THE PRUDENTIAL EXCEPTION IN THE GATS AFTER THE CASE ARGENTINA – FINANCIAL SERVICES

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Abstract: Experience has shown there has been a need for prudential measures to be imposed on financial services. The global financial crisis of 2007-08 is quite an emblematic example. Therefore, states and financial institutions have united to establish standards as for financial services like the Basel Committee. Only one case about prudential measures in the realm of financial services has been decided thus far at the WTO. In this case, adjudicators heavily utilized the recourse to the ordinary meaning of the main GATS expressions surrounding the prudential measures. This recourse may limit the aid that international norms other than the WTO legislation may provide when resolving issues related to the GATS prudential exception. Still according to the adjudicators, the prudential exception at issue is of evolutionary nature, evolving over time to adapt to particular situations. Besides, there has to be a rational relationship between the measures and their reasons.

Keywords: GATS, financial services, prudential exception.

INTRODUCTION

The international trading system has significantly developed over the last decades. The old GATT, created after the Second World War on an initially tentative basis, aimed at reducing obstacles to international commerce. Various negotiation rounds took place. In each of them, GATT members either improved the then existing rules or signed new agreements with a view to coping with new hurdles to trade such new types of subsidies, *inter alia*. In 1995, the WTO advent was a milestone because it not only established several treaties that rendered the GATT

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legislation more sophisticated, but it also constituted a standing appellate body whose decisions are binding.

Concerning financial regulation, the IMF, also created after the Second World War, was designed in order to provide states with financial aid in case of an economic crisis. In the mid-1940s, many countries were economically ruined and had huge debts. The IMF has helped these states organize their economy and has signed loans with them under especial circumstances (for instance, low interest rates or extended grace periods). Central banks, on their turn, have improved their structure and have issued new measures with the aim of strengthening domestic economies. New sectors in domestic economies have evolved, thus usually requiring specific attention to not cause detrimental effects on the whole economy.

One may then wonder how international trade arrangements like the GATT/WTO system interact with domestic financial regulation. First, the treaties at hand produce effect on the most sensitive area of national regulation (SHEPRO, 2013, p. 7). As central banks have great responsibilities on fostering domestic economies by avoiding a crisis in the balance of payments or an undesirable currency devaluation and by fortifying the country's capacity on paying for its imports and promoting economic growth, among others, national legislators may feel frightened to lose power due to these arrangements. Second, pursuant to a commentator, these agreements may lead to a democratic deficit (SHEPRO, 2013, p. 8). In a democracy, politicians are elected to fulfill their mandate. Hence, a president is entitled to choose who will be the president of the central bank. On the other hand, those who will decide a case at the WTO involving national economic policies are unelected. As a result, an international institution may interfere on a country's economy without being elected for that.

1 THE GATS AND FINANCIAL SERVICES

Under the WTO system, the GATS (General Agreement on Trade in Services) is the treaty responsible for establishing rules as to the trade in services. Therefore, financial services fall within the GATS. However, the way the GATS will influence financial services will depend upon how WTO members perceive the sector at issue.

When states were negotiating the GATS, they had to assume commitments regarding their service sectors. They were free to open only the sectors they wanted to. Many countries were developed and, consequently, wished to liberalize a lot of sectors. Nevertheless, several developing countries sensed that some areas in their territories needed protection to foster the

development of national service providers. Thus, they opted to not liberalize some strategic sectors.

Another aspect to be bore in mind when assessing the convenience of including some areas in the GATS commitments is the degree of openness a state wants for the services offered within its borders. More specifically in the financial services realm, a certain national government may desire to attract more foreign competitors to its domestic market so as to widen the consumers' choices and to push down the prices charged by banks. Yet, if this country fears that the presence of international institutions may lead to a monopolistic or an oligopolistic system, it may then be of the view that, at least at the outset, a more restrictive market *vis-à-vis* foreign banks might be interesting.

