

2001

## Financial Services and Regional Integration: A Comparative Snapshot

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### Recommended Citation

Anna V. Morner, *Financial Services and Regional Integration: A Comparative Snapshot*, 7 LAW & BUS. REV. AM. 549 (2001)

<https://scholar.smu.edu/lbra/vol7/iss4/4>

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# Financial Services and Regional Integration: A Comparative Snapshot

*Anna V. Morner\**

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## I. Introduction

### A. GENERAL

International concern over access to, and regulation of, financial services has substantially increased over the last few decades. The tendency has been towards liberalization of access, with a reassessment of regulatory rules as a concomitant. Although international concerns obviously tend to focus on transborder access to services concerned, decompartmentalization of financial services at the national level has also developed substantially; with increased allowance for universal banking and for integration of banking and insurance ("banc-assurance") being the most obvious examples.

Indeed, we appear to be faced with a mutually re-enforcing process in which pressure for access leads to a more normative, less subjective, regulatory approach, which opens up new avenues for tearing down the fences between the various categories of players. On balance, it seems that regulation has moved from focusing primarily on the producer towards focusing on the product. In this context, transparency, increased emphasis on capital requirements, and increased competition seem to be the key phrases.

As a corollary, whatever the level of liberalization in terms of access, it seems safe to state that complete deregulation was never seen as a serious option. Although financial services are now seen as less "different" than they used to be, their specific characteristics still call for subjection to a regime of licensing and prudential supervision.

Accordingly, where rules and practices were perceived as obsolete under new market conditions, they have not simply been scrapped, but rather have been replaced by new rules and practices, applying different concepts to different factual situations. Hence the truism that, for financial services, "deregulation" is really a matter of "re-regulation."

This process of liberalization and reassessment of rules cannot be traced to simple causal links. Even within the sector itself it is not easy to distinguish, let alone weigh up, autonomous developments (that is, new methods for risk assessment, new products) and external influences, of which information technology is the obvious example. Furthermore, broader aspects, such as economic development, education, cultural diversity and political shifts, must be taken into account.

The complexity of factors to be entered into the process is directly relevant to the subject of this paper. Indeed, there appear to be marked differences—if not qualitatively then at least quantitatively—between international agreements, as compared to domestic decision-making processes, so far as the capacity for integrating different factors and priorities is concerned.

National decision-making tends to show a relatively strong integrative bias, if only as a consequence of the national budget and the pervasive authority of the national government; but international co-operation between states tends to be based on a relatively restricted brief, oriented towards a specified goal with regard to a specified category of cases.

It can be argued against this background that if it is indeed true that liberalization of financial services can only be realistically conceived on the basis of re-regulation, then the national framework is inherently more appropriate than that of international organizations, or negotiations. At the same time, this argument is subject to an obvious and important qualification; precisely because the national decision-making process tends to have a strong integrative bias, the autonomous capacity for change is limited, so from the outset there may be scant inclination towards liberalization.

In many instances, it may well be assumed that the only fair chance for meaningful change is through outside, or more precisely international, pressure. A further—again not very surprising—observation is that such outside pressures may be exercised, at least partially, through “insiders” in the national decision-making process who are interested, for their own reasons, in the changes being advocated internationally.

One of the purposes of this paper is to demonstrate that—while international agreements or organizations may provide essential channels through which forces for change may be expressed—any meaningful change in the access/regulation equation valid for financial services is contingent upon a broader framework of political, social, economic, and legal factors.

#### B. HARMONIZATION AND LIBERALIZATION THROUGH INTERNATIONAL ORGANIZATIONS

A substantial number of international organizations are concerned with access to and regulation of financial services. It is nevertheless possible to distinguish certain broad categories (with admittedly somewhat blurred dividing lines).

The first category of international organizations includes bodies, which may be characterized as “technical.” Examples are the Basle Committee on Banking Supervision, the International Organization of Securities Commissioners (IOSCO), the International Accounting Standards Committee (IASC), the International Swaps and Derivatives Association (ISDA), the International Securities Markets Association (ISMA) and the Emerging Market Traders Association (EMTA).

All these organizations—with different levels of authority and commitment between them—are essentially concerned with harmonization of certain conditions and standards relating to specific categories of financial services. Although it may be assumed that liberalization will be facilitated indirectly by such harmonization efforts, it is not their aim as such.

In contrast to those “technical” efforts at the international level, the case of the General Agreement on Trade in Services (GATS) provides a clear example of an international agreement focused primarily on the political commitment to liberalization, leaving aside the possible concomitant aspects of harmonization.

The European Union (EU) and the North American Free Trade Agreement (NAFTA), on the other hand, offer examples of international co-operation with the explicit purpose of combining, to different degrees, harmonization and liberalization. In other words, the technical and political aspects tend to be integrated here at the international level.

The following sections will discuss, in somewhat more detail, distinguishing features of the various examples mentioned above. The purpose of our discussion is to examine the extent to which these arrangements might be useful to the developing countries in their efforts to liberalize financial services within the framework for an RIA (section VI). The focus will be on the legislative and institutional framework.

## II. Efforts to Harmonize Technical Rules: The Basle Committee Example

The Basle Committee on Banking Supervision is a committee of banking supervisory authorities, established in 1975 by the central bank Governors of the Group of Ten

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countries. The recommendations of the committee—whose work has been immensely influential in the area of *inter alia* capital adequacy standards—do not have legal force, but have been adopted by many regulatory and supervisory authorities globally. In that sense, the recommendations constitute a prime example of soft law. The select membership of the committee has, at times, provoked criticism, which maintains that it is an exclusive “club,” setting standards that may not be of relevance in some countries. Most recently, however, in the publication of its “Core Principles for Effective Banking Supervision,”<sup>1</sup> the committee worked closely with a number of non-G-10 supervisory authorities.<sup>2</sup>

The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities in all countries, as well as internationally. The Core Principles should be examined against the background of a compendium of the existing Basle Committee recommendations, guidelines and standards.

The Core Principles are divided into seven sections, providing an extensive framework reflecting the aim of creating a comprehensive regulatory strategy to promote stable financial markets. These sections are as follows: preconditions for effective banking supervision; licensing and structure; prudential regulations and requirements; methods of ongoing banking supervision; information requirements; formal powers of supervisors; and cross-border banking.

While these principles may be of considerable influence globally,<sup>3</sup> they also raise a number of issues. First, the “soft law” nature of the principles should be stressed. They do not have any legal force whatsoever,<sup>4</sup> necessitating implementation in each country individually, or, should the appropriate legal framework exist, within the context of a Regional Integration Agreement (RIA). Second, they were designed to be verifiable by

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1. *Core Principles for Effective Banking Supervision*, Basle Committee on Banking Supervision (Sept. 1997), available at <http://www.bis.org/publ/bcb30a.htm> (last visited 7/3/02).
  2. The group producing the document, in addition to the Basle Committee, consisted of representatives from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia, and Thailand. Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland, and Singapore were also closely involved with the work. *Id.*
  3. Not least in view of the decision, for the purposes of the production of the Core Principles, to consult a wide range of countries and supervisory authorities.
  4. Although, in a process of “reverse regulatory competition,” endorsement of the Core Principles by individual countries indicates a determination to create stable financial markets and, hence, may actually attract business. Although they do not have legal force, there is a strong incentive to ensure the implementation of the Core Principles. As recognized by “The Working Party on Financial Stability in Emerging Market Economies” in relation to the establishment of international norms generally: “They derive their authority from the expertise of those that have formulated them and their wide acceptance from the consultative manner in which they are prepared. They come to be applied because they reduce risk, improve market functioning, and foster a level playing field. If the conventions or norms are not observed, market participants exact a risk premium.” *Financial Stability in Emerging Market Economies, A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems*, Report of the Working Party on Financial Stability in Emerging Market Economies (Apr. 1997) available at <http://www.bis.org/publ/gten02.htm> (last visited July 3, 2002) [hereinafter Report of the Working Party on Financial Stability].
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supervisors, regional supervisory groups, and the market at large and, therefore, by necessity, their content is not detailed.

