO laws, including those related to the OCTZ Approach and those that may provoke reflection on the current WTO laws related to financial sectors.

II. PROGRESSIVE FINANCIAL LIBERALIZATION, REGULATORY EXPERIMENTS AND THE OCTZ APPROACH

In recent years, controversies around trade liberalization have arisen. These controversies include the pace, degree, and form of liberalization.[24] Due to its inherent regulatory and prudential needs, financial sectors are conventionally less liberalized.[25] The outbreak of the Global Financial Crisis further subjected financial liberalization to more challenges.[26] To respond to these challenges, an economy needs to take greater caution when initiating the liberalization of their financial sectors. The OCTZ Approach is the product of this caution. It is in line with the traditional spirit, in the sense that it pursues liberalization in a practical manner, but it also challenges conventional wisdom in an unorthodox way because it does not pursue liberalization on a nationwide basis.

A. RATIONALE BEHIND PROGRESSIVE LIBERALIZATION AND

[24] *See infra* Part II.A.1.
[25] *See infra* Part II.A.2.
[26] *Id.*

1. Controversies around the Idea of Trade Liberalization

Since the end of the World War II, major developed economies and international economic organizations have embraced the idea of liberalization in international trade.[27] The trade liberalization movement reached its climax in the 1980s when the "Washington Consensus," as endorsed by the U.S. Treasury and the Washington-based international institutions (including the International Monetary Fund (hereinafter "IMF"), World Bank and Inter-American Development Bank) received worldwide popularity.[28] Under the Washington Consensus, the international community recognized the liberalization of trade policies, foreign direct investment, and financial market regulations (such as interest rate policies and exchange rate policies) as mainstream reform policies and widely implemented them, in particular in Latin America.[29] This recognition changed global development policies, accelerated globalization rules, and eventually gave birth to the WTO, which embodies the world's continued effort to promote trade liberalization.[30]

The world's pursuit of trade liberalization is not without obstacles, however. To the contrary, it is now facing serious problems. The deadlock of the latest trade negotiation round under the WTO, the so-called Doha Round, best illustrates them.[31] It is one thing to advocate the general idea of trade liberalization but it is another to put it into practice. Even developed Members, which are the major advocates of trade liberalization, at this present moment cannot assure that they will

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[27] The post-war world economic order was first established through the creation of the International Monetary Fund (hereinafter "IMF"), World Bank and the General Agreement on Tariffs and Trade (hereinafter "GATT"), with the aim to "attain the multiple objectives of full employment, freer and expanding world trade, and stable exchange rates." GERALD M. MEIER, BIOGRAPHY OF A SUBJECT: AN EVOLUTION OF DEVELOPMENT ECONOMICS 44 (2005). For a brief introduction of earlier intellectual discussions of international trade and development, which are featured by wisdom provided from Adam Smith, David Ricardo, John Stuart Mill, John Rae, etc., *see generally id.* at 22–26.

[28] It is widely accepted that John Williamson was the first person who provided an account of the Washington Consensus policies. *See generally* JOHN WILLIAMSON, *What Washington Means by Policy Reform*, *in* LATIN AMERICAN ADJUSTMENT: HOW MUCH HAS HAPPENED? 7 (John Williamson ed., 1990)

[29] *Id.* at 13-15.

[30] Robin Broad & John Cavanagh, *The Death of the Washington Consensus?*, 16 WORLD POL'Y J. 79, 80 (1999). For related intellectual discussion, *see* MEIER, *supra* note 27, at 103–11.

[31] For an introduction of the Doha Round deadlock, *see generally* Sungjoon Cho, *The Demise of Developments in the Doha Round Negotiations*, 45 TEXAS INT'L L. J. 573 (2010).

fully pursue it.[32] Not to mention the developing Members' even stronger stances against immediate liberalization.[33] These realities demonstrate that however ideal people claim trade liberalization to be, it involves many practical hurdles.

Theories of economic development also cast doubt on the unconditional devotion to trade liberalization. Despite the benefits associated with trade liberalization,[34] some academics have noted that trade liberalization risks preventing an economy from "climbing up the ladder."[35] To elaborate, trade liberalization, together with the power of comparative advantage, may lock in the current status of global division of labor.[36] This enables industrial economies to keep inventing technology in line with their comparative advantages.[37] In turn, it leaves developing economies to specialize in primary commodities, which are also in line with their current comparative advantages, but are at a lower rung on the global economy's ladder.[38] Trade liberalization thus contributes to uneven development within and across economies.[39] To break through, each economy should acknowledge that its comparative advantage under the world economy is "made" rather than "given." In this sense, a state's various forms of intervention in its economy are justifiable. Even free trade should "have different meanings and be organized in different ways, with different consequences."[40]

Critics of trade liberalization have their grounds. Drawing lessons from the history of global development in the late nineteenth century, several economists have vividly shown that developed

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[32] For instance, the strong stances taken by the United States and the European Commission on their agricultural subsidies and tariff policies during the Doha Round negotiation reflect this point. *Id.* at 578–82.

[33] *Id.*

[34] To name a few, with trade liberalization, a country producing for a larger world market than its domestic market can reap more benefits from the scale economy, thereby widen its scope of the division of labor, make better use of its machinery, and stimulate its innovations. An open economy may further better introduce foreign technology, foreign capital and new knowledge to improve its current condition. In general, based on the theory of comparative advantage, trade liberalization may facilitate a more efficient resource allocation. For a summary, *See* MEIER, *supra* note 27, at 103–11.

[35] *See* RODRIK, *supra* note 1, at 140-41.

[36] *See* RODRIK, *supra* note 1, at 140–41.

[37] *See* RODRIK, *supra* note 1, at 140–41.

[38] *See* RODRIK, *supra* note 1, at 140–41.

[39] *See generally* Deepak Nayyar et al., *Globalization and Development*, UNCTAD, TD(X)/RT.1/4 (2000).

[40] UNGER, *supra* note 8, at 13.

economies did not reach their success by virtue of trade liberalization.[41] Rather, the historic pattern showed that trade liberalization often followed, rather than preceded, an economy's development.[42] Therefore, an economy should not overly pursue trade liberalization before they become adequately developed. From this perspective, trade liberalization is not the panacea of economic development; instead, it suggests there should be more than one recipe to economic success.[43] As institutions vary, so does the optimal form of market economy for a given country. According to this observation, the world trade regime should not place hyper-globalization as its ultimate goal. Instead, it should respect the right of each economy to protect its own social arrangements, regulations, and institutions.[44] To do so, it should *minimize the requirement of institutional consistency*, so that each economy is allowed room to experiment with different forms of market economy.[45]

To be sure, none of the critics are against the idea of trade liberalization per se. What they highlight is simply that the world trade regime should adopt flexible rules on the pace, degree, and form of trade liberalization to permit each economy to find a pragmatic set of instruments for their own development.[46]

2. Liberalization versus Regulation in the Post-Crisis International Financial Structure

Liberalization of financial sectors always warrants caution. This is because compared with other sectors, financial sectors involve special "public goods" concerns, which are mostly regulatory and prudential in

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41 *See, e.g.*, UNGER, *supra* note 8, at 16–20; *See also* RODRIK, *supra* note 1, at 24–46.

42 *See* RODRIK, *supra* note 1, at 26–34; UNGER, *supra* note 8, 16–20.

43 RODRIK, *supra* note 1, at 13–54 (drawing the lessons from the economic miracles of East Asia in late 20th century as a result of their unorthodox trade policies and articulating provocative yet convincing arguments that there should be more than one recipe to the economic success).

44 RODRIK, *supra* note 1, at 236–59 (suggesting that future multilateral negotiations should endeavor in "*expanding the maneuvering room for individual nations* rather than narrowing it" and proposing to include a modified safeguard regime allowing Members' exercise of opt-outs for reasons other than a competitive threat to their industries, i.e. a "development and social safeguards" regime).

45 UNGER, *supra* note 8, at 180–93 (arguing that "the point is not to maximize free trade; it is to maximize the possibility of coexistence among different development strategies, institutional systems and forms of social life, and then, on that basis, to advance freer trade.").

46 *See* RODRIK, *supra* note 1, at 233–50; UNGER, *supra* note 8, at 179–92.

nature.[47] To address these concerns, there is a tendency to believe that domestic regulators will perform better than supranational regulatory bodies. This acknowledges that domestic regulators typically possess better knowledge and special techniques to address local regulatory issues.[48] This mentality has led to the view that world-trading rules should refrain from over-intervening in domestic financial regulatory fields.[49]

The prolonged negotiations concerning financial sectors at the WTO is telling. During the Uruguay Round, when Members decided to incorporate financial services, they soon realized the difficulty of negotiating these issues.[50] The Members had different conceptions of how financial liberalization should reconcile with their regulatory needs. The collapse of the Bretton Woods system and the outbreak of many banking and currency crises in the 1980s substantiated their regulatory concerns.[51] Many Members, notably Japan and many Asian and Latin American developing economies, thus wanted to maintain a lower level of market access commitment in financial sectors.[52] The United States, on the other hand, was dissatisfied with this minimal level of financial liberalization.[53] In the end, Members were unable to complete the negotiation of financial services when the GATS entered into force in 1995.[54] Only when most Members agreed to extend improved market access commitments did the negotiators reach a final agreement on financial services on December 13, 1997, which entered into force on

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[47] To name a few of these concerns: protection of depositors, monetary policy, economy financing, payments, credit allocation, undue concentration of power, negative externalities, national control and even fraud and money-laundering concerns, etc. For an elaborate account, *see generally* LAZAROS E. PANOURGIAS, BANKING REGULATION AND WORLD TRADE LAW: GATS, EU AND 'PRUDENTIAL' INSTITUTION BUILDING 18–22 (2006).

[48] Mary McAllister Shepro, *Preserving National Regulatory Autonomy in Financial Services: The GATS' Prudential Carve-out*, 12 (Dec. 31, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2418764.

[49] *Id.* at 11–12.

[50] *See* Kern Alexander, *The World Trade Organization and Financial Stability: The Balance between Liberalisation and Regulation in the GATS*, at 8–9 (Univ. of Cambridge, Ctr. for Fin. Analysis and Policy, Working Paper No. 1, 2003).

[51] *Id.*

[52] *See* Jarreau, *supra* note 4, at 24–26.

[53] In response, the United States wanted to introduce a "two-tier schedule" to exempt itself from being obliged to extend unconditional MFN treatment to all Members. Other Members rejected this proposal out of the concern that it would jeopardize the MFN principle. *See* Jarreau, *supra* note 4, at 24–26.

[54] Eric H. Leroux, *Trade in Financial Services under the World Trade Organization*, 36 J. WORLD TRADE 413, 426 (2002).

March 1, 1999.[55] This negotiation history illustrates the Members' serious concerns about opening up their financial sectors, in particular, the concern from developing Members whose financial sectors had not been well developed.

The Global Financial Crisis then shook the hope of further liberalization in financial sectors. When Members negotiated the WTO provisions related to financial services in the 1990s, there was "a prevailing consensus that the shift towards expansive deregulation would be permanent."[56] Such consensus, however, was "all but swept away after the 2007-09 financial meltdown."[57] In particular, because the crisis took place in the countries most open to trade and investment in financial services, it paints a grim outlook for financial liberalization in the near term.[58] Other developing countries are likely to become more hesitant of lifting their restrictions on foreign entry to their markets.[59]

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[55] The final agreement includes Members' specific commitments in financial sectors and the Financial Annex. For an comprehensive account of WTO's negotiation on financial services, *see id.* at 426–28; Jarreau, *supra* note 4, at 9–31.

[56] Pub. Citizen, No Meaningful Safeguards for Prudential Measures in World Trade Organization's Financial Service Deregulation Agreements 3 (Special Pittsburgh G-20 Report 2009) [hereinafter Public Citizen Report 2009].

[57] *Id.*

[58] *See* Panagiotis Delimatsis & Pierre Sauve, *Financial Services Trade After the Crisis: Policy and Legal Conjectures*, *in* INTERNATIONAL LAW IN FINANCE REGULATION & MONETARY AFFAIRS 288, 290-91 (Thomas Cottier et al. eds., 2012).

[59] For a detailed analysis, *see generally id.* To be sure, one should not exaggerate the negative impact of the Global Financial Crisis on financial liberalization if considering G-20's joint commitment to stand against protectionism after the outbreak of crisis. The G-20 Summit Communique on November 15, 2008 states:

> We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary.

See Statement from G-20 Summit, N.Y. TIMES (last visited April 2, 2016). The crisis, however, does shift the focus of global financial community away from liberalization to global regulation. On the other hand, there are several pieces of literature which note the anti-competitive effect of those crisis-related measures and advocate some role of the WTO in addressing these anti-competitive concerns. *See e.g.*, Bart De Meester, *The Global Financial Crisis and Government Support for Banks: What Role for the GATS?*, 13:1 J. INT'L ECON. L. 27 (2010); Delimatsis & Sauve, supra note 58; Anne van Aaken & Jurgen Kurtz, *Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law*, 12 J. INT'L ECON. L. 859 (2009).

At the same time, closing domestic financial sectors is not necessarily desirable. Foreign entry in financial sectors has its merits.[60] For instance, it could introduce competition into the domestic financial market and increase efficiency. Domestic financial institutions may also derive financial expertise and management skills from foreign financial institutions.[61] Domestic businesses may also have more access to cheap funding from abroad.[62] The inevitable side effects, however, are the associated financial risks, which require robust regulatory and governance systems. Therefore, the challenge is to find a model that balances the benefits from financial liberalization and reduces associated risks to a controllable level.

B. THE OCTZ APPROACH IN PRACTICE

To search for the liberalization-regulation balance, some economies have adopted a modest experiment, the OCTZ Approach. The ambitious PFTZ plan in China's Shanghai has received the most attention, with other economies, such as Japan and Taiwan, also adopting or contemplating the adoption of similar measures.

1. China's Experimental Projects of Pilot Free Trade Zones

On September 29, 2013, China launched its break-through project of PFTZs in Shanghai, which conducted a number of pioneer reform and opening-up in trade, finance, and investment.[63] The main tasks of SH PFTZ are: (1) to accelerate the transformation of the government's functions; (2) to expand the liberalization of investment areas; (3) to promote transformation of trade development methods; (4) to deepen financial liberalization and innovation; and (5) to improve institutional protection in laws.[64] The SH PFTZ, in particular, focuses on the liberalization of China's services sectors, including financial services,

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[60] Jan Kregel, *Financial Liberalization and Domestic Policy Space: Theory and Practice with Reference to Latin America*, *in* FINANCIAL LIBERALIZATION AND ECONOMIC PERFORMANCE IN EMERGING COUNTRIES 9, 12 (Philip Arestis & Luiz Fernando de Paula eds., 2008).

