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Chapter 14 of the NAFTA: The Financial Services Chapter

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Member States Developments: United States

Chapter 14 of the NAFTA: The Financial Services Chapter

The Financial Services Chapter (Chapter 14) of the North American Free Trade Agreement¹ sets forth a comprehensive approach and framework for regulating the provisions of services in the banking, securities, insurance, and non-banking financial service company sectors, subject to certain specific country reservations and transition periods.² This article is a brief summarization of the key provisions of the NAFTA as contained in the official text of the Agreement.³

The text of the Financial Services Chapter of the Agreement, with related Annex VII, can be broken into ten different areas: right of establishment, national treatment, new financial services, cross-border trade in financial services, self-regulatory organizations, senior management and boards of directors, transparency, dispute resolutions, incorporated provisions, and exceptions and reservations. This article summarizes each of the ten provisions.

I. Right of Establishment

Under the Financial Services Chapter, each NAFTA country permits an investor of another NAFTA country to establish financial institutions in its territory.⁴ Once the financial institutions are established they are allowed to provide a range of financial services, expand geographically, and operate without any ownership requirements specific to foreign institutions.⁵ To be eligible for the Financial Services Chapter benefits on market access, an investor of another NAFTA country must already be engaged in the business of providing financial services.⁶

NAFTA countries can restrict branching of financial institutions into their respective countries. Each NAFTA country can require an investor of another NAFTA country to incorporate financial institutions in its territory, thereby barring entry by direct cross-border branching.⁷ U.S. banks currently may operate in Canada and Mexico only through bank subsidiaries. However, if the United States allows American banks owned by other NAFTA

1. North American Free Trade Agreement, drafted Aug. 12, 1992, revised Sept. 6, 1992, U.S.-Can.-Mex., 32 I.L.M. 605 (entered into force Jan. 1, 1994) [*hereinafter* NAFTA or the Agreement].
 2. Harry G. Broadman, *International Trade and Investment in Services: A Comparative Analysis of the NAFTA*, 27 INT'L LAW. 623, 642 (1993).
 3. For an in-depth analysis of the Financial Services Chapter, see Kenneth L. Buchman et al., *Financial Services under the North American Free Trade Agreement: An Overview*, in JOSEPH J. NORTON ET AL., *NAFTA AND BEYOND: A NEW FRAMEWORK FOR DOING BUSINESS IN THE AMERICAS*, 209-231 (1995); and OLIN L. WETHINGTON, *FINANCIAL MARKET LIBERALIZATION, THE NAFTA FRAMEWORK*, 49-63 (1994).
 4. NAFTA, *supra* note 1, art. 1403(1)-(2).
 5. *Id.* art. 1403(2).
 6. *Id.* art. 1403(5).
 7. *Id.* art. 1403(4).
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countries to expand by direct branches into substantially all fifty states,⁸ then each NAFTA country has agreed to review and negotiate cross-border branching across NAFTA country borders.⁹

II. National Treatment

Each NAFTA country accords investors, financial institutions, and cross-border financial service providers from other NAFTA countries both national treatment and most-favored-nation treatment.¹⁰

The national treatment standard requires a NAFTA country to accord investors, financial institutions, and cross-border financial service providers of other NAFTA countries treatment no less favorable than it accords to its own investors, financial institutions, and cross-border financial service providers in like circumstances.¹¹ A NAFTA country's treatment of financial institutions and cross-border financial service providers meets the national treatment standard if the NAFTA country affords equal comparative opportunity.¹² A NAFTA country's treatment affords equal comparative opportunity if it does not disadvantage financial institutions and cross-border financial services providers of another NAFTA country in their ability to provide financial services as compared with the ability of the country's own financial institutions and financial services providers to provide such services, in like circumstances.¹³

The most-favored-nation standard requires each country to accord to investors, financial institutions, and cross-border financial service of other NAFTA countries treatment no less favorable than the most favorable treatment accorded to an investor or cross-border financial services from any NAFTA or non-NAFTA country in like circumstances.¹⁴ By requiring each NAFTA country to provide both national treatment and most-favored-nation treatment, "is to require the better of the two in any situation where one or the other is more favorable."¹⁵