Furthermore, these principles constitute minimum standards and, in many cases, may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries. Also, while the principles may serve as an impetus in the regulatory processes of many countries, they are not designed to affect the legal framework within which financial service providers operate. In many countries, problems relating to inadequate contract laws, property laws, and secured transactions law, for example, would need to be addressed as a matter of urgency.

### III. Political Commitment to Liberalization: GATS

The General Agreement on Trade in Services (GATS) is one of the major results of the Uruguay Round, finalized at the Ministerial Meeting in Marrakech in April 1994. In summary, it is the first attempt to transplant—to the domain of services—the principles and procedures which had proved successful over the years with regard to the international trade in goods within the framework of the General Agreement of Tariffs and Trade (GATT). Transplanting the basic principles of GATT to GATS in all their full vigor however, proved impossible.

The objective of GATS then is to liberalize trade in services between WTO members. For this purpose four different “modes” of service supply are distinguished.<sup>5</sup> Mode 1 relates to cross-border supply of a service, without either party to the transaction moving cross-border itself (for example, telecommunication). Mode 2 aims at situations where the consumer of the service moves to the territory of the supplier (for example, tourism). Mode 3 entails the commercial presence of a supplier of one country in the jurisdiction of another country (for example, a branch of a bank). Mode 4 covers the supply of services through the presence of natural persons originating in a country in the territory of another country (for example, consultants).

True to the GATT model, GATS provides a few basic principles to apply from the start, as well as gradual liberalization through multilateral negotiations between WTO members. The basic principles are: the most-favored-nation treatment (MFN),<sup>6</sup> the obligation of legislative and regulatory transparency,<sup>7</sup> and the availability of national remedies.<sup>8</sup> As for the negotiations, the essential point of reference for each member of the arrangement is its “Schedule,” in which it commits itself to a certain level of liberalization in terms of market access<sup>9</sup> and national treatment<sup>10</sup> with regard to each of the four modes.

This, in itself, contributes to transparency, one of the major aims of GATS, while the Schedules will be the object of future negotiations aimed at further narrowing barriers between WTO members.<sup>11</sup> Again, following the GATT model, these negotiations

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5. General Agreement on Trade in Services, Dec. 15, 1993, Part II, Annex 1B, art. I (2) [hereinafter GATS].

6. *Id.* art. II.

7. *Id.* art. III.

8. *Id.* art. VI.

9. *Id.* art. XVI.

10. *Id.* art. XVII.

11. *Id.* art. XIX.

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essentially have a multilateral dimension through the MFN principle, extending any concession made to one single WTO member to all other members. A series of bilateral bargaining exercises between single Member States, or restricted groups of members, within overall "rounds" involving all members then results.

The fact that the Uruguay Round, concluded at Marrakech in 1994, brought services within this sophisticated international framework for the first time, can be considered a notable success. After all, the intangible character of services, and the much closer identification of the product with the producer than is normally the case for tangible goods, renders hazardous any "automatic" transplantation of rules originally applying to goods only. It is no surprise, therefore, that in this first round not all GATT principles were transplanted in full to this new domain.

A major inroad in the system is the fact that the cornerstone of the GATT negotiation technique, the MFN principle, is, in relation to GATS, subject to exemptions.<sup>12</sup> If made at the time of entry into effect of GATS, these exemptions will be accepted until 2005, and could even be extended beyond, within the framework of future negotiations. The extent to which this loophole is closed will prove the litmus test for the GATS-system. The fact that "national treatment" is treated as a mere negotiable right within the framework for GATS<sup>13</sup>—in contrast to the situation within GATT—should not come as a surprise. In relation to goods, access to foreign markets is conditioned not only by internal rules and administrative practices, but also—and primarily so—by customs duties and other barriers traditionally linked with national borders; while, in relation to services, the internal rules and regulations are paramount. Therefore, the process of liberalization through negotiations, aimed at by GATS, may be expected to focus on objectivizing those internal rules and administrative practices. It should be stressed that GATS does not mandate deregulation of services in any way. Moreover prudential supervision is not subject to this GATS-negotiation mechanism.

It would appear, therefore, that GATS essentially accepts, as a point of reference for each WTO Member State, the *status quo* in terms of the substance of national regulation of services. Although transparency (to a point), and the availability of judicial remedies are important improvements, harmonizing such regulations between Member States is not the aim.

Finally, attention should be drawn to the institutional aspect of GATS. Part V of GATS provides for the establishment of a council for trade in services, with a view to administering the agreement, while GATS is also embraced by the WTO system of dispute settlement and enforcement.<sup>14</sup> It is this system that has marked a major development, in comparison with earlier GATT solutions where dispute settlement was strictly confined to the political level. The practical experience of the first few years of the WTO system has proved dispute settlement and enforcement to be a reality to be taken seriously.<sup>15</sup>

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12. *Id.* art. II (2) and Annex on Article II Exemptions.

13. *Id.* art. XVII (1): "In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall ...."

14. *Id.* art. XXIII.

15. See John H. Jackson, *Dispute Settlement and the WTO: Emerging Problems*, J. INT'L ECON. L. 329 (1998).



#### IV. A Common Market Approach: The European Union<sup>16</sup>

##### A. GENERAL BACKGROUND AND GUIDING PRINCIPLES<sup>17</sup>

The European Union, as it gradually evolved over the past four decades, has been intimately linked with political and economic developments of the European region and, increasingly, of the world. The development has been explained in terms of regional integration theories, beginning in the 1950s with functionalism.

The functionalist view—that integration would best be furthered by focusing on economic sectors that could be managed by supranational institutions to an extent insulated from political influence—was replaced by the neo-functional theory. This placed more importance on the spillover effects from successful integration of one economic sector to that of other, more controversial, sectors. In the intergovernmental phase of the 1970s, the interests of individual Member States dominated the process, reducing the influence of the supranational institutions.

Deepening and widening integration was, again, the focus of the process with the signature of the Single European Act in the 1980s. More recently, the debate has come to center on the different levels of lawmaking and policy-making within the EU—national, supranational, sub-national, private, and public.

##### B. INSTITUTIONAL FRAMEWORK<sup>18</sup>

There are five institutions charged with the duty of carrying out the tasks entrusted to the European Community (EC): the European Parliament (the parliament), the Council, the Commission, the Court of Justice (ECJ), and the Court of Auditors (CA).<sup>19</sup> The role and duties of each of the institutions have evolved gradually over time and each of them have, in the various stages of European integration, taken on functions beyond what would traditionally be described as legislative, executive, administrative, or judicial. Thus, a categorization akin to the separation-of-powers principle of a domestic legal system would largely be pointless. In the following brief description, the focus will be on the importance of each of the institutions in furthering the integration process.

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16. With effect as from 1 May 1999, the provisions of the Treaty on European Union (TEU) and those of the Treaty establishing the European Community (EC) have been renumbered. Hereunder, references will be to the new number, with the old number between brackets. In this section, articles mentioned without further reference are those of the EC Treaty.

17. For an excellent summary of the history of European integration, see P. CRAIG & G. DE BURCA, *EU LAW*, Ch. 1 (Oxford University Press 2d ed. 1998), and accompanying footnotes [hereinafter CRAIG & G. DE BURCA].