[61] *Id.*

[62] *Id.*

[63] CHINA (SHANGHAI) PILOT FREE TRADE ZONES, *Introduction* (last visited Feb. 1, 2017), http://en.china-shftz.gov.cn/About-FTZ/Introduction/.

[64] State Council, Notice on Overall Plans for China (Shanghai) Pilot Free Trade Zones, ¶¶ 2(1)-(5) (Sept 18, 2013).

shipping services, commercial and trade services, professional services, cultural services, and social service sectors such as education, job training, and health care services.[65]

The concept of PFTZ was not entirely foreign to China. In the 1980s, China deployed special economic zones to experiment with economic reforms, which marked the start of China's entry into the world trading system.[66] What makes the SH PFTZ distinct is not the liberalization of trade per se, but the objective of its reforms.[67] More relevantly, the most appealing aspects of the SH PFTZ project is its ambitious reforms of China's financial sectors.

a. Financial Reforms in SH PFTZ

Below, I briefly summarize some major financial reforms in SH PFTZ:

i. Interest rate liberalization:

One of the main experiments that the SH PFTZ conducted was interest rate liberalization.[68] When launching the SH PFTZ in 2013, China maintained deposit rate control, according to which Chinese banks could not set their deposit rate 1.1 times above the benchmark deposit rate.[69] The People's Bank of China ("PBOC") announced that it would steadily push forward interest rate marketization in the SH PFTZ.[70] Its major experiment took place in early 2014, which relieved in-zone banks from the obligation to observe the ceiling rate when taking retail deposits in foreign currency.[71] In-zone banks thus obtained more liberty when engaging with foreign retail currency deposit businesses.

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[65] *Id.* at ¶ 2(2)(b).

[66] Some commentators do treat the Shanghai PFTZ as one type of special economic zones. Daqing Yao & John Walley, *The China (Shanghai) Free Trade Zones: Background, Developments, and Preliminary Assessment of Initial Impacts* 13 (Nat'l Bureau of Econ. Research, Working Paper No. 20924, 2015).

[67] *Id.* at 13.

[68] State Council, Notice on Overall Plans for China (Shanghai) Pilot Free Trade Zones, ¶ 7 (Sep. 18, 2013).

[69] PBOC, The Decision to Reduce the Benchmark Rate for Financial Institutions' RMB Deposits and Loans and Adjust the Floating Range of Interest Rate (June 7, 2012), http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/125440/125835/2861207/index.html.

[70] PBOC, Opinion regarding Financial Supports of SH PFTZ (Dec. 2, 2013).

[71] PBOC, Notice regarding Liberalizing the Ceiling of Retail Foreign Currency Deposit Rate in SH PFTZ (Feb. 25, 2014).

This progressive liberalization led to nation-wide reform. On October 23, 2015, the PBOC cancelled the deposit rate control over commercial banks and rural cooperative financial institutions nation-wide.[72] This removed the interest rate control in China. China finally completed its interest rate liberalization movement after years of progressive reforms and regulatory experiments.

ii. Free trade account

The SH PFTZ also experimented with liberalization of capital accounts control, another well-known financial control in China. In mid-2015, the PBOC permitted in-zone financial institutions to open free trade accounts for in-zone organizations and individuals.[73] Under these accounts, RMBs and foreign currencies were subject to substantially the same rules, and account holders could settle their cross border capital transactions and direct investment in these accounts.[74] In-zone financial institutions thus obtained new free trade accounts and business.

iii. Simplification of approval requirements

Another reform in the SH PFTZ was the simplification of certain administrative procedures. Related measures included cancelling prior approval requirements for: in-zone banks' incorporation, modification, and termination of in-zone sub-branches;[75] in-zone banks' hiring of major responsible persons at their in-zone sub-branches;[76] in-zone reinsurance companies' incorporating of branches;[77] in-zone insurance companies' hiring of top executives at their in-zone sub-branches,[78] amongst others.[79]

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[72] PBOC, The Decision to Reduce the Benchmark Deposit and Lending Rates and Lower the Deposit Reserve Rate (Oct. 23, 2015), http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/125440/125835/2968725/index.html.

[73] PBOC, Implementing Rules on Accounts Differentiation and Calculation Businesses in SH PFTZ (May 21, 2014).

[74] *Id.*

[75] Chinese Banking Regulatory Commission ("CBRC"), Implementing Rules regarding Simplification of Entries of Banking Institutions and Top Executives to SH PFTZ, Art. 6 (Oct. 28, 2016).

[76] *Id.* at Art. 11.

[77] Chinese Insurance Regulatory Commission ("CIRC"), Notice regarding Further Simplification of Administrative Approval for Supporting the Development of SH PFTZ (May 15, 2014).

[78] *Id.*

These measures reduced the procedural costs and uncertainty of in-zone financial institutions with respect to network expansion and personnel employment.

iv. Liberalization of cross-border investments and services

The SH PFTZ also experimented with the liberalization of cross-border investments and services. These measures included permitting in-zone banks to operate offshore businesses through their in-zone branches,[80] supporting in-zone banks to engage in cross-border lending and investment financing businesses,[81] permitting qualified in-zone financial institutions to engage in cross-border securities and futures investment,[82] and others.[83] These measures allowed in-zone financial institutions to engage in more cross-border financial and investment business.

Other in-zone measures related to financial sectors included liberalization related to RMB-denominated capital account, banks' offshore businesses, foreign investment in domestic financial institutions, trading on Shanghai's securities and futures exchanges, nonresidents' investment in domestic securities and futures, qualified domestic individual investors, incorporation of foreign banks and Sino-foreign joint venture banks, and others.[84] In sum, the SH PFTZ conducted large-scale experiments in financial regulation. The experimental results, however, still require continued observation.[85]

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[79] *See e.g.*, PBOC et al., Plan for Further Promoting the Pilot Financial Liberalization and Innovation of the China (Shanghai) Pilot Free Trade Zone and Accelerating the Development of Shanghai into an International Financial Center (Oct. 29, 2015).

[80] CBRC, Notice regarding Experiments of Regulatory Institutional Arrangements of Banking Businesses in SH PFTZ, ¶ 4.1 (May 12, 2014).

[81] CBRC, Notice regarding Issues related to Banking Regulation and Supervision in SH PFTZ, ¶ 7 (Sept. 28, 2013).

[82] Chinese Securities Regulatory Commission ("CSRC"), Certain Policies and Measures regarding Capital Market's Support of Promoting the SH PFTZ, ¶ 2 (Sept. 29, 2013).

[83] *See e.g.*, PBOC, *supra* note 79.

[84] For related introduction of the financial measures in the SH PFTZ, see, for example, Eiichi Sekine, *Financial Impact from the Shanghai FTZ*, 5 NOMURA J. CAP. MKTS., 1, 1 (2014); Shen, *supra* note 11.

[85] For instance, it is documented that China's capital control reduced after the establishment of SH PFTZ, which was reflected in the increase in capital inflow and outflow, closer price spread between onshore exchange rate of RMB and offshore one in Hong Kong, etc. *See generally* Yao & Walley, *supra* note 11.

b. The Expansion of PFTZs in China

In addition, China has experimented with financial liberalization in more than one PFTZ. Before the SH PFTZ, China had already conducted financial experiments in Wenzhou in early-2012 and Shenzhen in mid-2012.[86] The financial experiments in Wenzhou mainly attempted to legalize underground finance and the entry of private banks in order to channel more funds to the private sector,[87] while those in Shenzhen attempted to free currency convertibility and relax China's capital account.[88] Based on the experience of the SH PFTZ, the Chinese government further expanded the experiments and launched three more PFTZs, namely, the Tianjin, Guangdong, and Fujian PFTZs.[89] The Chinese government launched the three zones in 2015, each of which contain certain measures related to financial liberalization.[90] In August 2016, China selected Chongqing, Sichuan, Hubei, Henan, Guangxi, Zhejiang, Shaanxi, and Liaoning as the third wave of PFTZs.[91] PFTZs have become one of the mainstream models for the Chinese government to initiate economic and financial reform and liberalization.

2. The OCTZ Approach as an Emerging Model of Progressive Liberalization

In addition to China, other economies have also adopted or considered adopting the OCTZ Approach to reform their economy. Japan is one prominent example. As part of the "Japan Revitalization Strategy" led by the Abe Administration, Japan initiated the so-called "National Strategic Special Zones" ("NSSZs") in 2014 to experiment in ambitious

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[86] For a comprehensive introduction of the financial experiments in Wenzhou and Shenzhen, *see generally* Shen, *supra* note 11.

[87] *Id.* at 400–07.

[88] *Id.* at 407–10.

[89] Standing Committee of the National People's Congress, Decision regarding Authorizing the State Council to Provisionally Adjust Administrative Approvals under Related Legal Rules in Guangdong PFTZ, Tianjin PFTZ, Fujian PFTZ and SH PFTZ's Expanded Areas (Dec. 29, 2014).

[90] For instance, in Fujian PFTZ, Chinese government attempts to experiment with interest rate marketization, negotiable certificate of deposit, offshore transfer of RMB assets or property management products, offshore foreign currency businesses, asset securitization businesses, investment, financing and insurance related to intellectual property, entry of foreign financial leasing companies, investment in domestic and offshore securities and futures, etc. State Council, Notice regarding Overall Plans for Fujian PFTZ, ¶ 3.5.12 (Apr. 8, 2015).

[91] Wang Xinyi et al., *China Gives Green Light to 7 New Free-Trade Zones*, CAIXIN (Sept. 1, 2016), http://www.caixinglobal.com/2016-09-01/100992374.html.

deregulation.[92] In May 2014, the Japanese government selected six cities, including, Tokyo to attract foreign businesses, Kansai to conduct medical reforms, Niigata and Yabu to conduct agricultural reforms, Fukuoka to conduct employment reforms, and Okinawa to conduct tourism reforms.[93] In Tokyo, the major reforms included providing various incentives (such as tax, subsidy and low-interest loans), deregulation measures (such as expedited immigration process, reduction of investment procedures, expedited patent review process), and business and living support to foreign companies.[94]

Taiwan is also contemplating adopting the OCTZ Approach. In December 2013, Taiwan's Executive Yuan proposed to the Legislative Yuan the draft bill for the Special Act for Free Economic Pilot Zones ("FEPZs").[95] The general idea was to designate certain areas (including existing science parks and new sites) as FEPZs,[96] in which businesses could apply experimental rules in respect to urban plans, land use, environmental assessment, foreign natural person movements, tax incentives, customs clearance for goods, and others.[97] The FEPZs project further proposed a number of reforms for certain sectors, such as agriculture, education, medical health, etc. Financial innovation was also part of the focused sectors.[98] The Taiwanese government expected to experiment within the FEPZs, by focusing on liberalizing the business and financial products that banks (including domestic banking units and offshore banking units) and securities firms (including offshore securities units and domestic securities units) may engage with and sell.[99] Up to

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[92] Before the 2014 plan, Japan also used to launch "Structural Reform Special Zones" in 2003 and "Comprehensive Special Zones" in 2011. Japanese National Strategic Special Zones, *supra* note 12.

[93] *Id.*

[94] For more information, see *Tokyo's Special Economic Zones*, INVEST TOKYO (last visited April 26, 2016), http://www.seisakukikaku.metro.tokyo.jp/invest_tokyo/index.html.

[95] Japanese National Strategic Special Zones, *supra* note 12.

[96] In the initial phase, these areas include seven free trade ports (Keelung, Taipei, Taichung, Kaohsiung, Su'ao, Anping and Taoyuan Aerotropolis) and one agricultural biotech park at Pingdong. *See* Tsar & Tsai Law Firm, *An introduction to Taiwan's Free Economic Pilot Zone* (Sept. 2, 2013), http://www.lexology.com/library/detail.aspx?g=73a64571-77bd-4947-8944-05c77cd19320 (last visited April 19, 2017).

[97] Japanese National Strategic Special Zones, *supra* note 12.

[98] Financial Supervisory Commission, FEPZ – Financial Services, http://www.fepz.org.tw/Upload/Plan_FILE/1030521%E9%87%91%E8%9E%8D%E6%9C%8D%E5%8B%99.pdf (last visited Feb. 1, 2017).

[99] Liu & Partners Attorneys-at-Law, *Introductions of the Free Economic Pilot Zones in Taiwan*, http://www.chinagoabroad.com/en/article/introductions-of-the-free-economic-pilot-zones-in-taiwan (last visited April 19, 2017).

date, however, the Legislative Yuan of Taiwan has not passed this Bill, and the new administration has suspended the initiative.[100]

While it is too soon to tell whether the OCTZ Approach will continue in this way in the future, this model of reform featured by progressive liberalization and regulatory experiments has at least become an option for developing countries.

3. The Merits of the OCTZ Approach

The OCTZ Approach is an advanced version of zoning strategies. To be sure, the concept of "zoning" is not novel. For instance, export-processing zones have been widely used in East Asia, notably Taiwan, since the 1960s, as a major development tool.[101] China itself has also employed various types of zones; the most notable were the special economic zones implemented during its early economic reforms in the 1980s.[102] The OCTZ Approach, however, is different. Unlike export processing zones and special economic zones that aim to promote an economy's exportation and therefore involve potential violations of the WTO's subsidy rules, PFTZs are regulatory experiments in liberalization. As such, they involve fewer subsidy or discrimination issues.

The OCTZ Approach embodies several novel economic functions. Primarily, it echoes the theory of the economists who cautioned against wholesale liberalization.[103] In financial sectors, liberalization may come with unintended systemic risks to the financial system, as evidenced in the Asian Financial Crisis and the Global Financial Crisis. Moreover, considering the complexity of the world financial system, the economic impacts of financial liberalization are hard to accurately predict.[104] In light of such uncertainty and unpredictability, adopting financial liberalization on a limited scale helps policy makers to *test the direction of wind* and derive empirical data for

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[100] Li Shunde (李順德), *The Tsai Administration Stops Promoting FEPZ* (自由經濟示範區 蔡政府不推了), UNITED NEWS (聯合報), Oct. 26, 2016.

[101] *See* WADE, *supra* note 2, at 139.