8. The recent enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, 12 U.S.C. Sec. 1811 (1995), is designed to reduce the barriers to interstate banking by allowing a bank located in one state to acquire a bank located in another state. For a thorough analysis of the effect of United States banking regulations on the NAFTA see Donna L. Lance, *Can the Glass-Steagall Act be Justified Under the Global Free Market Policies of the NAFTA?*, 34 WASHBURN L. J. 297 (1995). On September 29, 1995, "bank holding companies in some states will be permitted to operate their now separate bank subsidiaries as bank branches. The branching would automatically take effect June 1, 1997 unless a state elects to start earlier or rejects it." Jim Mitchell, *State's Right*, Dallas Morning News, Sept. 28, 1995, at D1, D2. As of September 28, 1994, most states remain undecided. "At least 16 states have approved 'branching.' Texas is the only state that decided not to adopt the law." *Id.*

9. NAFTA, *supra* note 1, art. 1403(3).

10. *Id.* arts. 1405, 1406.

11. *Id.* art. 1405(1)-(4).

12. *Id.* art. 1405(5).

13. *Id.* art. 1405(6).

14. *Id.* art. 1406(1).

15. Buchman, *supra* note 3, at 213.

III. New Financial Services

The Agreement also allows new financial services.¹⁶ "This would include certain advanced financial products, such as derivatives, where United States institutions may have a competitive advantage."¹⁷ A NAFTA country must permit any financial services of another NAFTA country to provide any new financial services similar to those services that are provided in its own country.¹⁸ However, a NAFTA country does not have to permit the new financial service if that country determines on prudential grounds that the service should not be authorized.¹⁹

Also, the Financial Services Chapter permits financial institutions of a NAFTA country the right to transmit information in electronic or other form into and out of another NAFTA country's territory in the ordinary course of business.²⁰ This will allow financial institutions in NAFTA countries to use existing processing centers in their own national territory rather than having to go to the expense of building additional facilities and adding staff to provide services in the other NAFTA country.²¹

IV. Cross-Border Trade in Financial Services

Another provision of the Financial Services Chapter concerns cross-border trade.²² No NAFTA country may adopt any measure restricting cross-border trade in financial services by cross-border financial service providers of another NAFTA country.²³ However, NAFTA countries may reserve the adoption of this provision.²⁴

In addition, the cross-border provision permits residents in any NAFTA country to buy financial services in any other NAFTA country. However, the cross-border provision does not guarantee financial firms the right to do business or to solicit financial service customers in another NAFTA country's territory.²⁵

V. Self-Regulatory Organizations

The Financial Services Chapter also applies to self-regulatory organizations. If a NAFTA country requires a financial institution or a cross-border financial service provider of another NAFTA country to be a member of, participate in, or have access to any self-regulatory organization in order to provide financial services in that country, then that NAFTA country must ensure that the self-regulatory organization abides by all the obligations of

16. NAFTA, *supra* note 1, art. 1407.

17. Wethington, *supra* note 3, at 51.

18. NAFTA, *supra* note 1, art. 1407(1).

19. *Id.*

20. *Id.* art. 1407(2).

21. Karen MacAllister, *NAFTA: How the Banks in the United States and Mexico will Respond*, 17 *Hous. J. INT'L L.* 273, 292 (1994).

22. NAFTA, *supra* note 1, art. 1404.

23. *Id.* art. 1404(1).

24. *Id.*

25. *Id.* art. 1404(2).

the Financial Services Chapter.²⁶ A self-regulatory organization means any non-governmental body that exercises its own or delegated regulatory or supervisory authority over financial service providers or financial institutions.²⁷

VI. Senior Management and Boards of Directors

No NAFTA country can require financial services of another NAFTA country to place national requirements on senior management. The Agreement also "limits the ability of the NAFTA government to require that more than a simple majority of members of a board of directors be nationals of the host country or resident in the territory of the host country."²⁸