18. It should be noted that the institutional framework of the European Community has been subject to a plethora of academic comment and has evolved gradually over the years. The following overview is intended only to provide a general understanding of the interaction between political, economic and legal factors in advancing economic integration, not least in relation to financial services. CRAIG & DE BURCA, *id.*, provide an up-to-date analysis of the EC institutional framework.

19. The Treaty Establishing the European Community, Mar. 25, 1957, art. 7 [hereinafter EC Treaty]. The role of the Court of Auditors is laid down in article 246 *et seq.* It is of limited relevance in this context, and it will not be discussed further.

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### 1. *The Council*

Consisting of a representative of each member state at the ministerial level,<sup>20</sup> authorized to commit the government of that state, the Council fulfills a pivotal role in the legislative process of the European Community.<sup>21</sup> The Council has to vote its approval of the legislative initiatives of the Commission in order for them to become law. Depending on the subject matter of the proposed legislation, voting takes place by unanimity, qualified majority, or simple majority. A complex system of vote weighting comes into operation when the Council has to take decisions by qualified majority.<sup>22</sup> For many years, unanimity in the Council was required for adopting measures intended to further economic integration. During this period, economic integration advanced largely on the basis of the decisions of the European Court of Justice, and, hence, mainly took the form of negative integration.

Following the publication of the Commission's White Paper in the mid-1980s,<sup>23</sup> and the subsequent adoption of the Single European Act, provisions extending the use of majority voting in relation to so-called internal market measures were inserted in the treaty. This enabled the council to adopt measures aimed ultimately at furthering European integration, but not necessarily favored by all Member States at the time of their adoption.

It has been observed that integration within the EC tends to advance in stages, or "windows,"<sup>24</sup> and that, over time, only very narrow periods have seen any real economic integration. The adoption of the Single European Act opened a window of opportunity in terms of economic integration, which was of immense importance in relation to

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20. *Id.* art. 203.

21. *Id.* art. 202.

22. *Id.* art. 205. The importance attached by the Member States to voting power in the Council is well illustrated by the Ioannina-compromise: Upon conclusion of the Maastricht negotiations in 1992, the Member States decided to extend invitations for membership of the EU to a select group of European states. It was agreed by the then Member States that negotiations for enlargement should not constitute an occasion for changing the Treaty rules on majority voting. Nevertheless, the governments of the U.K. and Spain, no doubt subject to considerable domestic political pressure, decided that they were unhappy with the prospects of alterations to the existing so-called blocking minority and declared that "the influx of a number of small countries should not lead to a weakening of the large countries' blocking power." The resulting Ioannina-compromise provided that, should a conflict arise on this issue in relation to the adoption of secondary legislation, the Council would make every effort to find a satisfactory solution. See also, Anna Möerner, *The Conflicts Inherent in Enlargement—Is History Catching Up with the European Union?* BUTTERWORTHS ANNUAL EUROPEAN REVIEW (London 1995) [hereinafter Möerner]. So far as the author of this paper is aware, the Ioannina-compromise has not had a very considerable effect on the legislative activities of the Council. It illustrates a way forward in situations necessitating political decisions affecting future legislative powers of an RIA. Of course, compromises of this nature can only be reached where there is a real political will to advance the integration process.

23. *Completing the Internal Market*, COM (85) 310 final (June 14, 1985).

24. The windows are identified as the periods 1956–63, 1969–72, and 1986–92. Joseph J. Norton, *Structuring the Banking Regulators and Supervisors: Developed Country Experiences and their Possible Implications for Latin America and Other Developing Countries*, Proceedings from the 1997 SELA Caracas Conference.

legislation on financial services. However, even in periods of relative legislative inertia on the part of the Council, judgments have been handed down by the Court of Justice, which paved the way politically as well as legally, in the Member States for the later introduction, by majority vote in the Council, of internal market measures.

## 2. *The Commission*

As noted above, the traditional division of powers in a domestic legal system is not an adequate tool to describe the EC structure. The commission carries out tasks, which may variously be described as administrative, legislative, executive and judicial. Consisting of twenty commissioners<sup>25</sup>—drawn one from each of the smaller Member States and two from the five larger Member States—the commission, on the basis of delegation from the council,<sup>26</sup> has considerable legislative power in certain well-defined areas. More importantly, the commission also has the power of legislative initiative.<sup>27</sup> In addition, more general policy-shaping documents published by the commission<sup>28</sup> have been of immense importance and have enabled the commission to seize some initiative in the shaping of the internal market.

The judicial powers of the commission<sup>29</sup> are twofold: first, the commission may bring action when it considers that a Member State is in breach of EC law<sup>30</sup> and, second, in relation to certain areas, notably competition policy, the commission will act as initial judge.

## 3. *The European Parliament*

The 626 members of the European Parliament are elected by direct elections in the Member States. The “democratic deficit,” lamented for many years, has gradually given way to increased influence for the parliament in the legislative process. Following the Single European Act, several procedures have been introduced that were designed to address the issue. The most recent one, the co-decision procedure, which gives the Parliament a power of veto, is now fairly widely used and has been further extended in the Treaty of Amsterdam. In addition, the Parliament has considerable influence in the appointment of commissioners, as well as a right to censure, which has been further enhanced by the new procedure set forth in article 214 by virtue of the Treaty of Amsterdam. A widely publicized recent threat by the parliament to censure the commission, which led to the resignation *en bloc* of the commission in May 1999, indicates that the Parliament is increasingly flexing its muscles and becoming more influential in many spheres of EC law.

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25. EC Treaty, *supra* note 19, art. 213.

26. *Id.* art. 211.

27. *See, e.g., id.* arts. 250, 251, 252.

28. Such as the White Paper. Report of the Working Party on Financial Stability, *supra* note 4.

29. EC Treaty, *supra* note 19, art. 251 (although the Parliament cannot force the Council to adopt its proposed changes).

30. *Id.* art. 226.

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#### 4. *The European Court of Justice*

The fifteen judges of the ECJ have jurisdiction over matters of substantive law, such as transport policy and competition policy, as well as over matters of constitutional significance, such as the division of powers between the Member States and the community.<sup>31</sup> The ECJ has frequently been described as “activist” by giving judgments, which have, in effect, enhanced the effectiveness of community law, furthered economic integration, and enhanced the role of community law within the legal systems of the Member States.

As noted above, in times of political stagnation in the council, the ECJ came to play an instrumental role in integration policy. Article 28 (ex article 30), providing for the free movement of goods, states that quantitative restrictions on imports and all measures having equivalent effect shall be prohibited between Member States.

In a pivotal judgment<sup>32</sup> the ECJ held: “measures of equivalent effect” include not only situations where Member States discriminate between domestic goods and goods coming from the outside, but also instances where the same rule applies to domestic and imported goods in a way that inhibits the free movement between Member States. This extensive interpretation—which has since been extended to other areas, such as the cross-border provision of services<sup>33</sup>—has been the subject of much criticism, and has also created difficulties for the ECJ in determining how far-reaching internal market legislation should be. In addition, the ECJ, in interpreting the treaty provisions providing for the four freedoms,<sup>34</sup> can only remove legislation. Its jurisprudence leads to negative integration, in turn necessitating positive legal action on the part of the legislature.

#### C. FINANCIAL SERVICES LEGISLATION

The EC Treaty (the treaty), in setting out the basic aim of achieving an internal market in which the cross-border movement of goods, persons, services, and capital is secured, provided the basis for the aim of creating a single market in financial services.

##### 1. *The Prerequisite—Free Movement of Capital*

The single market in financial services could not have been achieved without liberalization of capital movements.<sup>35</sup> The treaty expressly recognized that the liberalization of banking and insurance services, connected with movements of capital, should be effected

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31. craig & de burca, *supra* note 17, at 79; see EC Treaty, *supra* note 19, art. 220.