[102] For a summary of various types of economic zones and their implementation in China, *see generally* Kossof, *supra* note 11, at 4.

[103] *See supra* Part II.A.1.

[104] For instance, no financial economist can accurately predict how much capital will flow in or flow out if one economy liberalizes its control of capital account and what amount of flow is optimal and controllable.

deciding their next step. Hence, although the OCTZ Approach slows down the speed of liberalization, it also safeguards an economy's financial stability.

The OCTZ Approach also has social benefits. Notwithstanding the merits of trade liberalization, a democratic government needs to consider the social issues caused by the competition in global markets, such as industrial transformation, unemployment, excessive inventories, and others.[105] To resolve these issues, a government needs time to transition. By adopting the OCTZ Approach to conduct liberalization in a selective manner, a government picks and chooses those industries that urgently call for liberalization, while at the same time refrains from subjecting the whole economy to global competition. The economy thus can win some time for its uncompetitive industries to transition and mitigate the potential social issues resulting from trade liberalization.

The OCTZ Approach is also politically attractive. Liberalization often comes with a readjustment of the structure of domestic political interests.[106] In many cases, the vested stakeholders are against trade liberalization because they are afraid that the increased competition resulting from these changes may deprive them of their existing interests.[107] To safeguard their interests, these vested stakeholders may exert political power to stagnate the liberalization process, which compromises the efficiency of the whole economy.[108] The OCTZ Approach may serve as a compromise between reformers and vested stakeholders. Vested stakeholders may find this approach more politically acceptable if their businesses are not directly subject to liberalization and global competition. In this sense, the OCTZ Approach facilitates the process of needed reforms. Once the reforms are successful, perhaps they will create new interest groups with the economic and political power to counterbalance vested stakeholders and promote a larger scale of liberalization reform.[109] One may portray the

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[105] RODRIK, *supra* note 1, at 190–200.

[106] RODRIK, *supra* note 1, at 187–90.

[107] For a discussion of the case of Argentina in this context, see RODRIK, *supra* note 1, at 184–87.

[108] For an interest group theory of financial development where incumbents oppose financial liberalization in order to secure their competitive position, see generally Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003).

[109] For an application of the regulatory dualism to stock exchange and corporate governance reform, see generally Ronald J. Gilson et al., *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States and the European Union*, 63 STAN. L. REV. 475 (2011).

OCTZ Approach as a political yield to the vested stakeholders, but perhaps this is not a bad thing in the long term.

C. SUMMARY

With sound economic rationale and social and political support, the OCTZ Approach is an exciting development in international economics. Its pace and degree of liberalization might be relatively slow and small-scale, but it may be a more feasible method toward liberalization. The fact that SH PFTZ has received so much attention, with little criticism, illustrates that the international community has widely accepted this model of liberalization.

III. THE OCTZ APPROACH AND WTO LAWS

In this section, I will explore the legal implications of the OCTZ Approach under current WTO laws, focusing on those related to financial sectors. Through my analysis, the OCTZ Approach, regrettably, may be inconsistent with the "principle of consistency" under WTO case law and thus incur legal risks for Members adopting this approach.

A. WTO'S CURRENT REGIMES RELATED TO FINANCIAL SECTORS

The role of the WTO in international finance is relatively marginal. The international financial community is more concerned with the regulatory or prudential aspect of international finance than the liberalization aspect.[110] Accordingly, it mainly discusses contemporary issues of international finance in other international organizations dedicated to financial regulation; for instance, the Basel Committee on Banking Supervision ("Basel") on banking issues, the International Organization of Securities Commission ("IOSCO) on securities issues, the International Association of Insurance Supervisors ("IAIS") on insurance issues, the IMF on monetary issues, the World Bank, and the

[110] Thomas Cottier & Markus Krajewski, *What Role for Non- Discrimination and Prudential Standards in International Financial Law?, in* INTERNATIOANL LAW IN FINANCE REGULATION. & MONETARY AFFAIRS 271, 276 (Thomas Cottier et al. eds., 2012).

recently established Financial Stability Board ("FSB").[111] The WTO is somewhat out of the picture.[112]

That being said, the WTO remains relevant to international finance. It is the forum where the two most important topics in international finance, i.e. financial liberalization and financial regulation, meet.[113] Moreover, since the WTO possesses a dispute settlement mechanism, its rules are of theoretical and practical significance.[114] Currently, three main legal vehicles under the WTO govern the Members' obligations as related to financial services: the main texts of GATS, the GATS Annex on Financial Services, and individual Member's specific commitments.

1. GATS Obligations related to Financial Sectors

Since activities in financial sectors are mainly services in nature, the GATS is the major WTO covered agreement that governs. Below I briefly sketch the major GATS obligations that may apply to financial services.[115]

a. MFN Treatment

MFN treatment deals with the discrimination against service and service suppliers from specific Member(s) vis-à-vis those from other countries. According to GATS Article II, unless a measure is listed and meets the conditions of GATS Annex on Article II Exemptions, each Member shall accord immediately and unconditionally to *like services and service suppliers*[116] of any other Member *treatment no less*

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[111] *Id.* at 275.

[112] *Id.* (observing that "in the field of financial and monetary law, the central role of the GATS and its enforceable principles and rules have not yet been sufficiently recognized.").

[113] Public Citizen Report 2009, *supra* note 56, at 4 (considering that "the WTO financial service rules constitute a global regulatory ceiling.").

[114] Regis Bismuth, *Financial Sector Regulation and Financial Services Liberalization at the Crossroads: The Relevance of International Financial Standards in WTO Law*, 44 J. WORLD TRADE 489, 491 (2010).

[115] For a comprehensive account of the application of related GATS obligations on financial sectors, see Leroux, *supra* note 54, at 415–26; Jarreau, *supra* note 4, at 50–53, 61–70.

[116] Under the current WTO case law, "like services and service suppliers" refers to those services and service suppliers that are in a competitive relationship. Appellate Body Report, *Argentina – Measures relating to Trade in Goods and Services*, ¶¶ 6.18-6.34, WT/DS453/AB/R, (adopted April 14, 2016) [hereinafter *Argentina–Financial Services*]; Panel Report, *Argentina – Measures Relating to Trade in Goods and Services*, ¶¶ 7.155-7.162, WT/DS453/R, (adopted Sep. 30, 2015). To assess the likeness of services and/or service suppliers, the characteristics of services

favourable[117] than that it accords to like services and service suppliers of any other country.

b. Market Access

Market access deals with the entry of service and service suppliers from other Members into the domestic market of a Member. Pursuant to GATS Article XVI, a Member shall not accord services and service suppliers of any other Member treatment less favourable than that specified in its own Services Schedule.[118] Specifically, any measure that meets one of the six items as listed in GATS Article XVI:2,[119] but is not contained in its own Services Schedule, will violate GATS Article XVI.[120]

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and service suppliers, the classification and description of the service under the UN Central Product Classification and the business scope of service suppliers can be relevant. *Argentina–Financial Services*, *supra* note 116, ¶ 6.32. Moreover, where a measure provides for a distinction of services and/or service suppliers based exclusively on origin, meaning that the services and/or service suppliers involved are the same in all respects except for origin, likeness can be presumed. *Argentina–Financial Services*, *supra* note 116, ¶ 6.38.

[117] "Less favourable treatment" refers to the different treatment between two categories of like services or service suppliers that *modifies the condition of competition* favoring one than the other. *Argentina–Financial Services*, *supra* note 116, ¶ 6.106. *See also* Panel Report, *supra* note 116, ¶ 7.235. This includes both *de jure* and *de facto* discrimination. Appellate Body Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, ¶ 233–34, WT/DS27/AB/R (adopted Sep. 9, 1997) [hereinafter "*EC–Banana III*"].

[118] GATS, *supra* note 17, at art. XVI (1).

[119] These market access restriction measures include: (a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test; (b) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test; (c) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test; (d) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test; (e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and (f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment. This is an exhaustive list. Panel Report, *China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, WT/DS363/R, ¶¶ 7.1353 (Aug. 12, 2009) [hereinafter Panel Report, *China–Audiovisual Products*].

[120] GATS, *supra* note 17, at art. XVI (2).

c. National Treatment

National treatment deals with discrimination against service and service suppliers from specific Member(s) vis-à-vis the domestic ones of the adopting Member. Pursuant to GATS Article XVII, in the service sectors inscribed in its Schedule, each Member shall accord to services and service suppliers of any other Member treatment no less favourable than that it accords to its own like services and service suppliers.[121]

d. Domestic Regulation

In addition to the above non-discrimination and market access provisions, GATS also contains obligations related to domestic regulation.[122] Pursuant to GATS Article VI:1, in services 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.[123] Moreover, pursuant to GATS Article VI:5(a), in service sectors in which a Member has undertaken specific commitments, that Member shall not apply licensing and qualification requirements and technical standards that nullify or impair such specific commitments in specific manners.[124]

e. General Exception

Notwithstanding the above GATS obligations, Members may justify their GATS-inconsistent measures by invoking the general exceptions provided in GATS Article XIV.[125] The provided exceptions that relate to financial services include: the public moral or public order defense;[126] the compliance defense related to deception and fraud

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[121] The definition of "like service and service suppliers" and "less favourable treatment" basically resembles those under GATS Article II as discussed above. Appellate Body Report, *Argentina – Financial Services*, *supra* note 116, ¶¶ 6.25, 6.106; Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶¶ 7.160, 7.220.

[122] Other related obligations also include those related to monopoly (GATS Article VIII), payments and transfers (GATS Article XI), balance of payments (GATS Article XII), etc.

[123] GATS, *supra* note 17, at art. VI (1).

[124] These prohibitive manners include those which are not based on objective and transparent criteria, which are more burdensome than necessary to ensure the quality of the service, or, in the case of licensing procedures, which are in themselves a restriction on the supply of the service. These manners, however, should be those that could not reasonably have been expected of that Member at the time the specific commitments in those sectors were made. *See id.* at VI (5)(a).

[125] GATS, *supra* note 17, at art. XIV.

[126] GATS, *supra* note 17, at art. XIV(a).

prevention;[127] the protection of privacy and safety of individual data;[128] the imposition of collection of tax defense;[129] and others.[130] These exceptions are subject to the necessity test as a financial measure must be "necessary" to achieve the policy reason listed above.

Moreover, to invoke these exceptions, Members have to pass the GATS Article XIV chapeau review as well. That is, its financial measures cannot be applied in a manner that constitutes "a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services."[131] The interpretation of this chapeau is a major concern of this paper and will be discussed later.

2. The Financial Annex

The Financial Annex is an integral part of the GATS and is binding upon all Members.[132] The recently circulated Appellate Body Report[133] and the Panel Report[134] of *Argentina–Financial Services* have clarified certain provisions of the Financial Annex. Regrettably, they have not clarified all of the related issues.

a. Introduction

Pursuant to the Financial Annex Paragraph 1(a), the Financial Annex applies to any measures "affecting the supply of financial services."[135] The term "affecting" here broadly covers any measure that *has effect on* financial services,[136] "regardless of whether such a measure directly governs the supply of that service or whether it regulates other

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[127] GATS, *supra* note 17, at art. XIV(c)(i).
[128] GATS, *supra* note 17, at art. XIV(c)(ii), (iii).
[129] GATS, *supra* note 17, at art. XIV(d).
[130] GATS, *supra* note 17, at art. XIV.
[131] GATS, *supra* note 17, at art. XIV Chapeau.
[132] GATS, *supra* note 17, at art. XXIX.
[133] Appellate Body Report, *Argentina–Financial Services*, *supra* note 116.
[134] Panel Report, *Argentina–Financial Services*, *supra* note 116.
[135] GATS, *supra* note 17, at Annex on Financial Services ¶ (1)(a).
[136] Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶ 7.855.

matters but nevertheless affect trade in services."[137] This is a relatively broad scope of application.[138]

b. Prudential Exception

The most important and controversial provision under the Financial Annex is Paragraph 2(a), known as the "prudential exception."[139] It affords Members considerable autonomy to enact financial regulatory measures.[140] It also reflects the Members' understanding during the Uruguay Round of the importance of prudential regulation to the efficient and stable operation of financial markets.[141] Due to the complexity of this issue, during the negotiation of the Financial Annex, Members, came up with five different versions of the prudential exception.[142] In the end, Members agreed on the current version, which 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 with the provisions of the Agreement, they shall not be used *as a means of avoiding* the Member's commitments or obligations under the Agreement.[143]

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[137] Council for Trade in Services Committee on Trade in Financial Services, Financial Services – Background Note by the Secretariat, S/C/W312, S/FIN/W/73, ¶ 22 (Feb. 3, 2010) [hereinafter CTFS Background Note 2010].

[138] Despite this broad understanding, some academics highlighted that the Financial Annex does not apply to a Member's regulation of capital flows and capital account regulation. Alexander, *supra* note 50, at 11. Rather, these issues are instead governed by GATS Articles XI and XII. For detailed analysis, see Gabriel Gari, *GATS Disciplines on Capital Transfers and Short-term Capital Inflows: Time for Change?*, 17 J. INT'L ECON. L. 399 (2014).

[139] *See e.g.*, VU Nhu Thang, *Applicability of GATS Prudential Exception to Insurance Services: Some Interpretative Issues*, 4 MANCHESTER J. INT'L ECON. L. 88, 91 (2007).

[140] Jarreau, *supra* note 4, at 67.

[141] It is noted that during the negotiation, all major actors, including the United States, European Union, Malaysia, Canada and Sweden, agreed to leave considerable freedom regarding the possibility to change domestic laws regulating financial services markets. *See* Carlo Maria Cantore, *'Shelter from the Storm': Exploring the Scope of Application and Legal Function of the GATS Prudential Carve-Out*, 48:6 J. WORLD TRADE 1223, 1225 (2014).

[142] For a summary of these versions, *see* Public Citizen Report 2009, *supra* note 56, at 11.

[143] GATS, *supra* note 17, at Annex on Financial Services ¶ (2)(a).