Regardless of the position countries take on as for financial services liberalization, the GATS impacts the services concerned in three different ways: economic benefits, managerial expertise and legal changes (YOKOI-ARAI, 2008, pp. 615-618). Economically speaking, a potential gain would come from bank employment creation: either directly when banks hire their own employees or indirectly when financial institutions do businesses with other companies (for instance, a cleaning services company that cleans the bank's facilities). Other economic advantages are economies of scale and economies of scope (YOKOI-ARAI, 2008, p. 616). There are economies of scale when a bank offers services in several countries, hence diminishing its fixed costs. Economies of scope "can be gained when one institution provides services that are cross-sector, capitalizing on their network and resources" (YOKOI-ARAI, 2008, p. 616). In relation with managerial expertise, those working directly for the institutions, notably managers, would learn the managerial techniques that banks develop. Furthermore, companies doing business with financial institutions would also be aware of such techniques, thus improving domestic managerial standards. In terms of legal changes, countries usually establish a series of requirements that foreign financial institutions have to meet. Depending on the level of competition a country wishes, the conditions at hand may be loosened or strengthened. Accordingly, its competition laws may vary to adapt to the government's economic goals.

2 PRUDENTIAL MEASURES

2.1 THE NEED FOR PRUDENTIAL MEASURES

The global financial crisis of 2007-08 has been considered the greatest financial crisis since the Great Depression that happened in the 1930s. The 2007-08 crisis inflicted a lot of harm on banks many of which had to be bailed out by national governments. It also ruined several businesses, worsened consumer's health and caused the shrinkage of various economic sectors. The housing market also experienced negative effects. Besides, the crisis in question begot a sovereign-debt crisis in Europe.

Unfortunately, the crisis of 2007-08 is a remarkable episode showing how bad corporate governance, risk management and lack of transparency may be responsible for posing systemic hazards for the financial system. That is why prudential measures have been developed to avoid the collapse of the banking system. Indeed, according to Jung, it is worthwhile noting that "the financial services sector is heavily regulated by prudential measures because financial services are believed to be a very technical and sensitive area that is closely related to the integrity of the national economy" (JUNG, 2009, p. 49). Still, Sherpo points out that national regulators have seemed to be recalcitrant to transfer power to multilateral, regional and bilateral negotiators, thus becoming very possessive as to their prudential measures and discretion (SHEPRO, 2013, p. 12).

2.2 PRINCIPLES OF PRUDENTIAL REGULATION

Although states have sovereignty to decide about the measures they deem more convenient to resolve economic problems, initiatives aiming at establishing common denominators are welcome. Lately, the enactment of international standards and codes of good practices in the field of financial services and banking operations has substantially evolved (WTO, 1998, para. 38). In this vein, the Basel Committee[2] has endeavored to establish principles with a view to reducing the risk of arbitrary prudential measures. Accordingly, it published the "Core Principle for Effective Banking Supervision", containing principles on prudential regulation.

An important principle of the aforementioned document is the capital adequacy principle which is two-fold. First, domestic regulators shall define the minimum capital adequacy requirements in relation with the establishment of a bank. These requirements have

[2] The Bank for International Settlements (BIS) is the oldest international financial organization. Its main objective is to perform as a forum so that central banks from different countries can discuss matters concerning monetary and financial stability. The BIS has had several committees to fulfill its mission. One of these committees is the Basel Committee that is in charge of creating and fostering prudential practices of banks and act as a multilateral forum with respect to banking supervisory issues.

to take into account the risks that the bank assumes. Second, by means of the principle at hand, legislators shall define the components of the capital of the bank. Here it is of paramount relevance the fact that these components reflect the bank's capacity of absorbing losses. Pursuant to the Basel Committee, an important situation that the capital adequacy principle intends to find is when the same capital is utilized at the same time as a cushion against hazards in more than one legal entity (BIS, 1999, p. 4).

Another relevant principle is the risk management process. The basic idea behind this principle is that financial institutions shall keep and develop programs that are capable of detecting and controlling risks and of weighing capital adequacy *vis-à-vis* their risk profile. These programs shall be compatible with the institution's size. Moreover, the BIS (2015, p. 21) mentioned that:

> Taking into account the potentially greater contagion risks (eg traditional microlending institutions) and reputational risks (eg state-owned banks) faced by some types of institutions targeting unserved and underserved customers, supervisors should require and determine adequacy of the policies and processes of the individual institutions to address such risks.