32. Case 120/78, *Rewe Zentrale AG v. Bundesmonopolverwaltung für Branntwein* ECR 649 (1979).

33. Case C-76/90, *Säger v. Dennemeyer & Co.*, ECR I-4221 (1991).

34. See *infra*.

35. The importance of capital movements in relation to financial services is recognized *inter alia* in the so-called Second Banking Directive, which states: “. . . there is a necessary link between the objective of this directive and the liberalization of capital movements being brought about by the other Community legislation; whereas in any case the measures regarding the liberalization of banking services must be in harmony with the measures liberalizing capital movements.” Council Directive 89/646/EEC, 1989 O.J., L386/1.

in step with the progressive liberalization of movement of capital.<sup>36</sup> Unlike the other provisions setting out "the four freedoms," article 67, which provides for free movement of capital, was not declared by the ECJ to be directly effective,<sup>37</sup> and considerable legislative activity was necessary to promote capital liberalization. The 1988 Directive<sup>38</sup> was particularly important because it finally established the basic principle of free movement of capital. With the renewed impetus provided by the approach of a single currency, the Maastricht Treaty introduced new provisions on capital and payments. Crucially, a provision was adopted establishing, as a basic and all-encompassing rule, that within the framework of the provisions set out in that chapter all restrictions on the movement of capital between Member States shall be prohibited.<sup>39</sup> An article regulating procedures to be followed in "exceptional circumstances" accompanies this provision.

## 2. Financial Services—General Principles

The market for financial services within the EC has reached a high level of integration. Measures have been adopted in the fields of banking, investment services, and insurance, laying down detailed rules on most aspects of those activities. It is not possible, within the constraints of this paper, to give a complete picture of all those measures.<sup>40</sup> What follows is an overview of the core issues addressed within the EC framework. The measures have been chosen for their fundamental importance in furthering integration of financial markets, but they also illustrate the approach adopted by the European institutions and Member States in this process.

Perceived as high-risk activities, virtually all aspects of banking and financial services have traditionally been subject to a degree of regulation in all Member States. Common features of this regulation include: controls on the level of capital in relation to liabilities,

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36. E.C. Treaty, *supra* note 19, art. 51 para 2. This led the ECJ to conclude that if a service related to a capital movement, which had not been liberalized, the Treaty rules on freedom to provide services could not be invoked, i.e., the capital movements rule prevailed over the freedom to provide services. J. A. USHER, *THE LAW OF MONEY AND FINANCIAL SERVICES IN THE EUROPEAN COMMUNITY* 16 (1994) [hereinafter USHER]. The provision on capital movement was complemented by a provision on current payments, which, to the contrary, was declared by the ECJ to be directly effective, cases 286/82 and 26/83 *Luisi and Carbone v. Ministero del Tesoro* 1984 E.C.R. 377.

37. The notion of direct effect, subject to a plethora of academic comment, has been defined as follows: "... Community law therefore not only imposes obligations on individuals but is also intended to confer upon them rights which become part of their legal heritage" Case 26/62 *NV Algemene Transp.-en Expeditie Onderneming Van Onderneming van Gend & Loos v. Netherlands Inland Admin.*, 1963 ECR 3, and "... these provisions are therefore a direct source of rights and duties for all those effected thereby, whether Member States or individuals who are parties to legal relationships under Community Law," Case 106/77, *Amministrazione delle Finanze dello Stato v. Simmenthal SpA*, 1978 ECR 629.

38. Council Directive 88/361, EEC 1988 O.J. (L178/5).

39. E.C. Treaty, *supra* note 19, art. 56.

40. For an overview of the issues arising in the context of the creation of a single market in financial services, *BANKING AND EC LAW COMMENTARY* (M. van Empel & R. Smits, eds, 1992). USHER, *supra* note 36, also covers capital movements, monetary union and application of EC competition rules to financial services.

size of exposure to a single client or class of clients, as well as controls on the level of exposure to various types of risks such as interest rate risk, foreign risk, and risks on open positions in the financial markets. In addition, the provision of financial services is commonly subject to consumer protection legislation,<sup>41</sup> limitation on the type of business permitted, and laws on advertising.

For complex reasons not delved into in the current context, in the absence of harmonization, the nature, content, and extent of regulation differ considerably between nation states. Financial enterprises seeking to offer their services across borders, or to establish a business in another country, have to comply with the requirements not only of their home state but also those of regulatory and supervisory authorities in those other countries. This will, of course, severely hamper trade in financial services within an RIA. Although arguably of the nature of non-tariff barriers, the regulatory rules serve important purposes, such as protection of the financial system, and consumer protection. Their removal, without accompanying adoption of harmonized legislation, is not an alternative within an RIA.<sup>42</sup>

Initially, the picture within the EC was that of an ambitious harmonization but this proved unrealistic, precisely because of its ambitious character. Thus, the directive that was initially adopted was of very limited scope,<sup>43</sup> and progress on financial services as well as in other internal market areas, was extremely slow.

The new approach<sup>44</sup> signaled a new era, where liberalization would proceed without the need for detailed harmonization. In the commission's words: "The general thrust of the commission's approach in this area will be to move away from the concept of harmonization towards that of mutual recognition and equivalence. But there will be a continuing role for the approximation of Member States' laws and regulations, as laid down in Art 100(sic)."<sup>45</sup>

Instead of attempting to harmonize every aspect of financial regulation, a process that would have been extremely cumbersome, the commission adopted an approach whereby, once minimum harmonization had been achieved at the community level, each Member State would have to recognize that other Member States were pursuing similar ends, and were attempting to protect the same interests. Hence, once the regulatory requirements pertaining to a given aspect of the provision of financial services of one Member State had been satisfied, no other Member State would be permitted to impose

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41. As will be noted *infra*, consumer protection issues are covered by the notion of the general good.

42. Although it should be noted that some commentators, pointing to the direct applicability of the Treaty provisions of freedom of services and right of establishment, questioned the need for further legislative activity to enable providers of financial services to exercise these freedoms. For a summary of this discussion, see E. Lomnicka, *The Internal Financial Market and Investment Services*, Ch. 4, EC FINANCIAL MARKET REGULATION AND COMPANY LAW (M. Andenaes & S. Kenyon-Slade, eds., 1993).

43. The First Banking Directive: Council Directive 77/780 EEC on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, 1977 O.J. (L322/30).

44. The New Approach was set out in the Commission's White Paper on the completion of the internal market, *supra* note 4.

45. *Id.* para 13.

additional requirements. Member States would proceed on the basis that the regulations of other Member States offered sufficient protection.

The technique chosen to promote an internal market in financial services is based on the concepts of mutual recognition, home state control, and minimum harmonization. The Second Banking Directive (2BCD) states that an authorization by the competent authorities of the Member State of the seat of the company (the "home state") to carry on a certain activity shall be recognized by the authorities of other Member States.<sup>46</sup> More specifically, the provisions list a wide range of activities to be subject to the single passport, thereby extending throughout the EU the notion of universal banking.

Much discussed at the time of the adoption, since it would lead to less desirable results for credit institutions based in countries not traditionally recognizing universal banking,<sup>47</sup> the directive was complemented a few years later by the Investment Services Directive, providing for a single passport for investment firm.<sup>48</sup>

As noted above, mutual recognition should be accompanied by minimum harmonization. Accordingly, the 2BCD provides for an absolute minimum initial capital requirement, as well as a requirement to grant authorization subject to certain vetting procedures only.<sup>49</sup> More importantly, minimum harmonization in relation to prudential requirements was achieved with the adoption of the Own Funds Directive<sup>50</sup> and the Solvency Ratio Directive.<sup>51</sup> Capital adequacy requirements in relation to securities activities are set out in the Capital Adequacy Directive.<sup>52</sup> The process of achieving harmonization in this area was rendered less contentious as a consequence of the activities of the Basle Committee.<sup>53</sup>

Responsibility for the prudential supervision of credit institutions rests with the regulatory authorities of the home state, although the host state retains control over certain issues.<sup>54</sup> There is no attempt, however, to harmonize the organization of the institutions carrying out the supervisory functions and hence, the legal character of the designated competent authority may differ between Member States.