Pursuant to this paragraph, Members obtain legitimate grounds to depart from GATS obligations for prudential reasons.[144] The ambiguous wording of this paragraph, however, triggers several interpretative issues.

i. The legal character

Legal scholars debate over the legal character of Paragraph 2(a) of the Financial Annex.[145] Some scholars understand it to be an exception.[146] For instance, the GATS Scheduling Guidelines 2001 and the Committee on Trade in Financial Services consistently characterize it as an "exception."[147] Recent literature, however, has increasingly advocated that this paragraph is not an exception but a "carve-out" that "exclude[s] the application of other provisions."[148]

The legal consequence of the different characterization is the allocation of burden of proof. If this paragraph is a carve-out clause, it is the complainant who bears the burden of proof. In contrast, if it is an exception clause, it is the respondent who bears the burden to prove the challenged measures satisfy the elements of this paragraph.[149] In the recently circulated Panel Report of *Argentina–Financial Services*, the Panel found this paragraph an exception in nature, and therefore, assigned the burden of proof to the implementing Member.[150]

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[144] *Id.*

[145] *Id.*

[146] For literatures considering the prudential exception here an exception, *see e.g.*, Leroux, *supra* note 54, at 430; Alexander, *supra* note 50, at 22–25; Shepro, *supra* note 48, at 27–30; Delimatsis & Sauve, *supra* note 58, at 300; Joseph Windsor, *The WTO Committee on Trade in Financial Services: The Exercise of Public Authority within an Informal Forum*, 9 GERMAN L.J. 1805, 1821 (2008).

[147] Council for Trade in Services, *Guidelines for the scheduling of specific commitments under the General Agreement on Trade in Services (GATS)*, S/L/92, ¶ 20 (March 23, 2001) [hereinafter "GATS Scheduling Guidelines 2001"]; CTFS Background Note, *supra* note 137, at ¶ 28.

[148] *See generally* Cantore, *supra* note 141.

[149] For related WTO cases distinguishing these two concepts, *see* Appellate Body Report, *European Communities – Measures Concerning Meat and Meat Products (Hormones)*, ¶ 109, WTO Doc. WT/DS26/AB/R, WT/DS48/AB/R, (Feb. 13, 1998) [hereinafter *EC–Hormones*]; Appellate Body Report, *European Communities – Trade Description of Sardines*, ¶ 275, WTO Doc. WT/DS231/AB/R, (Oct. 23, 2002).

[150] Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶¶ 7.813–816.

ii. The scope of application

Legal scholars also debate what type of GATS obligations this paragraph exempts. This controversy arose because this paragraph is titled "domestic regulation," which appears to imply that it only applies to the Members' domestic regulation under GATS Article VI.[151] In this sense, the prudential exception may not exempt measures other than domestic regulation, such as market access measures as defined in GATS Article XVI.[152] This narrow interpretation, however, does not receive much support in the current literature. The mainstream opinion argues that by using the phrase "notwithstanding any other provision of the Agreement" at the beginning of this paragraph, the prudential exception should apply to all provisions of the GATS.[153]

The Appellate Body Report and the Panel Report of *Argentina–Financial Services* have clarified this issue. They both found that the prudential exception applies to a scope greater than that of GATS Article VI and covers all measures affecting the supply of financial services within the meaning of Financial Annex Paragraph 1(a).[154]

iii. Prudential reasons

Another controversial issue is how to define "prudential reasons." The first sentence provides an illustrative list of prudential

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[151] Some commentators do advocate that the title "domestic regulation" has the bearing here, and the prudential exception should accordingly correspond to Members' domestic regulations under GATS Article VI. *See* Jarreau, *supra* note 4, at 36. From a negotiating history perspective, this interpretation has its points if we consider the history that during the Brussels Ministerial Conference in December 1990 the original proposal was to append the prudential exception to GATS Article XIV as its addendum, but later the SASEAN countries successfully dissuaded the plan and placed it as the addendum to GATS Article VI (domestic regulation). *See* Cantore, *supra* note 141, at 1236–37.

[152] GATS, *supra* note 17, at art. XIV(2).

[153] Cantore, *supra* note 141, at 1225. Moreover, as the GATS Scheduling Guideline 2001 explicitly instructs Members that they are not obliged to schedule their prudential measures because these measures are exempted from the GATS coverage, it also implies that the prudential exception should extend to Members' obligations other than domestic regulations, such as market access or national treatment; otherwise Members would need to specify their prudential measures that involve these obligations in their specific commitments in order to save themselves from GATS violation. GATS Scheduling Guidelines 2001, *supra* note 147, at ¶ 20, at 7. In fact, the Committee on Trade in Financial Services also considers "'measures for prudential reasons' could include measures that are inconsistent with a Member's MFN obligations, or specific commitments on financial services." CTFS Background Note 2010, *supra* note 137, at ¶ 28, at 8.

[154] Appellate Body Report, *Argentina–Financial Services*, *supra* note 116, ¶ 6.262; Panel Report, *Argentina – Financial Services*, *supra* note 116, ¶ 7.847.

reasons, including those "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."[155] The list is not exhaustive because it uses "including" at the beginning.[156] Moreover, some commentators have noted that prudential reasons need not be static; they can be evolutionary in accordance with increasing complexity of financial sectors.[157] This involves the issue of how encompassing the concept of "prudential reasons."[158] After all, there must be a boundary,[159] but the contour of any such boundary is less than clear.[160]

On this issue, the Panel Report of *Argentina–Financial Services* took a relatively deferred stance. It found that "WTO Members should have sufficient freedom to define the prudential reasons that underpin their measures, in accordance with their own scales of values."[161] In addition, in response to Panama's assertion, it emphasized that the prudential reasons need not be imminent.[162]

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[155] For some further introduction of these illustrated prudential reasons, *see* Cantore, *supra* note 141, at 1227–28.

[156] Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶ 7.869; *See also* Cantore, *supra* note 141, at 1227-28; Gari, *supra* note 138, at 422.

[157] Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶ 7.873; *See also* Gari, *supra* note 138, at 422.

[158] For instance, in the aftermath of the Global Financial Crisis, Members have different opinions about whether prudential reasons here can cover measures aiming to ensure macro-prudential concerns. *See generally* Reports of meetings of the Committee on Trade in Financial Services held on Apr. 26, 2010 (S/FIN/M/63, June 25, 2010), Mar. 9, 2011 (S/FIN/M/67, Apr. 12, 2011), Oct. 31, 2011 (S/FIN/M/71, Nov. 4, 2011) and June 27, 2012 (S/FIN/M/73, July 30, 2012). For some introduction of the view of the United States, *see* Inu Barbee & Simon Lester, *Financial Services in the TIIP: Making the Prudential Exception Work*, 45 GEORGETOWN J. INT'L L. 953, 961–64 (2014). Nevertheless, in light of the fact that the prudential exception clause here does not intend to exhaust the circumstances of prudential purposes, it should not be understood as freezing the prudential reasons; rather, it should be encompassing enough to cover evolving financial regulatory concerns as long as they are with prudential nature. Leroux, *supra* note 54, at 430.

[159] For instance, Gari made a very articulated analysis of how capital control for the purpose of fiscal reasons or cannot be considered as "prudential measure" here. *See* Gari, *supra* note 138, at 423–25.

[160] For a summary of potential discourse, *see* Public Citizen Report 2009, *supra* note 56, at 12.

[161] Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶ 7.871.

[162] Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶ 7.879.

iv. Measures "for" prudential reasons

The next controversial issue is, how to define the element of "for" prudential reasons. The general consensus is that the element does not require a "necessity test" to establish a qualified link because the first sentence takes a different approach than that of the general exception under GATS Article XIV.[163] The question remains as to how to determine if a measure is "for" prudential reasons? One may argue that, based on the text itself, the examination should focus mainly on the motivation underlying the measure.[164] This interpretation risks subjectivity.[165] Commentators, therefore, advocate a variety of objective standards to address the concern of subjectivity. These standards include requiring a "close and genuine" relationship between the measure and prudential reasons,[166] adopting a "means-ends test,"[167] or introducing a "reasonableness test."[168] The outbreak of the Global Financial Crisis also provoked many commentators to consider how to establish a link with related international standards recommended by international financial organizations, such as Basel Committee, IOSCO, and IASA.[169] They are,

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[163] That is, based on the use of "for prudential reasons" as opposed to "necessary for" here, Members should be understood as adopting a relatively liberal method, which justifies a measure as long as it serves prudential reasons. For literatures arguing that the necessity test is not required under the prudential exception, *see e.g*, Gari, *supra* note 138, at 422; Shepro, *supra* note 48, at 33–34, 57–59; Mamiko Yokoi-Arai, *GATS' Prudential Carve out in Financial Services and Its Relation with Prudential Regulation*, 57 INT'L & COMP. L. Q. 613, 624 (2008); *See also* CTFS Background Note, *supra* note 137, at ¶ 31, at 8.

[164] Shepro, *supra* note 48, at 37–38.

[165] For literature raising the concern of subjectivity, *see* Alexander, *supra* note 50, at 24–25.

[166] Byungsik Jung, *Standard of Review for Jurisprudence on Prudential Measures*, 1 ILSP L. J. 49, 53 (2009).

[167] Barbee & Lester, *supra* note 158, at 960.

[168] For instance, Shepro proposes to check if a measure is for prudential reasons by examining if it has "plausible objective or reasonable relation to the prudential reason advocated." Shepro, *supra* note 48, at 52; *See also* Bismuth, *supra* note 114, at 495.

[169] For those who argue for harmonizing the prudential exception with international financial framework. *See* Alexander, *supra* note 50, at 25–27; *See generally* Cottier & Krajewski, *supra* note 110; Bismuth, *supra* note 114; For those who argue for harmonizing the prudential exception with international financial framework, *see* Alexander, *supra* note 50, at 25-27. For a further analysis, *see generally* Cottier & Krajewski, *supra* note 110; Bismuth, *supra* note 114, at 275; Dan Juma, *Tempering Services Liberalization with Regulation: The World Trade Organisation and the International Financial Architecture*, 14 INT'L TRADE & BUS. L. REV. 247 (2011).

in particular, interested in whether these international standards may be the benchmarks for determining if a measure is for prudential reasons.[170]

The Panel Report of *Argentina–Financial Services* spent considerable paragraphs clarifying this element. In the Panel's view, the phrase "measures for prudential reasons" should refer to *a rational relationship* of cause and effect between the measure and the prudential reason.[171] Specifically, "[a] central aspect of this rational relationship of cause and effect is the *adequacy* of the measure to the prudential reason, that is, whether the measure, through its design, structure and architecture, *contributes to achieving the desired effect*."[172] This appears to require a relatively loose link between the measures and the prudential reasons.[173]

v. Anti-avoidance provision

The last issue related to the prudential exception is how to interpret the second sentence of this paragraph. The general consensus, as endorsed by the Committee on Trade in Financial Services, is that it is "essentially an *'anti-avoidance' provision*, the purpose of which is to prevent the abuse of the exception for prudential measures."[174] Its bottom line is to prevent "measures that are *purely or primarily protectionist in effect*."[175]

Nevertheless, how to further interpret this provision's exact meaning remains controversial. Some commentators consider it sharing the same non-protectionism purpose with GATS Article XIV chapeau

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[170] For instance, Switzerland supports the use of Basel principles as a benchmark here, while the United States prefers leaving more discretion to domestic regulators. *See* Alexander, *supra* note 50, at 24 n.89.

[171] Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶ 7.891.

[172] *Id.*

[173] *See id.* The Panel of the *Argentina–Financial Services*, however, turned out to apply this requirement relatively stringently in that case. In determining whether the contested measures had rational relationship with the claimed prudential reason, it examined not only if the prudential concerns validly supported the adoption of the contested measure, but also if any services or service suppliers bearing the same prudential concern were treated differently. *Id.* ¶¶ 7.910-919, at 216–17. This examination appears to extend beyond a simple contribution test and amount to an "arbitrary discrimination" test, which will be discussed later.

[174] *See e.g.*, CTFS Background Note, *supra* note 137, ¶ 30, at 4; *See also* Leroux, *supra* note 54, at 430-31.

[175] CTFS Background Note, *supra* note 137, ¶ 30, at 4. In contrast, some extreme opinions argue to the opposite direction that the second sentence, read together with the first sentence, constitute a "self-cancelling clause" that provides no prudential protection at all to a Member's financial regulations. *See* Public Citizen Report 2009, *supra* note 56, at 5.

and thus advocate a parallel interpretation.[176] The problem of this position is that the wording contained in GATS Article XIV chapeau, *e.g.*, "arbitrary or unjustifiable discrimination" is absent here.[177] Other commentators believe that this provision reaffirms the international law principle of *abus de droit*, i.e. parties to a treaty should not abuse their treaty rights, and reflects the "obligation of good faith."[178] Regrettably, the newly released *Argentina–Financial Services* report does not offer us further guidance on this issue.[179]

c. Members' Specific Commitments

The specific commitments of individual Members related to financial services are also an integral part of the GATS.[180] Different Members, in fact, commit to different degrees of openness for their financial sectors. To provide some consistency and enable Members to commit to further liberalization, Members agreed on the "Understanding on Commitments in Financial Services" (hereinafter the "Financial Understanding") as a template for individual Members to incorporate into their own specific commitments.[181] The Financial Understanding is not binding on every Member. Only those Members that voluntarily adhered to the Financial Understanding are obliged to comply with it.[182]

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[176] Barbee & Lester, *supra* note 158, at 960–61; Barbee & Lester, *supra* note 158, at 960-61; Delimatsis & Sauve, *supra* note 58, at 300 (arguing that "it appears that no demonstration of 'discrimination in application' is required. We submit, however, that a broader discrimination test seems to be implied here and that a delicate balancing exercise between the objective pursued and the alleged discriminatory treatment is warranted.)

[177] *See* Shepro, *supra* note 48, at 41.

[178] According to Cantore, this principle is embodied in the international law principle of *pacta sunt servanda* under VCLT Article 26. Cantore, *supra* note 141, at 1234, 1243–44; *See also* Cottier & Krajewski, *supra* note 110, at 278. For further analysis of how to introduce the good faith principle here, *see* Shepro, *supra* note 48, at 39–49. This "good faith obligation" position also receives support from the Committee on Trade in Financial Services. CTFS Background Note, *supra* note 137, ¶ 30, at 4.

[179] The Panel of the *Argentina–Financial Services* skipped this issue by exercising judicial economy. Panel Report, *Argentina–Financial Services*, *supra* note 116, ¶ 7.945.

[180] GATS, *supra* note 17, at Part III, art. XX (3).

[181] Additional commitments as provided under the Financial Understanding include standstill, market access, national treatment and further definition. For an introduction of these additional obligations, *see* Leroux, *supra* note 54, at 432–41.