Another useful principle refers to liquidity risk. By liquidity, we mean that an asset is relatively changed by another asset. For instance, a car is easily considered a good with liquidity on the grounds that its owner can exchange the vehicle for other product. Yet, a good with a much higher level of liquidity is money. In everybody's transaction, they use money to pay bills, buy food, gamble, travel, etc. In other words: "the liquidity of an asset is the ease and quickness with which it can be exchanged for goods, services, or other assets" (Abel, Bernanke & Croushore, 2011, p. 245). According to the principle concerned, financial institutions shall develop mechanisms with the aim of controlling and monitoring eventual risks of liquidity.

Internal control and audit are also another principle. Sadly, it is not uncommon to watch the news and know that a central bank discovered a fraud. A bank had manipulated the information in its fact sheet over the last years, hence harming thousands of clients throughout the country. A more concrete example refers to the Greek crisis: it was found out that Greek banks had altered the data transmitted to economic authorities, particularly when Athens was trying to enter the European Union. Ergo, if financial institutions provide their clients and the monetary authorities with transparent procedures by virtue of efficient compliance rules and audits, this would certainly diminish the possibilities of banks' failure and would protect clients' interests.

2.3 THE PRUDENTIAL MEASURE UNDER THE GATS

When the negotiators of the Uruguay Round were dealing with the Agreement on Services, they came up with the idea that domestic authorities should be given some leeway so as to tackle systemic economic problems. Therefore, when trying to reconcile the development of one of the pillars of the GATT legislation – the progressive liberalization of goods and services – with the countries' difficulty in solving complex problems in their national economies, the diplomats opted for the insertion of the prudential exception (also known as the prudential carve-out) into a specific annex to the GATS. Thus, said exception, which is in paragraph 2(a) of the Annex on Financial Services, reads the following:

> 2. Domestic Regulation
> (a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform 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.

After the WTO inception in 1995, there has seemed to be few debates about the actual meaning of the prudential exception and its width. For instance, the Ecuadorian delegation, in October 2011, required that the Ministerial Declaration for the 8th WTO Ministerial Conference should consist of a communication addressed to the Committee on Trade In Financial Services in order to "review the WTO rules so as to promote and ensure the preservation of policy space for macro-prudential regulations and the integrity and stability of the financial system" (WTO, 2011, para. 4). On another occasion, Ecuador's diplomats stressed that "it would be very useful if the Secretariat prepared a Note on the scope of the GATS and gave examples of prudential measures that Members might adopt" (WTO, 2012a, para. 5). Washington, on its turn, mentioned that "the exceptions in the GATS provided Members with wide latitude to impose prudential regulation" and "cautioned against suggestions of conducting a legal review of the prudential exception" (WTO, 2012b, para. 20).

Apparently, two justifications may explain the paucity of debate regarding the scope and objectives of the prudential measure. The dimensions of the market openness were highly prioritized during the talks about financial services rather than focusing on regulatory measures that do not discriminate (Delimatsis, Panagiotis & Sauvé, 2010, p. 850). What is more, the regulatory capacity of WTO members of establishing such measures has been considered a valuable asset by these members, which fear that, by defining the very signification of the

exception in question, they might lose this power of regulation (Delimatsis, Panagiotis & Sauvé, 2010, p. 850).

Despite the fact that the discussions about the precise meaning of the prudential exception have been rare, the exception concerned has flexibility and even a certain degree of subjectivity (Kern, 2003, p. 25). Besides, it is a notorious fact that GATT negotiators had to mix legal and diplomatic language with a view to drafting the agreements. While legal language is usually precise about its meaning, diplomatic language is vague at times in order to accommodate opposite ideas. In this way, pursuant to De Meester (2009, p. 21), the initial negotiators wanted the wording of the prudential exception to be vague.