Critics have questioned the approach adopted by the EC, maintaining that achieving an internal market in financial services would require complete, rather than minimum, harmonization. Some argue that regulation should be adopted at a supranational level, since minimum harmonization does not remove the risk of regulatory competition nor the risk of "regulatory meltdown."

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46. See Mörner, *supra* note 22.

47. "Non-credit institutions" such as investment firms and insurance firms cannot acquire a passport under the 2BCD because they are not "credit institutions" as defined; yet, in the provision of investment activities they are in competition with universal banks who can. Lomnicka, *supra* note 42.

48. Council Directive 93/22/EEC on investment services in the securities field, 1993 O.J. (L141/27).

49. Council Directive 89/646/EEC, arts. 4.1 and 5, 2BCD.

50. Council Directive 89/299/EEC on the own funds of credit institutions, 1989 O.J. (L124/16).

51. Council Directive 89/647/EEC on a solvency ratio for credit institutions, 1989 O.J. (L386/14).

52. Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions, 1993 O.J. (L141/1).

53. See *id.*

54. Council Directive 89/646/EEC 1989 O.J. L386/1 art. 14.

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Complete harmonization is not a realistic alternative, as evidenced by recent history, more specifically the failure of near complete harmonization originally sought. Although it could be argued that the opening of the "integration window," achieved by virtue of the new approach set out in the Commission's White Paper, was sufficiently wide for the adoption of wholesale harmonization. It is submitted that the situation was the opposite. Only the realization that mutual recognition—accompanied by minimum harmonization—was the maximum attainable,<sup>55</sup> enabled the commission to open the window at all.

Moreover, in relation to financial services, it has been convincingly argued that, rather than encouraging "competition in laxity," the capital standards may serve as a constraint on the growth of banks originating in the weaker Member States, since they may find it difficult to meet them due to low profitability and limited ability to raise new capital.<sup>56</sup>

### 3. *Perfecting the Single Market in Financial Services—Outstanding Issues*

The legislative efforts of the past decade have served to create a near complete single market in financial services. In relation to the retail industry in financial services, for example, the commission has stated that, "In principle you can keep your money where you want to, transfer your money wherever you want to, and borrow money wherever it suits you best."<sup>57</sup>

Nonetheless, critics have pointed to a number of unresolved issues. For example, the extent to which Member States should be permitted to protect the interests of their consumers has generated much debate. To do this effectively requires regulating all business taking place within state territory, not only that of locally licensed businesses. This creates a dilemma in relation to the aim of removing barriers to trade by recognizing the principle of mutual recognition. Distortion in the playing field is an inevitable consequence of permitting each Member State to adopt separate rules to protect consumers.

The problem is compounded by what has become known as the "general good-provision."<sup>58</sup> This provides that host Member States may "take appropriate measures to prevent or to punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interest of the general good."<sup>59</sup> It does

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55. Based, it will be recalled, in no small measure on the jurisprudence of the Court of Justice.

56. C. Hadjiemmanuil, *The European Central Bank and Banking Supervision*, ESSAYS IN INTERNATIONAL FINANCIAL AND ECONOMIC LAW 17, (1996), published by the London Institute of International Banking, Finance and Development Law in cooperation with The International Financial Law Unit, Centre for Commercial Law Studies, Queen Mary & Westfield College, University of London and The SMU Institute of International Banking and Finance.

57. EUROPEAN COMMISSION, EUROPEAN CONSUMER GUIDE TO THE SINGLE MARKET 171 (1995).

58. The Commission's Interpretative Communication "*Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive*" was published to clarify these issues, 1997 O.J. (C209/6).

59. Council Directive 89/646/EEC Art. 21:5, 1989 O.J. (L386/1). The corresponding provision of the ISD goes further, detailing the principles those rules must implement: Council Directive 77/780/EEC Art. 11, 1977 O.J. (L322/30).

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not, however, clarify the extent to which Member States may take regulatory action, or interests that may be protected by such action.

The Court of Justice has recognized professional rules intended to protect the recipient of services<sup>60</sup> and consumers,<sup>61</sup> as well as the preservation of the good reputation of the financial services sector,<sup>62</sup> as being covered, amongst other areas, by the concept of the general good. Furthermore the ECJ, in its case law on the general good, has established certain principles that must be respected by the Member State.

Another area where no harmonization has taken place is the structure of the regulatory and supervisory authorities. At present, differing systems exist in all Member States.

All in all, we contend that the most important message to emerge from the EU experience, in relation to developing countries and their efforts at creating RIAs providing for cross-border liberalization of financial services, is one of caution. Relative success was achieved as a consequence of strong political commitment among the Member States, as well as relatively favorable and, more importantly, converging, macroeconomic factors. In addition, the strong legislative framework provided for in the original treaty enabled the institutions to pursue integration in times of political or legislative inertia.

## V. A Free Trade Approach: NAFTA

### A. FINANCIAL SERVICES LEGISLATION

#### 1. General Background and Guiding Principles

Three features became dominant in negotiating the North American Free Trade Agreement. First, it was negotiated by two countries with high per capita income, Canada and the United States, and one lower income country, Mexico. Second, it brought together one dominant economic partner, the United States, with two relatively smaller countries, Canada and Mexico. Third, it reinforced a U.S. emphasis on regionalism that had begun to emerge some decades earlier.<sup>63</sup>

NAFTA, signed by the United States, Mexico, and Canada entered into force on January 1, 1994.<sup>64</sup> Its institutional framework is considerably less sophisticated than that of the EU. As discussed earlier, the functioning of any given integration effort is closely connected with the institutional framework provided for it. This constitutes one of the main differences between NAFTA and the EU. The adoption of NAFTA must be seen against the background of several initiatives undertaken during the past four decades

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60. Joined cases 110/78 and 11/78 *Ministere Pub. v. van Wesemael* 1979 E.C.R. 35.

61. Case 205/84, *Commission v. Germany*, [1986] E.C.R. 3755.

62. Case C-384/93, *Alpine Investments BV v. Minister Van Financiën* [1995] E.C.R.

63. Sidney Weintraub, *The North American Free Trade Agreement*, In *ECONOMIC INTEGRATION WORLDWIDE*, p. 203 (Ali M. El-Agraa, ed., 1997) [hereinafter Weintraub].

64. Judith H. Bello & Alen F. Holmer, *The North American Free Trade Agreement: Its Major Provisions, Economic Benefits, and Overarching Implications*, in *NORTH AMERICAN FREE TRADE AGREEMENT: A NEW FRONTIER IN INTERNATIONAL TRADE AND INVESTMENT IN THE AMERICAS* (Judith H. Bello et al. eds., 1994).

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to increase U.S. involvement in hemispheric integration,<sup>65</sup> with the ultimate goal of achieving free trade but stopping well short of any "common market" commitment. Initiatives such as the Alliance for Progress, the Caribbean Basin Initiative, and the Enterprise for the Americas Initiative bear witness to the increasing recognition, by a succession of U.S. Presidents, that elimination of cross-border obstacles to trade among American states would be beneficial.