[182] CTFS Background Note, *supra* note 137, ¶ 35, at 4.

d. Summary

In short, the current WTO rules governing financial sectors are quite flexible. Members generally retain much discretion in formulating their own financial regimes. This reflects the idea of progressive liberalization in services sectors as stated in the GATS preamble. It also considers the special concerns in financial sectors, which is in line with the interests of the majority of Members.

The WTO's current rules are not entirely satisfactory. On the one hand, the degree of financial liberalization committed by Members is relatively low.[183] On the other hand, the recent Global Financial Crisis imposed further pressure on the WTO to rethink its regime related to financial sectors. For instance, a United Nations Committee report in 2009, chaired by the Nobel Prize winner Joseph E. Stiglitz, found "[t]here is some evidence that, at least in some countries, the entry of foreign banks has done nothing to increase lending in general or to small and medium enterprises in particular *but has contributed to the faster unwinding of lending in a crisis*."[184] The Committee report holds the position that:

> The framework for financial market liberalization under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may *restrict the ability of governments to change the regulatory structure* in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors.[185]

Recent developments in global trade regimes sway between liberalization and regulation. Financial liberalization still has considerable support

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[183] For instance, it has been raised that Members are generally reluctant to open the Mode 1 services in financial sectors. This may be out of the regulatory concern in the sense that their financial regulators can hardly regulate and supervise financial services suppliers outside of their territory. Or alternatively, it may be out of the competitive concern in the sense that they tend to protect their local financial institutions from cross-border competition. Regardless of which concerns, the current WTO regime is unable to alter this phenomenon. Leroux, *supra* note 54, at 441–42. According to Leroux, this dilemma can only be solved through enhanced international coordination and cooperation in financial regulation and supervision, in particular through the intermediary of those international financial standardizing body such as the Basel Committee. *See id.*

[184] U.N. Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, at 82 (Sept. 21, 2009).

[185] *Id.*

among Members.[186] In the Doha Round negotiations, several proposals related to financial liberalization and deregulation were proposed.[187] Current negotiations of the Trade in Services Agreement ("TiSA") also have contained some progress in financial liberalization.[188] In contrast, many Members hold relatively conservative attitudes against liberalization and prefer to maintain their right to regulate. For instance, even the United States, one of the most financially open countries in the world, was reportedly resistant to more liberal financial rules when negotiating the Transatlantic Trade and Investment Partnership ("TTIP") with the European Union.[189]

B. THE OCTZ APPROACH FACED WITH THE "PRINCIPLE OF CONSISTENCY"

The OCTZ Approach does not expressly contravene current WTO laws. After all, this approach does not per se involve explicit discriminatory treatment and/or market access restrictions. To the contrary, it aims at liberalization. As witnessed in the SH PFTZs, in-zone financial regulations generally impose fewer restrictions on foreign financial services and services suppliers and lift stringent domestic regulations.[190] From this perspective, the WTO should welcome it. Unfortunately, this approach is implicitly dissuaded by WTO case law.

1. WTO's Direct Restriction on In-Zone Financial Regulations

There are at least two types of in-zone financial regulations that are of concern under the GATS.

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[186] Many Members in fact have also adopted measures that are more liberalized than their GATS commitments, due to, for instance, the participation in regional trade agreements or the economic and financial restructuring programs of the IMF and the World Bank. Alexander, *supra* note 50, at 15 n.57.

[187] For a summary, *see* Public Citizen Report 2009, *supra* note 56, at 8–9.

[188] This is reflected in its Annex X containing expanded rules and principles for financial services, although I fail to see any real progress in the negotiation of a new rule for prudential exception. *See* Draft art. X(17). For online version of the current TiSA draft related to financial services, *see* https://wikileaks.org/tisa- financial/#start (last visited April 26, 2016).

[189] Barbee & Lester, *supra* note 158, at 954.

[190] *See infra* Part II.B.1.i.

a. GATS's Implications of In-Zone Financial Regulations

The OCTZ Approach is not a haven from WTO-rules. All in-zone financial regulations remain subject to existing WTO rules. Therefore, if in-zone regulations accord discriminatory treatment, impose market access restrictions, or apply domestic regulations in violation of certain requirements under the GATS, the GATS Articles II, VI, XVI, or XVII may apply. For instance, if a PFTZ relaxes certain financial regulations for in-zone financial services originating from a specific Member, while failing to extend such favourable treatment to other Members' in-zone financial services, such differential treatment may violate the MFN obligation under GATS Article II.[191] Generally speaking, existing WTO rules apply to in-zone financial regulations in the same manner as they apply to every domestic measure.

b. GATS's Implications of the In-zone/Out-zone Differential Treatments

The OCTZ Approach almost inevitably accords more favourable treatment to in-zone financial services or service suppliers compared with out-zone ones. Each group may contain some domestic financial services or service suppliers and some foreign ones. One might, accordingly, compare the in-zone domestic ones with out-zone foreign ones, arguing that the OCTZ Approach causes discriminatory treatment against the latter and therefore violates the national treatment obligation under GATS Article XVII.

In most cases this argument can hardly be sustained because there often lacks *de jure* or *de facto* discrimination between Members.[192]

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[191] For instance, in China's Fujian PFTZ, China plans to lift some financial measures specifically for the interest of Taiwanese financial institutions, such as liberalizing the businesses of cross-border RMB lending and borrowing, foreign currency exchange, equity trading, etc.. *See* ACT OF CHINA (FUJIAN) PILOT FREE TRADE ZONE, Ch. VII, art. 41. These measures might risk violating China's MFN obligation under the GATS Article II.

[192] For simplification purpose, I assume that in-zone and out-zone services/service suppliers are alike. This should be generally the case. As mentioned above, under GATS Article XVII, like services are determined by if the services at issue are essentially or generally the same in competitive terms or if two services are in a competitive relationship with each other, while like service suppliers may be determined based on inquiries such as whether two service suppliers describe their business scope in very similar terms or whether they are perceived as competitors in the marketplace. In ordinary cases, in-zone and out-zone financial services and service suppliers should remain in competitive relationship notwithstanding the distinction by zones; the only difference is simply that one service is eligible to being recognized as in-zone business while the other is not. Therefore, the above assumption should be a fair one.

De jure discrimination refers to a measure according to services and service suppliers of any other Member *formally different treatment* to that it accords to its own like services and service suppliers and modifying the conditions of competition in favor of the latter.[193] In the case here, although there is formally discriminatory treatment against out-zone foreign services or service suppliers, such treatment is not based on the origin of these services or service suppliers, but based on if they receive in-zone eligibility. Since the discrimination is not formally based on the origin of services/service suppliers, the OCTZ Approach is less likely to implicate *de jure* discrimination.[194]

The OCTZ Approach is less likely to be *de facto* discrimination between Members as well. Pursuant to GATS Article XVII:3, the central inquiry of the *de facto* discrimination assessment is if a formally identical treatment in effect "modifies the conditions of competition" in favor of domestic services/service suppliers compared to foreign ones.[195] Drawing reference from GATT jurisprudence, the focus of such examination is on if there is less favourable treatment accorded to *the group of* like imported services or service suppliers, in other words, protection of *the group of* domestic services or service suppliers.[196] The Panel Report of *EC–Biotech* best illustrates this point.[197] It pointed out:

> [E]ven if it were the case that, as a result of the measures . . . , the relevant imported biotech products cannot be marketed, while corresponding domestic nonbiotech products can be marketed, . . . this would not be sufficient, in and of itself, to raise a presumption that the European Communities accorded less favourable treatment to the group of like imported products than to the group of like domestic products. [I]t is not self-evident that the alleged less favourable treatment of imported biotech products is explained by the foreign origin of these products rather than, for instance, a perceived

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[193] *See* Panel Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas – Recourse to Article 21.5 by Ecuador*, WT/DS27/RW/ECU, ¶ 6.147 (Apr. 12, 1999) [hereinafter *EC–Bananas (Article 21.5)*].

[194] Not to mention that according to GATS Article XVII (2) and (3), even if *de jure* discrimination is found, a complaining Member still needs to establish that there is a modification to the competitive condition against foreign like services/service suppliers, i.e. *de facto* discrimination. *See* Panel Report, *China – Audiovisual Products*, *supra* note 119, ¶¶ 7.977–978; *China–Electronic Payment*, ¶ 7.687, WTO Doc. WT/DS413/10 (adopted Aug. 21, 2013).

[195] Panel Report, *EC–Bananas (Article 21.5)*, *supra* note 195, ¶ 6.148.

[196] Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-containing Products*, WT/DS135/AB/R, ¶ 100 (Mar. 12, 2001); *See also* Panel Report, *European Communities – Measures Affecting the Approval and Marketing of Biotech Products*, ¶ 7.2514, WTO Doc. WT/DS291/R, (adopted Sep. 29, 2006) [hereinafter *EC–Biotech*].

[197] Panel Report, *EC–Biotech*, *supra* note 196, ¶ 7.2514.

> difference between biotech products and non-biotech products in terms of their safety, etc.[198]

Therefore, *de facto* discrimination cannot be found by simply pairing a domestically favored service/service supplier with a foreign disfavored like one. The examination should rather consider all relevant factors to determine if a measure *per se* distinguishes its treatment based on origin of services/service suppliers and modifies the competitive condition against foreign ones.[199] In fact, previous GATT cases which found *de facto* discrimination would look for a pattern of less favourable treatment that is "systemically against" the group of foreign like products.[200] For instance, in *Philippines–Distilled Spirits*, the Panel found the contested origin-neutral measure *de facto* discrimination based on the fact that the measure favored virtually most domestic services or service suppliers while virtually disfavoring a vast majority of foreign like ones.[201] In the case of the OCTZ Approach, if the eligibility requirement to operate in-zone services does not disfavor foreign services/service suppliers, the zoning *per se* is less likely a *de facto* discrimination.[202]

c. Summary

In sum, the in-zone financial regulations under the OCTZ Approach can involve some GATS issues, yet most of them should be minimal. In my observation, what may incur legal risks are not those in-zone financial regulations, but the out-zone ones that are already in place.

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[198] *Id.*

[199] Relevant factors may include the particular characteristics of the industry at issue, the relative market shares in a given industry, consumer preferences, and historical trade patterns, etc. Appellate Body Report, *United States – Certain Country of Origin Labeling (COOL) Requirements*, ¶ 269, WTO Doc. WT/DS384/AB/R, WT/DS386/AB/R, (adopted Jun. 29, 2012) [hereinafter *US–COOL*].

[200] *See e.g.*, Panel Report, *Philippines – Taxes on Distilled Spirits*, ¶¶ 7.89, 7.182-83, WTO Doc. WT/DS396/R, WT/DS403/R (adopted Aug. 15, 2011) [hereinafter *Philippines–Distilled Spirits*]; *See also* Panel Report, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, ¶¶ 8.119-8.121, WTO Doc WT/DS308/R, (adopted Oct. 7, 2005).

[201] Panel Report, *Philippines–Distilled Spirits*, ¶¶ 7.89.

[202] On the other hand, if the in-zone eligibility requirement indeed disfavor foreign services/service suppliers, the eligibility requirement itself, together with the substantive regulation, may be subject to related scrutiny under the GATS, notably GATS Article XVII. The scrutiny then reverts back to the analysis as mentioned above in (a).

2. WTO's Indirect Restriction on the OCTZ Approach Posed by the Principle of Consistency

At first glance, the adoption of the OCTZ Approach should not pose any impact on a Member's existing out-zone financial regulations. After all, these regulations are already in place and should have passed the WTO's scrutiny before a Member introduced the in-zone regulations. If there is any WTO issue, the problem should rest on these out-zone regulations, not the adoption of the OCTZ Approach. This observation, however, overlooks a crucial characteristic of financial regulations. Financial regulations are restrictive in nature, and compliance with the WTO rules largely relies on the safeguard of exceptions (such as prudential exception or general exception). These safeguards are not automatic. In particular, the adoption of the OCTZ Approach might compromise them.

a. The Principle of Consistency Embedded in WTO's Exception Clauses

Both the GATS Article XIV and the Financial Annex's prudential exception contain clauses preventing protectionism and abuse of exceptions. In respect of GATS Article XIV, WTO case law has well established that its chapeau aims at preventing the abuse of exception,[203] while in respect of the prudential exception, it is also generally recognized that the second sentence bears a similar function.[204] This safeguard against protectionism has its logic. To invoke other public policy concerns to justify a trade restrictive measure, a Member must demonstrate that it is truly and sincerely pursuing its claimed public policy; otherwise, its restrictive measures are merely a disguise of its protectionist intent in the name of public policy.[205] This anti-protectionism principle has become increasingly crucial for WTO dispute

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[203] Panel Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, ¶¶ 6.574-575, WTO Doc. WT/DS285/R (adopted Nov. 10, 2004) [hereinafter Panel Report, *US–Gambling*]; *See also* Appellate Body Report, *United States – Standards for Reformulated and Conventional Gasoline*, ¶ 22, WTO Doc. WT/DS2/AB/R (adopted Apr. 29, 1996) [hereinafter *US–Gasoline*]; Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, ¶ 158, WTO Doc. WT/DS58/AB/R (adopted Oct. 12, 1998) [hereinafter *US–Shrimp*].

[204] *See e.g.*, CTFS Background Note, *supra* note 137, ¶ 30.

[205] *See* Appellate Body Report, *Brazil–Tyres*, *supra* note 20, ¶¶ 224-27.

settlement to deal with conflict between free trade and other public policies.

The adoption of the OCTZ Approach, however, might weaken a Member's originally solid position under this protectionism examination. This requires a review of the jurisprudence of GATS Article XIV chapeau, which relates to that of GATT Article XX chapeau as both contain similar wording and serve similar functions.[206]

i. Consistency as a virtue

After two decades of evolution, WTO case law has developed a principle that I term as "the principle of consistency" for examining protectionism. To elaborate, the GATS Article XIV chapeau and the GATT Article XX chapeau both require that the application of a measure cannot constitute "arbitrary or unjustifiable discrimination."[207] In the *US–Gambling* case, the Panel clarified that this mandates "consistency."[208] If a Member's measure restricts trade for certain public policy reasons, but fails to apply such restrictions to other similar situations with similar concerns *in a consistent manner*, its application of that measure might constitute arbitrary or unjustifiable discrimination.[209] In that specific case, the Panel found that the United States maintained a series of federal laws (including the Wire Act, the Travel Act and the Illegal Gambling Business Act), which altogether prohibited remote supply of gambling and betting services and thus refused the market access to foreign gambling and betting service suppliers.[210] Later, the United States passed

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[206] The *US–Gambling* Panel took the same position. *See* Panel Report, *US–Gambling*, *supra* note 203, ¶ 6.571.