VII. Transparency

Additionally, each NAFTA country obligates the NAFTA governments to make transparent the public regulatory requirement and procedures in the financial field and to move without undue delay on regulatory matters affecting financial entities of other NAFTA countries.²⁹ Regulatory authorities must make administrative decisions on completed applications of a financial institution within 120 days.³⁰ In addition, each NAFTA country's regulatory authority must make public all rules and procedures relevant to interested financial persons.³¹ The Financial Services Chapter also permits interested parties the opportunity to provide comments on the proposed measure.³²

VIII. Dispute Resolution

A. THE FINANCIAL SERVICES COMMITTEE

Should a dispute arise between NAFTA parties, the Financial Services Chapter sets forth dispute settlement provisions relevant to financial services.³³ A Financial Services Committee is established under the Agreement to supervise the implementation of, consid-

26. *Id.* art. 1402.

27. *Id.* art. 1416.

28. Wethington, *supra* note 3, at 52 (construing NAFTA, *supra* note 1, art. 1408).

29. NAFTA, *supra* note 1, art. 1411. Matthew Barrett, chairman of the Bank of Montreal recently commented that "[t]he financial services chapter of NAFTA significantly enhances transparency in the industry, setting out general principles and rules that all three countries must observe." *NAFTA Promotes More Transparency in Financial Services, Banker Says*, Int'l Trade Rep.(BNA), June 21, 1995, at 1062.

30. NAFTA, *supra* note 1, art. 1411(4).

31. *Id.* art. 1411(2).

32. *Id.* art. 1411(1)(c).

33. *Id.* arts. 1412-1415. For an article thoroughly outlining the dispute resolution chapters of the NAFTA see Jeffrey P. Bialos and Deborah E. Siegel, *Dispute Resolution Under the NAFTA: The Newer and Improved Model*, in JOSEPH J. NORTON ET AL, NAFTA AND BEYOND: A NEW FRAMEWORK FOR DOING BUSINESS IN THE AMERICAS, 315-339 (1995).

er issues regarding, and participate in the settlement of financial services disputes.³⁴ The Treaty requires the Financial Services Committee to meet annually to assess the functioning of the NAFTA as it applies to financial services.³⁵

B. HOW FINANCIAL SERVICES DISPUTE RESOLUTION DIFFERS FROM OTHER DISPUTE RESOLUTION PROVISIONS PROVIDED FOR UNDER THE NAFTA

According to scholars, "[t]he dispute settlement provisions ... modify the general dispute settlement provisions in the NAFTA and provide certain special arrangements in the case of disputes in the financial services sector."³⁶ The financial services dispute settlement procedures differs most dramatically from the other dispute settlement procedures of the Agreement in that disputes in the financial services sector are to be handled by experts in the financial field rather than by general trade experts.³⁷

IX. Incorporated Provisions

The Financial Services Chapter contains most of the provisions related to financial services. However, other sections of the Agreement are incorporated into the Financial Services Chapter.³⁸

A. CHAPTER 11 - INVESTMENT

The Agreement incorporates several provisions of the Investment Chapter regarding transfers, expropriation and compensation, special formalities and information requirements, denial of benefits, and environmental matters. Each NAFTA country must permit all transfers relating to an investment of an investor of another NAFTA country to be made freely and without delay.³⁹ Also, the expropriation of investments in the financial services sector is permitted only if the taking is for a public purpose, is nondiscriminatory, and payment of compensation is made without delay and at fair market value.⁴⁰

Additionally, each NAFTA country can adopt or maintain any measure that prescribes special formalities in connection with the establishment of investments by investors of another NAFTA country provided that such formalities do not materially impair the protection afforded to the investors of the other NAFTA countries.⁴¹ Furthermore, nothing in the Financial Services Chapter shall be construed to prevent a NAFTA country from adopt-

34. NAFTA, *supra* note 1, art. 1412.

35. *Id.* art. 1412(3). For a critique of the implementation provisions of Chapter 14, see Valerie J. McNevin, *Policy Implications of the NAFTA for the Financial Services Industry*, 5 COLO. J. INT'L ENVTL. L. & POL'Y 369, 386-389 (1994).