In Canada, an important step towards liberalization of financial services was taken with the adoption of the 1980 Bank Act, providing for entry of foreign banks under a substantially liberalized category. By setting an 8 percent limit on the foreign share of Canadian bank assets, the scene was set for an increase in trade in financial services. There was a limit on foreign ownership of Canadian banks of 10 percent for any individual investor and 25 percent for accumulated foreign ownership.<sup>66</sup> In the 1988 free trade agreement between Canada and the United States (CUFSTA), Canada agreed to grant national treatment to U.S. banks, thereby exempting them from the ceilings laid down on foreign bank assets in Canada. According to the agreement, Canadian banks were allowed to underwrite and deal in Canadian government securities, and they were thereby partially exempted from Glass-Steagall restrictions.<sup>67</sup> From an institutional point of view, one of the most important features of CUFSTA was that financial services were exempted from the dispute resolution mechanism and, instead, consultations were provided for<sup>68</sup> between the Canadian Department of Finance and the U.S. Department of the Treasury.

In many respects, NAFTA represents a continuation of CUFSTA. It constitutes a free trade area, with removal of tariffs on trade between the Member States but, unlike the European Union, it does not create a customs union.

In organizational terms, chapter 12 of the agreement covers services generally, but excludes financial services. Of greatest importance to financial services are chapters 11 (investment), 14 (financial services), and 20 (dispute resolution). In addition, reservations and exclusions are set out in a number of annexes. Mexico is seen as "under-banked,"<sup>69</sup> and reservations were expressed in the negotiations against the impact of allowing U.S. and Canadian banks to compete with Mexican banks. The potential for expansion of the financial services industry, however, was seen as one of the benefits the United States received in exchange for the agreement to open up its markets for Mexican goods and services.<sup>70</sup>

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65. O'Hop, P.A. Jr, *Hemispheric Integration and the Elimination of Legal Obstacles Under a NAFTA-based System*, 36 H.I.L.J. 127, 148 (1995).

66. Porter, T., *North American Financial Integration and Regulatory Cooperation in Banking and Securities*, in *THE NEW WORLD ORDER IN INTERNATIONAL FINANCE* 176 (G.R.D. Underhill, ed., 1997) [hereinafter Porter].

67. *Id.* at 177.

68. *Id.*

69. *Id.* at 180.

70. J.P. Trachtman, *Trade in Financial Services under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 COLUM. J. TRANSNAT'L. L. 37, 58 (1995).

## 2. Institutional Framework<sup>71</sup>

Although it has been claimed that, "The lack of a sizable and powerful central executive does not mean that NAFTA has no institutional depth,"<sup>72</sup> the institutional arrangements are far less sophisticated than those of the EU. Supranationality is kept at a minimum, and the "depth" is evidenced only by numerous working groups that deal with salient issues for the operation of the agreement.

A number of different dispute settlement mechanisms are provided in relation to, for example, financial services, agriculture, and trade. Rosters of panelists have been created for the resolution of many disputes; for example, the financial services chapter provides for specialist resolution of certain disputes. Chapters 18 and 20 cover administration and dispute settlement procedures. According to chapter 20, there are two institutions to facilitate joint administration of the agreement, as well as to avoid or settle disputes between Member States regarding interpretation of the agreement.

A Free Trade Commission, comprised of cabinet-level representatives designated by each Member State, is the "central institution." The commission is responsible for overseeing implementation of the agreement, resolving disputes regarding its implementation or application, and supervising the work of committees and working groups established in accordance with the agreement. It meets at least once a year in regular sessions, chaired successively by each party. Decision-making is by consensus, unless the commission decides to the contrary. In addition, the agreement established a secretariat staffed and supported by the Member States. The secretariat provides administrative assistance to the commission, including anti-dumping matters.

In the aftermath of the peso crisis one can argue that certain macroeconomic features should have been part of the agreement, but this would have entailed a political commitment that none of the parties was ready to give. It has been stated that: "an alert and more independent secretariat might have signaled danger signs."<sup>73</sup>

The agreement contains a separate chapter on dispute resolution. Since chapter 11 on investment and investment disputes allows private investors to seek binding arbitration to enforce NAFTA provisions, the chapter on dispute resolution is only applicable to matters of prudential financial regulations, and to the financial services agreement contained in chapter 14.

## 3. Financial Services Liberalization

### a. Investment Matters

Expanding on recent bilateral arrangements entered into by the parties, chapter 11 provides that each party shall extend: national treatment (treatment no less favorable than it accords, in like circumstances, to its own investors),<sup>74</sup> most-favored-nation treatment (treatment no less favorable than it accords, in like circumstances, to investors of another party or of a non-party),<sup>75</sup> and non-discriminatory treatment (the better of

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71. For a summary of the institutional provisions, see Paul et al. *North American Free Trade Agreement. Summary and Analysis* 100-14 (1993).

72. See Weintraub, *supra* note 63, at 213.

73. *Id.* at 217.

74. North American Free Trade Agreement, Dec. 17, 1992, art. 1102 [hereinafter NAFTA].

75. *Id.* art. 1103.

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national treatment or most-favored nation treatment).<sup>76</sup> The chapter applies to investors of another party and their investments.<sup>77</sup>

A private investor may make use of the dispute settlement mechanism provided specifically for investment disputes. The intention of subchapter B is to ensure both equal treatment among investors of the parties, in accordance with the principle of international reciprocity, and due process before an impartial tribunal.

#### b. Financial Services

In relation to cross-border trade in financial services, NAFTA provides for "mobility of the consumer" as well as "mobility of the provider." Each party shall permit purchase of financial services from service providers of another party.<sup>78</sup> Each party, however, retains the right not to permit such providers to do business or solicit in its territory, and the agreement expressly provides that each party may adopt its own definition of the two expressions. This right is qualified by a duty not to adopt any measure restricting cross-border trade in financial services that is permitted on the date of entry into the agreement.

A financial services provider is permitted to provide a range of financial services through separate financial institutions, in the territory of another party, as may be required by that party to expand geographically within that territory, and to its own financial institutions without the application of ownership requirements specific to foreign financial institutions.<sup>79</sup> In other words, financial services providers of a NAFTA country may establish a commercial presence in the other countries, and new restrictions may not be imposed, unless listed.

During a transitional period, which ended in the year 2000, market share limits are applicable in Mexico. At the end of the transition period, the agreement no longer restricts U.S. and Canadian banking presence in the Mexican market except that the largest Mexican bank may not be acquired.<sup>80</sup>

The agreement also provides for financial services of a type that may not yet exist. In relation to "New Financial Services," a separate provision provides that financial institutions of another party shall be permitted to provide any new financial service of a type similar to those that the party permits its financial institutions, in like circumstances, to provide under its domestic law. A party may determine the institutional and jurisdictional form through which the service may be provided, and may also require authorization. Authorization may only be refused for prudential reasons.<sup>81</sup> It is interesting to note that Mexico has chosen the form of either subsidiary or affiliate for the participation of foreign financial entities, thus banning the establishment. This was to

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76. *Id.* art. 1104.

77. *Id.* art. 1101.

78. *Id.* art. 1405.2.

79. *Id.* art. 1404.2.

80. Broadman, H. G., *International Trade and Investment in Services: A Comparative Analysis of the NAFTA*, in *THE NORTH AMERICAN FREE TRADE AGREEMENT: A NEW FRONTIER IN INTERNATIONAL TRADE AND INVESTMENT IN THE AMERICAS* 205 (Judith H. Bello et al. eds., 1994).

81. NAFTA, *supra* note 74, art. 1406.

facilitate the control of monetary policies by the Bank of Mexico, as well as the financial supervision of affiliates.<sup>82</sup>

Universal banking would always be a contentious issue, with the U.S. Glass-Steagall Act generally restricting the participation of U.S. banks in securities activities.<sup>83</sup> Discontent had already been expressed in Canada in relation to CUFSTA, in which Canada granted national treatment to U.S. banks, as well as partial exemption from the Glass-Steagall provisions, allowing them to underwrite and deal in Canadian government securities.<sup>84</sup> In Mexico, steps were taken to extend the range of activities banks could undertake in the wake of the peso crises in 1994.