[207] The chapeaus also require a measure not a "disguised restriction on international trade." Nevertheless, since WTO jurisprudence generally relates this concept to "arbitrary and unjustifiable discrimination" and gives these two concepts similar meanings, the discussion of the latter in this paper also applies to the former. *See id.* at ¶¶ 6.579–580; *See also* Appellate Body Report, *US–Gasoline*, *supra* note 203.

[208] *See* Panel Report, *US–Gambling*, *supra* note 203, ¶¶ 6.584.

[209] *See id.* And the GATT jurisprudence has well established that the comparison here may encompass not only different treatment between exporting Members, but also that between exporting Members and the importing Members, and also that between products of the territories of all these Members. *See* Appellate Body Report, *US–Shrimp*, *supra* note 203, ¶ 150; Panel Report, *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather*, ¶ 11.314, WTO Doc. WT/DS155/R (adopted Dec. 19, 2000) [hereinafter *Argentina–Bovine Hides*].

[210] Appellate Body Report, *Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, ¶ 5, WTO Doc. WT/DS285/AB/R (adopted Apr. 7, 2005) [hereinafter Appellate Body Report, *US-Gambling*].

the Interstate Horseracing Act (hereinafter "IHA") which legalized interstate horse race gambling over internet.[211] In the Panel and the Appellate Body's view, such regulatory inconsistency could not be reconciled with the United States' claimed public moral protection purpose and constituted an arbitrary discrimination that violated GATS Article XIV chapeau.[212]

Following the same rationale, in the case of financial regulations, if a Member restricts certain financial services out of prudential reasons, but fails to restrict other financial services with similar prudential concerns in a consistent manner, such inconsistency may invite protectionism concerns and thereby deprive the Member of the protection of the prudential exception.

ii. Rational connection required for justifying inconsistency

To be sure, the principle of consistency does not require regulatory consistency in all occasions. After all, the term used in these chapeaus are "arbitrary or unjustifiable" discrimination, not purely "discrimination."[213] Therefore, the principle of consistency tolerates some level of inconsistency as long as it is not "arbitrary or unjustifiable."[214] Under early GATT jurisprudence, the implementing Member may defend for itself by providing "justification" for its inconsistent application.[215] What type of justification is acceptable remains an open question.

Recent WTO jurisprudence has highlighted that the justification offered by Members needs to bear "rational connection" with the objectives to be pursued.[216] The Appellate Body in *Brazil–Tyres* for the first time established the rationality requirement and clarified its underlying rationale:

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[211] Panel Report, *US –Gambling*, *supra* note 203, ¶¶ 6.595-600.

[212] *Id.; See also* Appellate Body Report, *US–Gambling*, *supra* note 203, ¶¶ 368–69.

[213] In the *US – Gambling* case, on appeal the United States raised this defense. While the Appellate Body did not therefore reverse the Panel's finding, it appeared to take this legal position. *See* Appellate Body Report, *US– Gambling*, *supra* note 203, ¶¶ 349–51.

[214] *See id.*

[215] *See* Panel Report, *European Communities – Conditions for the Granting of Tariff Preferences to Developing Countries*, ¶ 7.228, WTO Doc. WT/DS246/R (adopted Dec. 1, 2003); Panel Report, *Argentina–Bovine Hides*, *supra* note 209, ¶ 11.328.

[216] Appellate Body Report, *Brazil–Tyres*, *supra* note 20, ¶ 227.

> [W]e are mindful of the function of the chapeau of Article XX, which is to prevent abuse of the exceptions specified in the paragraphs of that provision there is arbitrary or unjustifiable discrimination when a measure provisionally justified under a paragraph of Article XX is applied in a discriminatory manner "between countries where the same conditions prevail", and when the reasons given for this discrimination *bear no rational connection to* the objective falling within the purview of a paragraph of Article XX, or would *go against* that objective we have difficulty understanding how discrimination might be viewed as complying with the chapeau of Article XX when the alleged rationale for discriminating *does not relate to the pursuit of or would go against* the objective that was provisionally found to justify a measure under a paragraph of Article XX.[217]

More importantly, the Appellate Body took reference from its report in the *US–Shrimp* case and provided a concrete benchmark to clarify its point. It elaborated that arbitrary or unjustifiable discrimination exists where the inconsistency is "*difficult to reconcile with* the declared objective."[218] Despite associated controversies,[219] the principle of consistency, together with the rationality requirement, is by far the most specific method that WTO case law has adopted for examining if a measure is protectionist in nature.[220]

WTO jurisprudence has further transposed the principle of consistency as developed under GATT Article XX chapeau to the

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[217] *Id.*

[218] *Id. See also* Appellate Body Report, *US–Shrimp*, *supra* note 203, ¶ 165, at 65 (finding that "shrimp caught using methods identical to those employed in the United States have been excluded from the United States market solely because they have been caught in waters of countries that have not been certified by the United States. The resulting situation is difficult to *reconcile with* the declared policy objective of protecting and conserving sea turtles.").

[219] For related comments on the *Brazil–Tyres* Appellate Body Report, *see e.g.*, Arwel Davies, *Interpreting the Chapeau of GATT Article XX in Light of the 'New' Approach in Brazil-Tyres*, 43(3) J. WORLD TRADE 507, 508 (2009); Nikolaos Lavranos, *The Brazilian Tyres Case: Trade Supersedes Health*, 1(2) TRADE L. DEV. 230 (2009); Benn McGrady, *Necessity Exceptions in WTO Law: Retreated Tyres, Regulatory Purpose and Cumulative Regulatory Measures*, 12(1) J. INT'L ECON L. 153 (2008).

[220] For subsequent Panel and Appellate Body Reports following the principle of consistency and rationality requirement for examining GATT Article XX chapeau, *see e.g.*, Appellate Body Report, *European Communities – Measures Prohibiting the Importation and Marketing of Seal Products*, ¶¶ 5.306, 5.318, WTO Doc. WT/DS400/AB/R, WT/DS401/AB/R (adopted May 22, 2014) (stating that "one of the most important factors in the assessment of arbitrary or unjustifiable discrimination is the question of whether the discrimination *can be reconciled with, or is rationally related to*, the policy objective with respect to which the measure has been provisionally justified under one of the subparagraphs of Article XX."); Panel Report, China – *Measures related to the Exportation of Rare Earths, Tungsten, and Molybdenum*, ¶¶ 7.658-663, WTO Doc. WT/DS431/R (adopted Mar. 26, 2014); Panel Report, *United States – Measures concerning the Importation, Marketing and Sale of Tuna and Tuna Products: Recourse to Article 21.5 of the DSU by Mexico*, ¶ 7.553, WTO Doc. WT/DS381/R (adopted Apr. 14, 2015).

analysis of GATS Article XIV chapeau. In *Argentina–Financial Services*, the Panel found Argentina's measure inconsistent with GATS Article XIV chapeau based on the finding that Argentina applied its measures "in a manner that is *counterproductive with regard to the objective it has itself declared* in order to justify the distinction."[221] Although the Panel did not use the exact words of "bear no rational connection to the objective" or "go against the objective," the term "counterproductive with regard to the objective" has grasped the essence of the *Brazil–Tyres* case.[222] It appears highly likely that the future GATS Article XIV jurisprudence will continue applying the principle of consistency.

The principle of consistency has considerable merits. If a Member is truly concerned with specific public policies, it should pursue them in a wholehearted manner. Inconsistent pursuit of such public policies, as reflected in the failure to treat other similar occasions similarly, may suggest that the Member is not pursuing the policies sincerely. If that is the case, the measure that distorts international trade in the name of public policy is simply a trade distortion measure, and WTO should consider such a measure protectionist. Put it in another way, acknowledging the difficulty of examining a Member's subjective motivation, WTO case law uses the principle of consistency to ascertain if a Member's claimed public policy concerns indeed motivates the measure.

Based on the similar rationale, the principle of consistency has all the potential to be applied to the prudential exception, in particular to its anti-avoidance provision.[223] As mentioned above, it is widely recognized that the anti-avoidance provision embodies the anti-protectionism purpose.[224] Therefore, the principle of consistency, a well-established principle under current WTO case law for examining protectionism, is of reference. For those commentators who are convinced that the anti-avoidance provision parallels the GATS Article XIV chapeau, this point is more apparent.

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[221] Public Citizen Report 2009, *supra* note 56, ¶ 7.761.

[222] In fact, the Panel did cite the Appellate Body Report of *Brazil–Tyres* as its support. *Id.*

[223] Although the Panel Report of the *Argentina–Financial Services* did not address the issue of prudential exception's second sentence, its analysis regarding the first sentence (i.e. the element of "measure for prudential reasons") appears to have incorporated the spirit of the principle of consistency. *Id.* ¶¶ 7.916-919. Regrettably, the Appellate Body did not follow on this point because both parties did not appeal this issue.

[224] *See supra* Part III.A.2.v.

If the principle of consistency applies to the prudential exception and the anti-avoidance provision, the OCTZ Approach might incur considerable legal risks.

b. Incompatibility of the OCTZ Approach with the Principle of Consistency

For Members that adopt the OCTZ Approach to progressively liberalize their financial sectors, the principle of consistency as embedded in these exception clauses could be fatal.

i. Inconsistency inherent in the OCTZ Approach

The OCTZ Approach involves inconsistency that is inherently against the principle of consistency. As mentioned above, Members heavily rely on exception clauses, notably the prudential exception, to protect out-zone financial regulations.[225] To invoke these exceptions, a Member has to follow the principle of consistency under the above analysis. Adopting the OCTZ Approach, however, creates apparent inconsistency. The same financial regulatory matter is subject to different regulations depending on whether it is in-zone or out-zone. Admittedly, such inconsistency does not involve traditional non-discrimination concerns since its different treatment is not based on the origin of services or service suppliers. The inconsistency, however, is enough to trigger further inquiries under the prudential exception or the GATS Article XIV chapeau.

Consider a hypothetical case for illustration. Assuming that a Member, out of prudential concerns, maintains commercial presence requirement on foreign securities firms as a condition for them to engage in the underwriting of securities, but lifts this requirement in its PFTZ. This constitutes an inconsistent treatment in respect to the underwriting of securites. Then, that Member has to face a challenge about whether its

[225] The GATS Scheduling Guideline 2001 in fact promoted this phenomenon: as mentioned above, it instructs Members not to schedule its prudential measures in their specific commitments, which leaves the prudential exception the main protection for Members' GATS-inconsistent measures. While some prudential measures were still scheduled into Members' commitments, others are largely missed out. Absent the protection from specific commitments, these prudential measures can only resort to prudential exception as their major safe harbour. Council for Trade in Services, *Guidelines for the Scheduling of Specific Commitments Under the General Agreement on Trade in Services (GATS)*, WTO Doc. S/L/92 (Mar. 28, 2011) [hereinafter "GATS"].

commercial presence requirement applied to out-zone securities firms is truly for prudential reasons or is instead motivated by protectionist reasons. This is a legal problem that this Member would not encounter had it not liberalized the requirement in the PFTZ. Once it does so in the PFTZ, a financial regulatory measure that was originally for a "prudential" reason may be suspected as being for a "protectionist" reason.

This inference sounds illogical at the first glance, but it appears in the WTO case law. The *US–Gambling* case offers useful insights on this point. In that case, the United States originally prohibited the remote supply of gambling and betting services,[226] but later on legalized the interstate horse race gambling over internet.[227] From the perspective of trade liberalization, the latter move was an improvement. Moreover, one may even portray the United States' way of liberalizing its gambling sectors as progressive, in the sense that it did not open the whole remote gambling services all in a sudden but took the horseracing as an *experiment*.

This progressive liberalization backfired. Antigua and Barbuda initiated a WTO complaint against the United States' prohibition of remote gambling and betting services.[228] The Appellate Body preliminarily found these federal laws in violation of the GATS Article XVI (Market Access) but provisionally justified by the GATS Article XIV(a) (i.e. the public moral defense).[229] It, however, eventually found arbitrary and unjustifiable discrimination, holding that prohibiting remote gambling under the challenged federal laws and permitting remote gambling on horseracing were inconsistent in the sense that both cases concerned the United States' public moral but were treated differently.[230] As this was the sole reason that the Appellate Body offered for the finding of arbitrary discrimination, one may reasonably suspect that if the United States did not take this partial liberalization, but simply maintained its closed regime of remote gambling, the outcome might be different. The result of the *US–Gambling* case gives us a lesson: under

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[226] *See* Appellate Body Report, *Unites States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, ¶ 1, WTO Doc. WT/DS285/AB/R (adopted Apr. 7, 2005) [hereinafter App. Report, *US–Gambling*].

[227] Panel Report, *US - Gambling*, *supra* note 203, ¶¶ 6.595–600.

[228] Request for Consultations by Antigua and Barbuda, *Unites States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/1 S/L/110 (Mar. 27 2003).

[229] *See* Appellate Body Report, *US–Gambling*, *supra* note 203, ¶ 373.

[230] *Id.* ¶ 373.

the principle of consistency, an absence of liberalization might be more legally sound than selective liberalization.

ii. An inconsistency hardly justifiable

The inconsistent application of financial policies under the OCTZ Approach might arguably have justified reasons. After all, the adoption of the OCTZ Approach is often backed by serial projects of progressive liberalization, which conforms to the object and purpose of the GATS as reflected in the GATS preamble.[231] In this sense, any inconsistency caused by the OCTZ Approach should be justifiable.

Unfortunately, claiming this justification can hardly pass the rationality requirement. For a cause of the inconsistency to be a qualified justification, current WTO case law requires it to "be rationally connected with" and "reconcile with" the public policy objective provisionally justifying the measure.[232] As such, the public policy objective is the prudential reason behind the contested financial regulation. In contrast, the cause of the inconsistency in the OCTZ Approach is progressive liberalization and regulatory experimentation. Whether these causes are rationally connected with or reconcile with the underlying prudential reasons is arguable. It appears that in-zone and out-zone financial services or service suppliers bear the same prudential concerns, but are treated differently. One may even argue that the more relaxed treatment of in-zone financial services or service suppliers "goes against" or "is counterproductive with regard to" the original prudential reasons. If viewed in this way, those out-zone financial regulations are likely to be found protectionist, just as the case of *US–Gambling*.