36. Wethington, *supra* note 3, at 52.

37. NAFTA, *supra* art. 1414.

38. Articles 1109 through 1111, 1113, 1114 and 1211 are incorporated into the Financial Services Chapter. Furthermore, Articles 1115 through 1138 are incorporated into the Chapter solely for breaches by a NAFTA country of Articles 1109 through 1111, 1113 and 1114. *Id.* art. 1401(2).

39. *Id.* art. 1109(1).

40. *Id.* art. 1110.

41. *Id.* art. 1111(1).

ing, maintaining or enforcing any measure it considers appropriate in order to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.⁴² Lastly, the Investment Chapter provides for special dispute resolution procedure that will apply to the Financial Services Chapter.⁴³

B. RULES OF ORIGIN

The rules of origin provisions of the Investment Chapter and the Cross-Border Trade in Services Chapter are also incorporated into the Financial Services Chapter. The rule of origin provisions permit the government of a NAFTA country to deny benefits of the NAFTA to any enterprise owned or controlled by residents of a country with which the NAFTA member country's government does not maintain diplomatic relations.⁴⁴

X. Exceptions and Restrictions

A. GENERAL

The NAFTA provides general exceptions to the Financial Service Chapter obligations.⁴⁵ These exceptions are viewed as having limited applications. "The two key exceptions being referenced here are the so-called prudential exception and the exceptions for monetary and exchange rate policies."⁴⁶

The prudential exception states that nothing in the Financial Services Chapter shall prevent a NAFTA country from taking measures to protect the safety, soundness, integrity, or financial responsibility of their financial market.⁴⁷ The measures must be reasonable and must be for 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.⁴⁸

The monetary and exchange rate policies exception provides that NAFTA countries are allowed to implement non-discriminatory measures of general application that effect the monetary policy or exchange rate policy.⁴⁹

B. RESERVATIONS IN SCHEDULES OF THE AGREEMENT

The most significant reservations and exceptions to the provisions of the Financial Services Chapter are contained in Annex VII of the Agreement. In Annex VII, all three NAFTA countries set out a schedule to the Agreement that contains three sections. Section A provides reservations of the NAFTA country with respect to existing measures that do not

42. *Id.* art. 1114(1).

43. *Id.* art. 1115 through 1138.

44. *Id.* arts. 1113 and 1211.

45. *Id.* art. 1410(1)-(2).

46. Wethington, *supra* note 3, at 53.

47. NAFTA, *supra* note 1, art. 1410(1)(b).

48. *Id.* art. 1410(1)(a).

49. *Id.* art. 1410(2).

conform with the obligations imposed by the Financial Services Chapter.⁵⁰ Section B sets out future measures that the NAFTA country may adopt or maintain that do not conform with the obligations of the Financial Services Chapter.⁵¹ Lastly, Schedule C lists specific commitments from the NAFTA countries to liberalize financial services in order to conform to the NAFTA.⁵²

Section C of the Annex includes a limited U.S. commitment applicable to Mexican banks regarding interstate banking.⁵³ In addition, Canada limits ownership in Canadian-controlled financial institutions, with a limited exemption in Section C from restrictions on total Canadian assets that may be held by foreign bank subsidiaries to enterprises controlled by residents of the United States and Mexico.⁵⁴ However, the most significant commitments are made by Mexico focusing on access by U.S. and Canadian financial service firms to the Mexican financial market.⁵⁵

The Mexican government used Annex VII to set forth its progressive financial market liberalization. However, Mexico was concerned that rapid liberalization policies could harm Mexican financial markets. Consequently, Mexico bargained for a transition period of six years. The transition period began on January 1, 1994 and ends, except for a few exceptions, on January 1, 2000. The schedule for Mexico sets forth transitional obligations with respect to each of the five major segments of the financial market: banking, securities, insurance, leasing and factoring, and non-bank financial institutions.⁵⁶ "Negotiators on all sides sought to ensure a large measure of comparability among the various segments of the financial market. This comparability resulted from a perceived need to avoid any public sense that particular segments were receiving more advantageous treatment than others."⁵⁷

50. *Id.* Annex VII(1)-Reservations, Specific Commitments and Other Items.