Although banks may only undertake activities listed in the Law of Credit Institutions, in practice there are few operations that banks may not perform.<sup>85</sup> NAFTA does not extend the principle of universal banking; in fact, Canadian banks have again expressed disappointment at the very limited possibilities for expansion in the U.S. market.<sup>86</sup>

### c. The Dispute Resolution Mechanism

The financial services chapter provides a special mechanism for dispute settlement. In general terms, the procedures provided for in chapter 20 apply with certain modifications. Thus, a roster of up to fifteen individuals, with expertise or experience in financial services law or practice, shall be established.<sup>87</sup> A basic requirement of any dispute resolution mechanism is the independence of its members and, in this respect, the agreement provides that financial services roster members must be independent of, and not be affiliated with or take instructions from, any party.<sup>88</sup> Furthermore, the agreement provides for the establishment of a code of conduct governing the work of roster members.<sup>89</sup>

Where a party alleges that a dispute has arisen under the financial services chapter, the general rule on panel selection contained in chapter 20 applies, with certain modifications. Thus, the panel shall be composed entirely of members of the financial services roster where the disputing parties agree.<sup>90</sup> In any other case, panelists may be chosen either from the "general" roster provided for in chapter 20, or from the financial services roster, unless a party complained against alleges the prudential "carve out" contained in article 1403 in its defense.

If, in its final report, a panel finds that a measure is inconsistent with the obligations of the agreement, and that no resolution has been reached between the parties within a

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82. Miguel A. Garza, *The Mexican Financial System: Toward a German Universal Banking Model? A Comparative Analysis*, 3 NAFTA L. & BUS. REV. 46, 67 (1997). Mexican banks in the U.S. were granted a five-year exemption from the Glass-Steagall prohibition against engaging in securities transactions. *Id.* at 54.

83. Limited opportunities exist for banks to engage in securities transactions, for example to underwrite securities through bank holding affiliates.

84. Porter, *supra* note 66, at 177.

85. Garza, *supra* note 82, at 67. Mexican banks in the U.S. were granted a five-year exemption from the Glass-Steagall prohibition against engaging in securities transactions.

86. Porter, *supra* note 66, at 179.

87. NAFTA, *supra* note 74, art. 1415.

88. *Id.* art. 2009(2)(b), applicable by virtue of art. 1415(3).

89. *Id.* art. 2009(2)(c) applicable by virtue of art. 1415(3).

90. *Id.* art. 1415(4)(a).

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specified period of time, the complaining party may suspend the application of benefits of equivalent effect to the other party until agreement has been reached on a resolution of the dispute.<sup>91</sup> Where a dispute relates to a financial services sector only, only benefits in that sector may be suspended.<sup>92</sup> It will be recalled that the chapter on investment provides for a special dispute resolution mechanism for disputes between a party and an investor of another party.

#### d. Harmonization of Prudential Rules

Liberalization of financial services unaccompanied by harmonization of prudential rules may lead to a process of "regulatory meltdown."

Very little attempt at harmonization is made in NAFTA. Indeed, the agreement contains a very broad "prudential carve-out" providing that parties shall be permitted to adopt and maintain reasonable measures for prudential reasons. This includes the protection of investors, depositors, financial market participants, policy-holders, policy-claimants, or persons to whom a fiduciary duty is owed by a financial service provider, as well as the maintenance of the safety, soundness, integrity or financial responsibility of financial service providers, or financial institutions, while ensuring the integrity and stability of a party's financial system.<sup>93</sup>

A specialist Financial Services Committee is provided for, but its brief is relatively unspecified. It consists of officials of the governmental agencies responsible for financial services. It is charged with the task of supervising the implementation of the financial services chapter, considering issues regarding financial services that are referred to it by a party, participating in dispute settlement procedures, and examining technical issues under the chapter.<sup>94</sup>

The so-called peso crisis in 1994 offered an opportunity to test the strength of a free trade mechanism in the face of a severe currency crisis suffered by one of the members.

#### e. Critical Assessment and Perspective

Several commentators have discussed the importance of regulatory harmonization, or the lack thereof, within the NAFTA framework. One school of thought holds that the peso crisis "starkly highlights the danger of enthusiastic pursuit of liberalized international markets without adequate consideration of the role of regulatory and political institutions."<sup>95</sup> A slightly different view is that: "despite its comprehensiveness, the NAFTA document did not deal with the one area that turned out to be critical—namely, Mexico's macroeconomic policy."<sup>96</sup>

The macroeconomic framework is of immense relevance, insofar as it constitutes a determinant factor in relation to the extent to which liberalization of trade in goods and services may take place and, consequently, the type of integration arrangement that may be created. In the context of NAFTA, for example, arrangements involving a common

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91. *Id.* art. 2019(1).

92. *Id.* art. 1415(5)(a).

93. *Id.* art. 1407.

94. *Id.* art. 1414.

95. Porter, *supra* note 66, at 183.

96. Weintraub, *supra* note 63, at 216.

external tariff were never part of NAFTA and accordingly, Mexico, in the wake of its financial crises, raised many of its tariffs in relation to countries with which it did not have free trade agreements.<sup>97</sup>

The issue of macroeconomic harmonization must be thoroughly, and separately, examined against the background of each regional integration arrangement. Thus, while a sub-regional arrangement between a few countries displaying relatively similar economic performances may lend itself to, and may benefit from, fairly immediate macroeconomic harmonization, an arrangement such as NAFTA involving a number of heterogeneous countries may be unsuited to any attempts at any meaningful macroeconomic harmonization.

The European Union, which constitutes a highly integrated arrangement, has a very elaborate and sophisticated institutional framework. The institutions of NAFTA, on the other hand, are less sophisticated and consist mainly of working groups created to continuously oversee different trade areas. From its inception, the EU, in its various guises, was intended to provide close economic and political integration between the Member States. The situation is entirely different in NAFTA: there is simply no desire to reach the same level of integration. Measures to achieve positive harmonization are generally not on the agenda. No "common market" is aimed at, in the first place.

Many attempts at liberalization of financial services within an RIA among developing countries aim to create a common market. NAFTA illustrates an alternative approach. Where a common market is not a realistic alternative—as a consequence, perhaps, of macroeconomic factors—a free trade area may seem a superior choice. It is clear that this option, too, requires political commitment by all Member States. Whether the RIA provides for an elaborate institutional framework or not, integration will only proceed when each of the Member States is clearly involved in the process, politically as well as legally.

## VI. Strategies for the Future

What can be derived from the experience discussed above? First and foremost, there is strong pressure on all states to participate in the GATS system. With the expected entry of China into the WTO system, non-participation will become an option for only resolute outsiders to the world system. With GATS an intrinsic part of the WTO, liberalization of services has become an inescapable issue.

At the moment of writing, the actual content of commitments, under the general GATS rules in combination with the respective schedules of the individual Member States, is still modest. The philosophy of GATS, however, is clearly that of a one-way street towards ever more comprehensive and "deep" liberalization.

For financial services, it would appear to be a realistic assumption that many WTO Member States, especially those that are not members of the OECD, will, in the foreseeable future, find themselves committed to liberalize, due mainly to outside pressure rather than as the result of an autonomous choice.

At present, as has been mentioned above, GATS allows for the full implementation of national prudential rules, as well as for a gradual approach to liberalization in terms of

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97. *Id.* at 224.

national treatment. This is, of course, particularly relevant to the financial services sector. Indeed, individual WTO Member States will be able to maintain regulatory systems of their own.