To elaborate upon this point, I again use the commercial presence requirement example. The prudential reason for a Member to impose such requirement on foreign securities firms, which underwrite securites, is perhaps out of regulatory effectiveness. Foreign securities firms with a commercial presence in the territory of a Member are subject to the regulatory and supervisory power of that Member, and the domestic regulator can thus directly communicate with local executives in charge of the business when finding, for example, consumer disputes

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[231] GATS, *supra* note 17, preamble (stating that Members "wishing to establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and *progressive liberalization* and as a means of promoting the economic growth of all trading partners and the development of developing countries.").

[232] *See supra* Part III.A.2(a).

or some irregular activities. The domestic regulator can even investigate the presence of the suspected foreign securities firm if needed. If a foreign securities firm underwrites securities without establishing any domestic commercial presence, the domestic regulator may have increased difficulty asking for cooperation, which makes its regulation and supervision less enforceable. This prudential concern sounds fair. If that Member, however, later on establishes a PFTZ, in which as an experiment in-zone securities firms are no longer subject to this commercial presence requirement, how can that Member defend for its continued application of such requirement on out-zone firms? Now the complaining Members may challenge the authenticity of this prudential defense, questioning if there is indeed such regulatory effectiveness concern, or why those in-zone banks need not observe the same requirement? They may further argue that the lifting of in-zone regulation does not "reconcile with" and in fact "goes against" the claimed prudential reasons, and thus assert that the out-zone regulation is for avoiding this Member's commitments. Protection awarded by the prudential exception to that Member thus risks collapsing.

Proponents of the OCTZ Approach might try to intercede for the said inconsistency. For instance, they might defend that such inconsistency, if any, is minimal and ignorable. The essence of this defense is that the relaxed restriction implemented in the zone applies to a limited amount of businesses (i.e. in-zone businesses) which are few when compared with out-zone businesses. Therefore, when the panel applies the anti-avoidance provision, it may ignore this small amount of inconsistency resulting from the OCTZ Approach. This defense, however, is likely to be invalid if considering the current jurisprudence of the GATT Article XX chapeau. As emphasized by the Appellate Body of *Brazil–Tyres*, the assessment of whether an inconsistent treatment is justifiable shall not depend on the "quantitative impact of this discrimination on the achievement of the objective of the measure at issue."[233] Rather, it is the *cause or rationale* of the inconsistency instead of the *effect* of the inconsistency that determines if such inconsistency is justifiable.[234] This holding basically rejects the so-called "*de minimis* defense."[235] Therefore, even if the inconsistency bears only minimal impact, it risks violating the GATT Article XX chapeau. Following the

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[233] *Brazil–Tyres*, *supra* note 20, ¶ 229.

[234] *Id.*

[235] PETROS C. MAVROIDIS, THE REGULATION OF INTERNATIONAL TRADE 468 (MIT Press 2016).

same rationale, the *de minimis* defense is less likely a valid one under the prudential exception's anti-avoidance provision as well.

iii. Summary

In sum, under the principle of consistency developed by recent WTO case law, Members are advised to maintain consistent regulation on specific subject matters. The violation of this principle does not constitute a WTO violation *per se*, but it may compromise a Member's invocation of public policy defense for its trade restrictive measures. For financial regulations whose WTO legitimacy largely relies on public policy defense, the OCTZ Approach thus involves considerable legal risks.

To be sure, the chance for the realization of these risks is hard to tell. Other Members may choose to ignore the inconsistency resulting from the OCTZ Approach and allow its continued use. As a matter of fact, compared with the export processing zones as used by East Asian economies for promoting their export-oriented development model, which resulted in plenty of contemporary WTO rules, we rarely see major countries challenging the trade fairness or trade distortion effect of the PFTZs in China. Therefore, there is space for optimism notwithstanding the potential WTO legal risks.

The identified legal risks may be more likely for those measures that other Members have already challenged based on their WTO-consistency. Adopting the OCTZ Approach for liberalization may strengthen the challenging Members' legal arguments and increase the likelihood of disputes. Taking China for instance, in the banking sectors, China still maintains its long-time restriction on foreign investors' holding of Chinese banks' shares, as such prohibiting any foreign financial institutions from holding more than 20 percent shares of a Chinese financial institution.[236] Many Members frequently complain that this amounts to a violation of China's GATS commitment and market access obligation under the GATS Article XVI.[237] China might invoke

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[236] Order of China Banking Regulatory Commission (No. 6, 2003) Art. 8. [CHINA BANKING REGULATORY COMMISSION, Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions, art. 8, http://www.cbrc.gov.cn/EngdocView.do?docID=552.

[237] For related discussion, *see generally* Daniel C. Crosby, *Banking on China's WTO Commitments: "Same Bed, Different Dreams" in China's Financial Services Sector*, 11(1) J. INT'L ECON. L. 75, 88–96 (2007).

the prudential exception to justify this restrictive measure. If China, however, adopts a liberalization experiment in one of its PFTZs and relaxes the investment restriction, other Members which are already unsatisfied might use this point to strengthen their complaints against China. Being aware of this increased legal risk, China might in turn hesitate to experiment with this means of liberalization.[238] In this aspect, the principle of inconsistency, designed to promote liberalization, in effect, slows down the pace of financial liberalization. Haste makes waste!

C. SUMMARY

In sum, the OCTZ Approach can be a legally risky move. The legal risks indirectly propel Members to play a zero-sum game by either maintaining the status quo or adopting a full-scale liberalization. In contrast, a halfway liberalization separating in-zone and out-zone financial activities is not as desirable. This conclusion appears to be unreasonable, in particular when we consider the merits of the OCTZ Approach in economic, social, and political terms as illustrated in Part II. I advocate that WTO laws should not impede this progressive and experimentalist approach.

IV. PROPOSED METHODS FOR CLEARING LEGAL UNCERTAINTIES FOR EXPERIMENTALIST MEMBERS

The world trade regime should liberate the OCTZ Approach from the restraints of existing WTO jurisprudence. In this Part, I provide some thoughts on how to modify the world trade regime to accommodate the OCTZ Approach, from both an interpretative approach and a rule-making approach.

A. AN INTERPRETATIVE APPROACH

The interpretation of the WTO laws matters for the future use of the OCTZ Approach. When we consider the deadlock in the current

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[238] There are several other regulatory areas in China's financial sectors whose WTO-consistency is questioned by other Members. *See generally id.*; *See also* Jiaxiang Hu, *Market Access or Market Restrictions – Analysis on the Regulations of PRC on Administration of Foreign-Funded Banks*, 1 GOETTINGEN J. INT'L L. 417 (2009).

Doha Round negotiation, which obstructs any modification of current WTO laws, exploring a reasonable interpretation of current WTO laws becomes even more pressing. To the extent that this paper deals with financial liberalization, in this sub-section I will focus on the prudential exception, the major legal rule governing the financial reforms adopting the OCTZ Approach.[239]

1. Prospective Ways of Interpreting the Prudential Exception

The fundamental barrier underlying the prudential exception is its non-protectionism mandate contained in its anti-avoidance provision. To be fair, perhaps few would argue for the abandonment of this mandate. After all, Members are likely to adopt the OCTZ Approach for the purpose of protectionism instead of progressive liberalization or regulatory experiment.[240] From this perspective, maintaining the anti-avoidance provision as a safeguard remains necessary.

The problem then is how to interpret such mandate so as to screen out those protectionist zones from experimental ones. There may be several options that interpreters may consider.

a. A Subjectivity Standard

The principle of consistency adopted by current WTO case law for identifying protectionism is problematic. Treaty interpreters should not automatically suspect an inconsistent application of a Member's financial regulation as protectionism. Instead, protectionism should be based on a Member's subjective mind, and treaty interpreters should explore this mind through a Member's legislative intent or motive. Following this line of argument, one may be tempted to argue that WTO laws should not determine protectionism based on a domestic regime's objective inconsistency; it should determine it based on a Member's subjective intent.[241]

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[239] But the discussion in this sub-section should be similarly applicable to the interpretation of GATS Article XIV chapeau.

[240] For instance, a Member may use the OCTZ Approach to limit its liberalization efforts to one geographic zone as a means to promote local development. The object and purpose of such measure could bear no regulatory concerns and contain no plan for further liberalization at all; it is exclusively for local development, under the mask of progressive liberalization and/or regulatory experiment.

[241] In fact, the Appellate Body in the *US–Gambling* appeared to hint that a Member's discriminatory intent matters when examining the chapeau of GATS Article XIV. In addressing the

If it is the subjective intent that counts, the regulatory inconsistency caused by the OCTZ Approach should matter less. Rather, the adoption of the OCTZ Approach would not violate the anti-avoidance provision of the prudential exception unless evidence demonstrates that it is motivated by protectionist purpose. To ascertain a measure's intent is not impossible. In some occasions, WTO dispute settlement bodies ascertained the legislative intent of a measure, and WTO case law has developed some general criteria for this task.[242] For instance, in the *Canada–Periodical* case, the Appellate Body examined the legislative history to derive the legislative intent of the contested measure and in the end found such intent protectionist in nature.[243] In other cases, WTO case law also examined the preamble of a measure,[244] the texts, the stated legislative intent of a measure,[245] and in particular, the "design, architecture and the revealing structure of a measure."[246] By focusing on the design, architecture, and the revealing structure of a measure, which are objective in nature, treaty interpreters can objectify the examination of a measure's subjective motivation based on pieces of objective evidence. This method permits objective assessment of whether a financial measure is for protectionist reasons or not.

Opponents might argue that this interpretation is against the current trend of WTO jurisprudence. This argument may be based on the reluctance of recent WTO case law in allowing for subjectivity tests.[247]

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complainant's argument that the U.S. prosecutors' delayed prosecution of five U.S. firms engaging in remote gambling services constituted arbitrary discrimination, the Appellate Body seemed to hold that these are merely individual cases which cannot sustain a pattern of non-enforcement. It further added, "Indeed, enforcement agencies may refrain from prosecution in many instances for reasons unrelated to discriminatory *intent* and without discriminatory effect." Appellate Body, *US–Gambling*, *supra* note 203, ¶ 356 (emphasis added). This might support the subjectivity claim mentioned above.

[242] For an introduction, *see* SHARIF BHUIYAN, NATIONAL LAW IN WTO LAW: EFFECTIVENESS AND GOOD GOVERNANCE IN THE WORLD TRADING SYSTEM 226–31 (Cambridge Univ. Press 2007).

[243] Appellate Body Report, *Canada – Certain Measures Concerning Periodicals*, WTO Doc. WT/DS31/AB/R, at 30–32 (adopted June 30, 1997) [hereinafter *Canada–Periodicals*].

[244] Appellate Body Report, *EC–Hormones*, *supra* note 149, ¶ 191.

[245] Appellate Body Report, *United States – Continued Dumping and Subsidy Offset Act of 2000*, ¶ 259, WTO Doc. WT/DS217/ AB/R, WT/DS234/AB/R (adopted Jan. 16, 2003) [hereinafter *US–Offset Act*].

[246] Appellate Body Report, *Japan – Taxes on Alcoholic Beverages*, ¶ 29, WTO Doc. WT/DS8/AB/R (adopted Oct. 4, 1996) [hereinafter *Japan–Alcohol II*]; Appellate Body Report, Chile – Taxes on Alcoholic Beverages, ¶ 62, WTO Doc. WT/DS87/AB/R, WT/DS/110/AB/R (adopted Dec. 13, 1999); *See also US–Shrimp*, *supra* note 203, ¶¶ 137–42.

[247] For instance, to interpret the term "so as to afford protection" under GATT Article III:1, the Appellate Body made it clear that "*[t]his is not an issue of intent*. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and

For one thing, however, WTO case law is not always consistent on this issue.[248] More crucially, the text and wording of the prudential exception says something. As opposed to the GATS Article XIV chapeau that uses the term "constitute" as in the phrase "applied in a manner *which would constitute* a means of arbitrary or unjustifiable discrimination," the prudential exception instead uses the term "avoid" as in the phrase "a means of *avoiding* the Member's commitments or obligations."[249] Compared to the term "constitute," the term "avoid" contains more subjective elements, which may justify a subjectivity standard. This interpretation also permits more space to Members, which coincides with the object and purpose of the prudential exception to respect Members' right to regulate financial industries.

b. A "Good Faith" and "Reasonableness" Standard

A step-back way to interpret the anti-avoidance provision is to adopt a good faith standard. As mentioned above, a number of commentators have proposed that treaty interpreters should interpret the anti-avoidance provision as a good faith obligation.[250] For those who have concerns over the unpredictability of the subjectivity standard, they may find more comfort here.

WTO case law has established some preliminary criteria for putting into practice the concept of good faith under WTO laws. For instance, in the *U.S.–Offset* case, the Appellate Body made it clear that:

> Nothing, however, in the covered agreements supports the conclusion that simply because a WTO Member is found to have violated a substantive treaty provision, it has therefore not acted in good faith. In our view, it would be necessary to *prove more than mere violation* to support such a conclusion.[251]

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weigh the relative significance of those reasons to establish legislative or regulatory intentFalse *It is irrelevant that protectionism was not an intended objective* if the particular tax measure in question is nevertheless, to echo Article III:1, 'applied to imported or domestic products so as to afford protection to domestic production.'" *Japan–Alcohol II*, *supra* note 246, at 27–28.

248 For instance, it is noted that in the *Canada–Periodical* case, in ascertaining if Canada's measure is to afford protection, the Appellate Body largely focused on legislative history of the measure, in particular the legislative debate on the bill that later became the law. Bhuiyan, *supra* note 242, at 228.

249 GATS, *supra* note 17, at Annex on Financial Services ¶ 2(a).

250 *See e.g.*, Leroux, *supra* note 54 at 430–31; Shepro, *supra* note 48, at 39–49.

251 Appellate Body Report, *US–Offset Act*, *supra* note 245, ¶ 298.

Furthermore, in the *US–Shrimp* case, the Appellate Body further elaborated as follows:

> [T]he principle of good faith . . . at once a general principle of law and a general principle of international law, controls the exercise of rights by states. One application of this general principle, the application widely known as the doctrine of *abus de droit*, prohibits the abusive exercise of state's rights and enjoins that whatever the assertion of a right impinge on the field covered by a treaty obligation, *it must be exercised bona fide, that is to say, reasonably*."[252]

In light of the above, treaty interpreters can interpret the concept of good faith as "reasonableness."[253]

Case law of the GATS Article XIV chapeau, which is analogous to the anti-avoidance provision, also supports this reasonableness test. In the *US–Gambling* case, the Appellate Body considered GATS Article XIV chapeau as serving to "ensure that Members' rights to avail themselves of exceptions are exercised *reasonably*, so as not to frustrate the rights accorded other Members by the substantive rules of the GATS."[254] Moreover, the reasonableness test echoes the GATS Article VI:1, which requires all services measures to be administered in a *reasonable*, objective, and impartial manner.[255] In this sense, the GATS Article VI:1, the XIV chapeau, and the prudential exception are intertwined with each other,[256] and the reasonableness test can be a central theme running through these three provisions.