3 THE PRUDENTIAL CARVE-OUT IN PRACTICE

Notwithstanding the debate in the academic literature, there has been only one case involving the application of the prudential measure thus far under the WTO system: the case *Argentina – Financial Services*. Hence, this paper will now analyze how the adjudicators ruled on the exception at hand. In order to render the scrutiny more interesting, this paper will also mention the case in which the prudential exception was investigated by a NAFTA panel which was the first one to grapple with the exception.

3.1 THE NATURE AND SCOPE OF THE PRUDENTIAL CARVE-OUT

In the case *Argentina – Financial Services*, the adjudicators were of the view that the prudential carve-out is really an exception (WTO, 2015, para. 7.814). Both the parties and some third parties agreed that paragraph 2(a) of the Annex on Financial Services enshrines an exception. Furthermore, two WTO documents shed light on the issue. The Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services (GATS) reads that "any prudential measure taken in accordance with paragraph 2(a) of the Annex on Financial Services constitutes an exception to the Agreement and should not be scheduled", clearly indicating that the prudential carve-out is an exception" (WTO, 2001, para. 20). Likewise, the document entitled "Scheduling of Initial Commitments in Trade in Services" stipulates that "any prudential measure justifiable under paragraph 2.1 of the Annex on Financial Services constitutes an exception to the Agreement" (WTO, 1993, para. 13).

Having decided that the prudential carve-out is an exception, the panel had to establish who had the burden of proof. It is a principle of procedural law that the party alleging a fact has to prove it. As Argentina, the respondent, had invoked the exception, the burden of proof lay on Buenos Aires who had to demonstrate that the challenged measures could be justified pursuant to the exception at issue. In this distinctive manner, it is important to highlight what the WTO Appellate Body (AB) said (WTO, 1997, p. 14):

> [T]hus, hardly surprising that various international tribunals, including the International Court of Justice, have generally and consistently accepted and applied the rule that the party who asserts a fact, whether the claimant or the respondent, is responsible for providing proof thereof. Also, it is a generally-accepted canon of evidence in civil law, common law and, in fact, most jurisdictions, that the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence.

There is no restriction as to the type of measure falling within the scope of paragraph 2(a) of the Annex on Financial Services. The introductory sentence of paragraph 1(a) of the Annex reads that "this Annex applies to measures affecting the supply of financial services." This introductory sentence does not impose limits on the type of measures falling within the whole annex. It simply makes use of the expression 'measures' in the plural form. Additionally, the second sentence of the second part of paragraph 2(a) also refers to the expression 'measures' when it states that "they [the measures] shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement" (WTO, 2016, para. 6.254). Another aspect to be bore in mind is that recitals three and four of the GATS preamble plainly refer to 'national policy objectives'. Therefore, an interpretation limiting the measures would contravene the idea of balance between rights and duties expressed in the GATS preamble (WTO, 2016, para. 6.260).

3.2 THE REQUIREMENTS CONCERNING THE PRUDENTIAL EXCEPTION

In order to justify the application of the exception in question, the respondent has to fulfill three requirements: it has to adduce evidence that the challenged measures were utilized for prudential motives and that it did not use the measures concerned as a way of avoiding its commitments under the GATS. In addition, it has to demonstrate that the measures affect the supply of financial services (WTO, 2015, paras. 7.821 and 7.825).

With regard to the demonstration of whether the measures affect the supply of financial services, the panel checked the ordinary meaning of 'affecting'. The panel stated that 'affecting'

has a wider meaning than the expressions 'regulating' and 'governing' (WTO, 2015, 7.855). When WTO adjudicators scrutinize the ordinary meaning of the words, they resort to dictionaries. In the case *Argentina – Financial Services*, three dictionaries were used: the dictionary of the Real Academia Española, the Shorter Oxford Dictionary and Le Petit Robert.[3] It was also necessary to verify whether the nature of the challenged measures was financial. Here the panel mentioned that the services listed in paragraph 5 of the Annex can be considered financial services (WTO, 2015, para. 7.857).