51. *Id.* Annex VII(4)-Reservations, Specific Commitments and Other Items.

52. *Id.* Annex VII(5)-Reservations, Specific Commitments and Other Items.

53. *Id.* Annex VII(C)-U.S.

54. *Id.* Annex VII(C)-Can.

55. *Id.* Annex VII-Mex.

56. In the ongoing negotiations for Chile's accession to the NAFTA, Chile "may ask, as Mexico did, for the establishment of a transition period in which it will have certain control of the issuance of licenses" for financial firms owned by Mexican, United States, or Canadian investors. *Chile Businesses Prepare for NAFTA, While Doubts Remain in Some Sectors*, Int'l Trade Rep. (BNA), Jan. 25, 1994, at 174.

57. Wethington, *supra* note 3, at 55. Between April 1, 1994 and July 31, 1994, one hundred two financial services providers applied to do business in Mexico under NAFTA with the Mexican Ministry of Finance. Included in the petitions were applications from twenty banks. *Mexico Evaluating Applications Filed by Financial Firms, Official Says*, Int'l Trade Rep. (BNA), Oct. 5, 1994, at 1527.

1. *The Banking Sector*⁵⁸

During the transition period, the combined market share of United States and Canadian banks in Mexico began at eight percent of the entire Mexican banking market (i.e., on January 1, 1994) and rises to fifteen percent by January 1, 2000.⁵⁹ The single financial institution capital limit for a United States or Canadian investor-owned bank is 1.5 percent of the entire Mexican banking market through the year 1999.⁶⁰ Both of these limits expire on January 1, 2000. However, after the end of the transition period, no United States or Canadian financial institution will be permitted to acquire an existing Mexican bank if the capital of the acquired bank, together with the capital of any Mexican bank already controlled by the acquirer, would exceed four percent of the aggregate capital of the Mexican banking market.⁶¹

In addition, the schedule of Mexico provides a safeguard provision from the year 2000 to 2004. If at any time during the safeguard period the aggregate capital of all United States and Canadian investor-owned commercial banks established in Mexico reaches twenty-five percent of the aggregate capital of all commercial banks in Mexico, Mexico may extend and freeze for three years the aggregate capital limit of United States and Canadian investor-owned banks.⁶² Furthermore, if the rate reaches twenty-five percent, Mexico may request consultations with the other NAFTA countries to discuss the need for remedial action, including further temporary limitations on market participation.⁶³ If no consensus is reached in these discussions, any NAFTA country may request that the matter be submitted to arbitration under the NAFTA.⁶⁴

2. *The Securities Sector*

The securities sector has similar provisions to that of the banking sector. For United States and Canadian investor-owned securities firms, the aggregate capital limit will rise from ten percent in 1994 to twenty percent by 2000.⁶⁵ The single United States or Canadian investor-owned financial institution capital limit is four percent until the year 2000.⁶⁶ Both

58. For in-depth articles discussing the history of the Mexican banking sector and the effect of NAFTA on the Mexican banking industry, see MacAllister, *supra* note 21; Carlos M. Nalda, *NAFTA, Foreign Investment, and the Mexican Banking System*, 26 GEO. WASH. J. INT'L L. & ECON. 379 (1992); and Bronwen Davis, *Mexico's Commercial Banking Industry: Can Mexico's Recently Privatized Banks Compete with the United States Banking Industry After Enactment of the North American Free Trade Agreement?*, 10 ARIZ. J. INT'L & COMP. L. 77 (1993).

59. NAFTA, *supra* note 1, Annex VII(B)(5)-Mex.

60. *Id.* Annex VII(B)(2)-Mex.

61. *Id.* Annex VII(B)(13)-Mex. "This provision was incorporated to provide Mexican regulators the option of keeping the largest Mexican banks, each of which exceeds four percent of the Mexican Market, in the hands of Mexican nationals." Wethington, *supra* note 3, at 57.

62. *Id.* Annex VII(B)(9)-Mex.

63. *Id.* Annex 1413.6(B).

64. *Id.*

65. *Id.* Annex VII(B)(5)-Mex.