The interpretation of this reasonableness test may take further reference from jurisprudence regarding the GATT Article X:3.[257] As a parallel provision to the GATS Article VI:1, this provision requires Members to administer their measures regulating trade in goods in a

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[252] *US–Shrimp*, *supra* note 203, ¶ 158.

[253] For further summary of the integral content of the good faith principle under international law, see Shepro, *supra* note 48, at 47; *See also* ANDREW D. MITCHELL, LEGAL PRINCIPLES IN WTO DISPUTES 119–20 (2008).

[254] *US–Gambling*, *supra* note 203, ¶ 339. There are also such hints hidden in the GATT jurisprudence. *See US–Gasoline*, *supra* note 203, at 22.

[255] GATS, *supra* note 17, art. VI: 1.

[256] GATT jurisprudence also provides some reference here: it acknowledges the inter-connection between GATT Article X:3 (resembling GATS Article VI:1 here) and GATT Article XX chapeau (resembling GATS Article XIV chapeau here). *See* Panel Report, *Thailand – Customs and Fiscal Measures on Cigarettes from the Philippines*, ¶ 7.920, WTO Doc. WT/DS371/R (adopted Nov. 15, 2000) [hereinafter *Thailand–Cigarettes*].

[257] GATT, *supra* note 17, art. X:3.

uniform, impartial, and *reasonable* manner.[258] Related case law defines the term "reasonable" as "in accordance with reason," "not irrational or absurd," "proportionate," "sensible," and "within the limits of reason, not greatly less or more than might be thought likely or appropriate."[259] Treaty interpreters should examine the features of the administrative act at issue *in the light of its objective, cause or the rationale behind it*.[260] Therefore, instead of searching for the formalistic inconsistency, the reasonableness test would look more substantially into the "rationale."

Most importantly, the "rationale" acknowledged under the reasonableness test is broader than the "rationality requirement."[261] Previous GATT Article X case law did not require the rationale of an administrative act to be rationally related to the measure's objective.[262] Any justifiable reasons would suffice. Applying this standard to the OCTZ scenario, an interpreter would no longer need to follow the principle of inconsistency and rationality requirement. Rather, he/she would only need to examine if a Member provided convincing reasons for its OCTZ. As long as its reasons are not irrational or absurd, proportionate, sensible, and within the limits of reason, not greatly less or more than might be thought likely or appropriate, its OCTZ would not be considered protectionist and could pass the anti-avoidance provision. Although this criterion might appear uncertain and vague, based on previously accumulated case law, it should not bother the WTO dispute settlement body.

c. Abrogating or Reinterpreting the "Rational Requirement"

A further way to interpret the anti-avoidance provision is to vest the principle of consistency with a new meaning. Requiring some level of consistency when interpreting the anti-avoidance provision might not be problematic *per se*. After all, the presence of inconsistent treatment of

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[258] *Id.*

[259] *See* Panel Report, *United States – Certain Country of Origin Labelling (Cool) Requirements*, ¶ 7.850, WTO Doc. WT/DS384/R, WT/DS386/R (adopted Nov. 18, 2011) [hereinafter *US – COOL*]; Panel Report, *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes*, ¶ 7.385, WTO Doc. WT/DS302/R (adopted Nov. 26, 2004).

[260] *US–COOL*, *supra* note 259, ¶ 7.851.

[261] *See e.g.*, Panel Report, *Thailand–Cigarettes*, *supra* note 256, at ¶¶ 7.922–929.

[262] *Id.* ¶¶ 7.922-929. Note that this Panel Report was issued after the Appellate Body Report of *Brazil-Tyres* which established the rationality requirement, and it in fact cited the latter in its GATT Article X:3 reasoning. But still, the Panel in that case did not dig into any analysis about the rational connection test. This implies that the reasonableness test can be more liberal than the rational connection test.

the same regulatory subject is at least a relevant suggestion of protectionism. What is problematic is the narrow interpretation of the principle of consistency as requiring a "rational connection" between the inconsistent treatment and the regulatory objective of the contested measure. This rationality requirement is perhaps too stringent and mechanic, considering that the inconsistency could result from some equally justified rationale unconnected to the claimed regulatory objective. If that is the case, treaty interpreters should not deem the inconsistency as protectionism. Therefore, a desirable moderation to the principle of consistency may be, whenever a Member can provide a justified reason for its inconsistent treatment, regardless if such reason rationally connects to the measure's regulatory purpose, the inconsistency is not protectionism.

An even humbler modification to the principle of consistency would maintain the rationality requirement but with a spin. Perhaps the "rationality requirement" *per se* is not that problematic as well. After all, the term "rational" is also a broad concept that may already contain enough interpretative space to consider different conditions in different cases. The problem is that the Appellate Body's further elaboration of this rationality requirement, which perceives inconsistent treatment *irreconcilable with* or *going against* the policy objective of the contested measure as bearing no rational relationship,[263] is too rigid. Such an interpretation asks for an over-coherent relationship between regulatory concerns and the inconsistent treatment. A Member may have all the motives to pursue its claimed policy objective, but this pursuit must balance with other competing policy interests, which may take compromise. By taking this compromise, the Member's pursuit of its claimed policy objective might appear less wholehearted. The less than wholehearted implementation of the objective, however, should not be equal to protectionism.

The main concern should be the protectionist purpose, not the claimed policy objective. The Appellate Body Report of *US–Gambling* illustrated this well. When explaining why the United States' failure to prosecute a number of gambling cases did not amount to an arbitrary discrimination under GATS Article XIV chapeau, the Appellate Body stated, "Indeed, enforcement agencies may refrain from prosecution in many instances *for reasons unrelated to discriminatory intent and*

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[263] *See supra* Part III.A.2(a).

without discriminatory effect (emphasis added)."[264] Drawing reference therefrom, perhaps the focus under the rationality requirement should not be whether the reasons for inconsistent treatment *reconcile with or rationally connect to the measure's policy objective*. Rather, the inquiry should be whether the reasons for inconsistent treatment *are related to protectionist or discriminatory intent*.

In substance, the proposal here largely resembles the proposal to instead adopt a reasonableness test as raised above. Its benefit lies in a harmonization of the currently developed WTO case law and the interpretation of the prudential exception clause. One can adopt the reasonableness test to replace the currently embraced rationality requirement.[265] One can also use the reasonableness test to "supplement" or "further interpret" the rationality requirement.

2. Summary

In summary, I propose that future interpretations of the anti-avoidance provision of the prudential exception should focus more on a Member's subjective motivation, supplemented by a "good faith" and "reasonableness" test. Even if interpreters wish to take into account the "rationality requirement" as established under the current GATT Article XX practice, they should refrain from directly applying a rigid "reconcilable test" or "going against" test. Instead, they should examine if the inconsistent treatment is reasonably related to any protectionism purpose or discriminatory intent. In this manner, Members will not face legal issues when they contemplate adopting the OCTZ Approach to pursue progressive liberalization and regulatory experimentation.

The *Argentina–Financial Services* case was supposed to be a great opportunity for the Appellate Body and the Panel to elaborate on the prudential exception. Fortunately or unfortunately, neither the Appellate Body nor the Panel touched upon the central issue of the prudential exception, in particular the anti-avoidance provision. The absence of an authoritative interpretation at this point at least offers treaty interpreters more space and time to ponder on a more desirable way of interpretation. In the short run, I propose that they should at least

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[264] *US–Gambling*, *supra* note 203, ¶ 356.

[265] In fact, the Panel Report of *Thailand–Cigarettes* smartly analogized GATT Article X:3 to GATT Article XX chapeau without at the same time analogizing the rational requirement, which can be seen as using the reasonableness test to replace the rationality requirement. *See Thailand–Cigarettes*, *supra* note 256, ¶ 7.920.

refrain from extending the principle of consistency to the service sectors, especially to the financial service sectors. In the long run, I propose a full-scale reinterpretation of the principle of consistency.

B. A RULE-MAKING APPROACH

Making new trade rules to clarify the legitimacy of the OCTZ Approach is still viable. Even if the new round of WTO negotiations remain in the deadlock, countries still possess considerable space for creating or experimenting with new transnational trade rules. This can be done through the growing establishment of regional trade agreements. In some sense, regional trade agreements embody the spirit of experimentalism as well. What differs is only that the experiment is at multinational levels.

Many regional free trade agreements contain provisions governing financial sectors. These provisions, in particular, contain specific clauses bearing similar functions with the prudential exception of the Financial Annex. Many of them maintain nearly identical provisions with the Financial Annex.[266] Taking the recently passed Trans-Pacific Partnership Agreement ("TPP") for instance, its prudential exception as stipulated in its Article 11.11.1 reads:

> Notwithstanding any other provisions of this Chapter and Agreement except for . . ., a Party shall not be prevented from adopting or maintaining 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 institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. If these measures do not conform with the provisions of this Agreement to which this exception applies, they shall not be used as a means of avoiding the Party's commitments or obligations under those provisions.[267]

Despite some discrepancies in wording, the general structure of TPP's prudential exception resembles that of the Financial Annex. Both contain a sentence stipulating that prudential reasons can serve as an exception to their members' treaty obligations. Most importantly, both contain an anti-avoidance sentence with nearly identical wording. In this sense, the

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[266] *See e.g.*, United States Model Bilateral Investment Treaty, art. 20(1); United States – Korea Free Trade Agreement, article 13.10, Mar. 15, 2012, https://ustr.gov/trade-agreements/free-trade-agreements/korus-fta/final-text.

[267] Trans-Pacific Partnership, art. 11.11.1, Feb. 4, 2016.

TPP does not add significant new elements to the prudential rules of the current trade regime.

On the other hand, some regional trade agreements have provided us with positive examples. For instance, the 2012 Foreign Investment Protection Agreement concluded between Canada and Czech Republic contains a different version of prudential exception clauses, which resemble those contained in the North American Free Trade Agreement ("NAFTA")[268] and provide that:

> Nothing in this Agreement shall be construed to prevent a Contracting Party from adopting or maintaining *reasonable* measures for prudential reasons, such as:
>
> a. the protection of investors, depositors, financial market participants, policy-holders, policy-claimants, or persons to whom a fiduciary duty is owed by a financial institution;
>
> b. the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions; and
>
> c. ensuring the integrity and stability of a Contracting Party's financial system.[269]

This version embodies the more desirable reasonableness test. Compared with the GATS's prudential exception, it does not contain a sentence similar to the anti-avoidance provision of the GATS's prudential exception. Instead, it takes advantage of one single word "reasonable" to control the use of prudential exception. Therefore, there is no need to interpret the anti-avoidance provision, while the meaning of "reasonable" is left for interpretation. Furthermore, by adding the term "reasonable" to describe prudential measures, this approach adopts the concept of reasonableness as a check, which is one of the proposed ways of

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[268] NAFTA Article 1410 stipulates:

> Nothing in this Part shall be construed to prevent a Party from adopting or maintaining reasonable measures for prudential reasons, such as:
>
> (a) the protection of investors, depositors, financial market participants, policyholders, policy claimants, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service provider;
>
> (b) the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers; and
>
> (c) ensuring the integrity and stability of a Party's financial system.

North American Free Trade Agreement, U.S.-Can.-Mex., art. 1410, Dec. 17, 1992, 32 I.L.M. 289.

[269] Agreement Between Canada and the Czech Republic for the Promotion and Protection of Investments, Can.- Cze., art. IX:2.

interpreting the prudential exception that we have discussed previously.[270] This approach may further solidify the reasonableness test as proposed above and provide Members with greater room to adopt experimental financial measures as long as they can provide good reasons. For countries that wish to preserve more space for progressive liberalization and regulatory experiment in their own financial sectors, they should consider this approach.[271]

V. CONCLUSION

The OCTZ Approach, defined by the use of PFTZs or similar zoning strategies, has generated extensive interest due to China's use. While it is not an orthodox way to pursue trade liberalization, it has practical merits in economic, social, and political terms. Such merits should receive particular attention when it comes to financial liberalization, considering the uncertainty and unpredictability of the impact of financial liberalization. In light of the above, I argue that WTO laws should permit Members to pursue financial liberalization in a progressive and experimentalist manner through the use of the OCTZ Approach.

The "principle of consistency," however, poses legal risks on the future use of the OCTZ Approach. I argue that this principle ignores the advantage of inconsistency as a way to balance competing interests. This advantage is particularly crucial in financial sectors where a balance between liberalization and prudential concerns is desperately needed. While trade disciplines should stamp out protectionism, they should not examine it through the mechanical lens of the principle of consistency that narrows Members' space to conduct financial experiments through the OCTZ Approach. As recent case law indicates an increasing likelihood that the dispute settlement bodies will extend the principle of consistency to the GATS Article XIV chapeau or even the prudential exception, the awareness of this principle's potential problems becomes imminent. Although this paper mainly focuses on how the rigid application of the principle of consistency is incompatible with the OCTZ Approach, it also highlights the inherent problem underlying this

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[270] Shepro also proposes the use of "reasonable" as a way to clarify the prudential exception. Shepro, *supra* note 48, at 67.

[271] For other proposed ways of rule-making, *see e.g.*, Barbee & Lester, *The Challenge of Cooperation: Regulatory Trade Barriers in the Transatlantic Trade and Investment Partnership*, 16 J. INT'L ECON. L. 847 (2013).

principle. The discussion herein should be applicable for revisiting the soundness of several leading cases, such as *Brazil–Tyres* or the recent *Argentina–Financial Services*.

As an even broader theme, as the world has become more cautious about trade liberalization, the world trade regime should correspondingly reflect on whether it over-focuses on a single mode of liberalization. While it should still respect the spirit of trade liberalization, perhaps it should also leave some space to individual Members to determine the optimal pace, degree, and mode of liberalization in their own territory. Bearing in mind the conventional wisdom's advice: haste does not bring success and can instead make waste!