With respect to the fact that the measures have to be taken for prudential reasons, the panel heavily distinguished between the expressions 'prudential measures' and 'measures taken for prudential reasons.' Panama, the claimant, argued that the expressions at issue could be used interchangeably. Nonetheless, the panel stressed that it would be a mistake to assume that these expressions are synonyms. Paragraph 2(a) of the Annex on Financial Services does not refer to 'prudential measures'; rather, it states that "a Member shall not be prevented from taking measures for prudential reasons." Accordingly, it is the motive that has to be prudential, not the measure itself.

Pursuant to the panel, another pertinent point to be taken into account is that paragraph 2(a) does not plainly enshrine a list of measures that could potentially be deemed prudential in a specific fashion. Moreover, there is no stipulation in paragraph 2(a) about any international provision that could act as a guide towards the nature of a certain measure. As a result, international references like the principles on prudential regulation published by the Basel Committee would not be useful in this situation (WTO, 2015, para. 7.861). Still, the panel did not ascertain the meaning of the expressions 'prudential measures' and 'prudential issues' contained in paragraphs 3 and 4 of the Annex (WTO, 2015, para. 7.862).

In order to check if the measures were taken for prudential reasons, it is necessary to define the concept of 'prudential reasons' and what constitutes a measure having been executed 'for' prudential motives.

Concerning the concept of 'prudential reasons', the panel again ascertained the ordinary meaning of this expression in the dictionaries (Real Academia Española, the Shorter Oxford Dictionary and Le Petit Robert) and found out that the term 'prudential reasons' signifies 'motivos cautelares' and 'raisons prudentielles', that is, causes or motives whose nature is preventive. The prudential reasons laid out in paragraph 2(a), such as the protection of investors,

[3] As an anecdote, some say that the Oxford Dictionary has become an important treaty in the WTO legislation.

depositors, and the integrity and stability of the financial system, appear to support this interpretation.

Prudential reasons may change over time (WTO, 2015, para. 7.870). What was considered an efficient reason some decades ago may be useless now. That is why the panel, echoed by some third parties, ruled that the expression 'prudential reasons' is of evolutionary nature (WTO, 2015, para. 7.873). It is dynamic and tends to adapt to the circumstances of a specific period. Accordingly, WTO countries should be granted a considerable leeway so as to be able to tackle difficulties in the services realm. The content of the fourth recital of the GATS also helps better understand this scenario, inasmuch as countries can execute their national policy objectives. Besides, owing to its evolutionary nature, the term 'prudential reasons' is not confined to the idea of 'imminence'; states have the right to prepare in advance against harmful effects on the field of services.

The following step is to know when a measure has been taken for prudential reason. One might feel tempted to draw a parallel with similar situations. In this vein, an apparent possible comparison might be the exceptions of GATT/94 article XX and GATS article XIV. When dealing with such exceptions, adjudicators have to do the 'necessity' test whose parameters are rather rigid. Nevertheless, the prudential exception "is less stringent than the "necessity test" found in [GATS] Article XIV (General Exceptions)" (Mamdouh, 2010), that is, the measure does not have to be the least trade-restrictive one. Hence, the 'necessity' test is not helpful in the present case (WTO, 2015, para. 7.884).

Having examined the ordinary meaning of the word under debate now – the preposition 'for' -, the panellists concluded that its meaning is 'affecting, with regard to, or in respect of' or '(having the thing mentioned) as a reason or cause'. As a result, when a WTO member wishes to apply a measure for prudential reason, it has to apply such a measure with a prudential cause. Therefore, there is a relationship of cause and effect between the measure and the prudential reason (WTO, 2015, para. 7.891). Consequently, because of this rational link between the measure and the motive, the adequacy of the measure to the prudential reason is of paramount importance. Yet, it is only possible to verify this adequacy on a case-by-case basis.