66. *Id.* Annex VII(B)(2)-Mex.

limits expire on January 1, 2000.⁶⁷ As with the banking sector, a safeguard exists until the year 2004. If the aggregate amount of United States and Canadian investor-owned securities firms rises to thirty percent or greater, Mexico can extend and freeze for over three years the aggregate capital limit on United States and Canadian investor-owned securities firms.⁶⁸

3. The Insurance Sector

The insurance sector is also patterned after the banking and securities field. However, some significant variations from the other financial services sectors exist. The insurance sector provides three ways for United States and Canadian investor-owned firms to gain access to the insurance sector.

First, United States and Canadian investor-owned insurance companies that enter the Mexican market through wholly owned subsidiaries are subject to an aggregate capital limit from six percent in 1994 to twelve percent by 2000.⁶⁹ However, this limit cannot be reimposed under any circumstances under the Agreement.⁷⁰ The single United States or Canadian investor-owned financial institution capital limit will be 1.5 percent until 2000.⁷¹ Furthermore, there is no limitation on acquisition of Mexican insurance companies by wholly owned United States or Canadian subsidiaries in Mexico.

The second and third ways for United States and Canadian investor-owned firms to gain access to the insurance market is through joint ventures with Mexican entities. Unlike the banking and securities sectors, the Mexican insurance sector at the time the NAFTA entered into force already had some significant minority participation by United States insurance companies.⁷² Insurance companies with joint ventures in Mexico in December 17, 1992, are permitted to move to majority control by January 1, 1996, including up to one hundred percent.⁷³ Lastly, United States and Canadian investor-owned insurance companies which enter the Mexican insurance market through joint ventures with Mexican parties after December 17, 1992, began with an ownership limit of thirty percent on January 1, 1994, which rises to majority ownership by 1998, and to one hundred percent after January 1, 2000.⁷⁴

4. The Leasing and Factoring Sectors

The transition schedule for the leasing and factoring sectors is much more simplified than the banking and securities sectors. The NAFTA will subject Mexican factoring and leasing companies owned by United States and Canadian investors to aggregate capital limits that will rise from ten percent in 1994, to twenty percent by the year 2000.⁷⁵ However,

67. *Id.* Annex VII(B)(9)-Mex.

68. *Id.*

69. *Id.* Annex VII(B)(6)-Mex.

70. *Id.*

71. *Id.* Annex VII(B)(2)-Mex.

72. Wethington, *supra* note 3, at 60. There existed only five United States and no Canadian insurance companies with joint ventures in Mexico in 1992. *Id.*

73. NAFTA, *supra* note 1, Annex VII(B)(4)-Mex.

74. *Id.*

75. *Id.* Annex VII(B)(5)-Mex.

unlike the banking and securities sectors, such companies will not be subject to individual capital limits.⁷⁶

5. *The Non-bank Financial Institutions*

At the outset of negotiations of the NAFTA, the non-bank financial institutions sector of the Mexican financial services market was underdeveloped.⁷⁷ Non-bank financial institutions include consumer finance operations, mortgage lending, and credit card banking. Foreign financial institutions in these categories were not permitted to operate in Mexico. Some Mexican activity existed in these areas, but that activity was conducted through Mexican banks.⁷⁸

Under the Agreement, Mexico created a limited scope finance company category.⁷⁹ Limited scope finance companies are permitted to raise funds in the domestic Mexican capital markets.⁸⁰ However limited scope finance companies are not permitted to fund themselves through accepting deposits from the public.⁸¹ Under the Agreement, United States and Canadian investor-owned non-bank financial institutions may establish limited scope finance companies in Mexico. However, until January 1, 2000, United States and Canadian investor-owned limited scope finance companies' aggregate assets may not exceed three percent of the aggregate assets of all banks and limited-scope financial companies in Mexico.⁸²

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76. *Id.* Annex VII(B)(2)-Mex.

77. Wethington, *supra* note 3, at 61.

78. *Id.*

79. NAFTA, *supra* note 1, Annex VII(B)(2)-Mex.

80. *Id.*

81. *Id.*

82. *Id.* Annex VII(B)(8)-Mex.