It is worthwhile noting that the first international tribunal grappling with the prudential exception was a tribunal established to analyze the Financial Services Chapter of the NAFTA. In this dispute, the complainant was questioning "a series of measures related to Mexico's bailout of its financial sector" (Tucker, Todd & Wallach, 2009, p. 14). According to this *ad-hoc* arbitral court, there is no NAFTA violation if the challenged measure is deemed a

reasonable measure taken for prudential reasons (ICSID, 2006, para. 159). Additionally, NAFTA article 1410(1) entitles countries to adopt reasonable prudential measures even if the measures' effects are discriminatory (ICSID, 2006, para. 162).

Regarding the last requirement, namely, whether the measures have not been taken as a way of avoiding the country's commitments under the GATS, this point remains unresolved thus far because the panel in *Argentina – Financial Services* concluded that it was unnecessary to settle this issue on the grounds that "Argentina [the respondent] has failed to demonstrate that measures 5 and 6 [some of the challenged measures] were taken for prudential reasons within the meaning of paragraph 2(a) of the Annex on Financial Services" (WTO, 2015, para. 7.945). Although this topic remains open to discussion, one may posit that the second sentence of paragraph 2(a) of the Annex on Financial Services, by asserting that the measures shall not be taken as a means of avoiding the country's commitments as for the GATS, may be viewed as 'self-cancelling', that is, in the end, the measures may be deemed useless (Gallagher, Kevin & Stanley, 2012, p. 4).

CONCLUDING REMARKS

The GATT/WTO system has markedly decreased the obstacles to international trade. The various negotiating rounds have been responsible for the enactment of several treaties aiming at liberalizing the flow of goods and services. These treaties have introduced detailed and specific rules; the Annex on Financial Services of the GATS is an example.

Financial services have become more and more sophisticated and diversified. Globalization has helped financial institutions operate in foreign markets. However, it is pertinent to notice that crises involving financial services may happen every now and then. The global financial crisis of 2007-08 deeply illustrates how difficulties faced by banks in one country easily spread over several other states.

With a view to alleviating the deleterious effects caused by systemic risks in the field of financial services, countries and institutions have tried to share experiences and develop principles of prudential measures and codes of good practices and stern compliance standards. The Bank of International Settlements is one of these initiatives. One of its committees, the Basel Committee, has established principles and guidelines to help financial institutions detect and control risks threatening the stability of the financial system.

The first case about prudential measures at the WTO was the case *Argentina – Financial Services* where adjudicators heavily utilized the recourse to the ordinary meaning of words to formulate the requirements authorizing the imposition of prudential measures. Nonetheless, this recourse may reveal to be unfair if used robotically. Due to this recourse, the panellists of the case at issue were of the view that, pursuant to the paragraph 2(a) of the Annex on Financial Services dealing with prudential measures, international references such as the principles of the Basel Committee on prudential measures may not be useful.

It is regrettable that the guidelines of the Basel Committee were not applied in the case *Argentina – Financial Services*. Three observations can explain why the panel should have ruled differently here. First, article 4 of the Annex on Financial Services reads that "panels for disputes on prudential issues and other financial matters shall have the necessary expertise relevant to the specific financial service under dispute." Second, GATS article XXVI provides for the cooperation between the WTO General Council and other institutions regarding services. Third, paragraphs 3 and 4 of the Annex on Financial Services allude to the expressions 'prudential measures' and 'prudential issues', both of which the panel refused to explain on the grounds that these paragraphs had not been invoked by the disputing parties. Putting all these observations together, they contribute to the idea that international principles on prudential measures like those developed by the Basel Committee should have been quite useful to solve the case.

By mentioning that the term 'prudential reason' is of evolutionary nature, the panel clearly signaled that the difficulties that financial institutions may tackle are likely to change over time. As financial services have developed in a significant way over the last decades and as speculation is often linked to them, national regulators need a certain margin of flexibility to cope with problems in advance.

Finally, there has to be a rational relationship between the measures aiming at mitigating the problems in the financial market and the reasons justifying the application of the measures. Proportionality is essential here: the measures can neither be too strong to cause new difficulties nor be too weak to keep the existing or potential risks to the market.

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Recebido em: novembro de 2018

Aprovado em: dezembro de 2018

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