Nevertheless, two major elements will substantially affect the actual implementation of this principle in practice. First, the transparency principle imposed by GATS forces the individual states to spell out their rules and practices, and forces them to implement these in an objective way. Second, many states simply do not have the basis for the autonomous development of such an objective set of rules and practices. This is due to the combination of a lack of experience in this field in the past, and a lack of financial resources to treat this as a realistic priority in the present.

Consequently, there will be great pressure on many WTO Member States to simply "import" complete sets of rules from where they have already been developed. This, then, implies a potential role for sub-regional, regional, or international organizations concerned with the development of such rules, of which the Basle Committee, discussed above, is an example.

There is no need to stress the fact that these organizations, whilst being objectively 'international,' rely on the involvement of the more sophisticated economies. Although, it is now a declared policy to involve other countries in these efforts,<sup>98</sup> it seems almost unavoidable that the harmonized rules developed in these organizations tend to be responsive to the specific needs, and resources, of the more sophisticated economies. While the less developed WTO Member States might welcome, in principle, the possibility of relying on these efforts by others, what they will "import" will not necessarily match their own conditions.

Many individual WTO Member States will find themselves caught in a situation where they are committed to liberalization and subject to a body of regulatory rules and practices, which are not necessarily a realistic proposition for them.

One obvious way out of this dilemma would be the pooling of resources between WTO Member States in a similar situation. Joining an RIA might be a useful intermediate step, which would allow them to comply with their obligations under GATS while, at the same time, being able to make use of the reservations, which are allowed under GATS.

A close look is required at the conditions that should be met for an RIA to fulfill this purpose. First, where the problem is the gap between the reality of the national economy concerned and the frame of reference implied in the rules at issue, substantial benefits can only be expected from cooperation between states in substantially the same position. This similarity should not be taken in too restricted or technical a sense but, rather, should be related to the various aspects of society that go into determining the level of sophistication of the national economy.

Second, it should be stressed that the issue is not confined to the drafting of a set of rules but, rather and even more crucially, relates to the day-to-day implementation. For the RIA to fulfill its purpose, it must provide guarantees in terms of administrative authorities and judicial remedies. Whether this would best take the form of joint institutions and procedures, centralized at RIA-level, or rather that of "home country control" combined with "mutual recognition," remains to be considered on a case-by-case basis.

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98. *Supra* note 2.



All this points towards a "common market," rather than a "free trade area." Indeed, the difference between the two concepts relates precisely to the sacrifice of autonomy, which is the price to be paid for a real pooling of resources. Another important aspect of this is that precisely because of the sacrifices in national autonomy, a "common market" tends to be perceived as inherently more stable than a free trade area. At the same time a word of caution. The EU, in its present form, is the unique result of a unique set of circumstances. Moreover, the present community framework for liberalization *cum* harmonization with regard to financial services was only realized some thirty years after the initial political commitment. Moreover, it would never have seen the light of day but for broader achievements in the trade of goods and services generally, and more particularly as a tributary from prior liberalization of capital movements.

Finally, it has been argued, with some consistency, that even the liberalization *cum* harmonization achieved in the early 1990s was not enough to provide the financial sector with a true sense of stability of political commitment. Rather, for this to become true, what is required is the perception of an irreversible reality of economic and monetary union.

## VII. The NAFTA and MERCOSUR Experience: Analyzing Other Models of Regional Integration

### A. BACKGROUND

This section reviews the impact of regional integration initiatives in North and South America. Specifically, this section looks at NAFTA, comprised of the United States, Mexico, and Canada and MERCOSUR, comprised of Brazil, Argentina, Uruguay, and Paraguay. The core concern is how each of these experiments, representing the second and third biggest regional groupings, has succeeded in liberalization of financial services. In this regard, analysis is focused on the banking and securities markets aspects, rather than insurance and reinsurance.

Accordingly, the first question is to understand the core institutions, and the legal process of decision-making. The next issue is to understand how the agreements function, in terms of intentions, and actual practical evolution of substantive law and implementation. The next question is to understand how disputes may be resolved within the system. Further, the question is asked what the role of the parties are, and to a limited extent, of the parties financial services sector.

The specific role of the financial services legislation is assayed, with a focus on what institutions have been charged with liberalization and what efforts have been undertaken to move the process forward. An understanding of obstacles here is critical as presented by financial circumstances. A look at the core substantive provisions at work here, and what disputes may arise, follows. A preliminary assessment of how good a model the NAFTA and MERCOSUR models may provide is the final concluding observation here.

### B. BASES OF COMPARISON OF CORE REGIONAL INTEGRATION PARAMETERS

Before delving into a full-blown discussion of NAFTA and MERCOSUR it is important to understand some key points about each of the regional integration experiments as to their utility as models for a liberalization of financial services in South America.

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Without pre-judging, such initial observations regarding market and legal system characteristics are valuable in orientating us as to how each regional integration initiatives efforts at liberalization may work in the context of South America.

As to NAFTA, it is a recent phenomenon. It only went into effect in 1994, after being signed by the three countries, and going through the respective ratification process of each country.<sup>99</sup> It is apparently the first treaty involving a regional integration process joining a less developed country (Mexico) and two highly developed ones (the United States and Canada). This is insignificant because in theory the less developed country may benefit from the more developed country's access to its markets, but it may expose itself to large-scale investments from the more developed countries, leading to greater foreign ownership.

In typically sensitive sectors, such as banking, it would not be uncommon for there to be a certain reluctance that U.S. banks may come in and dominate certain markets, shutting out domestic banks. The extent to which this tension has not been a problem in legislation reveals much about how far the markets may already be, as well as the individual receptiveness of Mexico to foreign investment. Finally, NAFTA may simply be viewed as less important, from an operational point of view, due to the operational code that the law is not really taken with the same level of seriousness as in North America.<sup>100</sup>

MERCOSUR was adopted in 1991 in the Treaty of Asuncion, and represents the first South American customs union, made up exclusively of the Southern Cone.<sup>101</sup> It has been slow in adopting any detailed financial services liberalization measures, unlike NAFTA. Its focus has been on trade expansion, with services generally on the back burner. This emphatic distinction may be due to the fact that MERCOSUR seems to have been formed in response to its exclusion from most of the rest of the world's trading partners while Mexico and Canada enjoy the United States as their biggest partner.

Also, Brazil, the biggest actor in the MERCOSUR integration process has a strong policy of protecting its national bank from foreign encroachment, owing perhaps to its desire to retain some control in private domestic hands of this sector. This does not mean greater information sharing and other measures leading to assessing the conditions under which liberalization might be undertaken have not been considered, as well as the basic question of opening the banks up.<sup>102</sup> Moreover, the smaller states such as Paraguay are hardly well prepared for opening up their banking sector to their better capitalized neighbors, given the others' greater sophistication and resources.

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99. ILM, (1993) 32:2 ILM 289, and 32:3 ILM 605; NAFTA AND BEYOND: A NEW FRAMEWORK FOR DOING BUSINESS IN THE AMERICAS (Joseph J. Norton et al. eds., 1995); see also K. N. Schaefer, *International Trade in Financial Services: The NAFTA Provisions* (2000) [hereinafter Schaefer].

100. Professor Michael Gordon, a leading U.S. and international business law scholar focusing on Mexico has often written about the operational code of Mexico whereby the real law must be distinguished from domestic codes. Unless NAFTA dispute resolution provisions are strong as to enforcement of awards, then domestic lack of recognition may obstruct the most beautiful of liberalization schemes.

101. See <http://www.mercosur.org> (last visited July 1, 2001).

102. *Id.* At discussion of sub committees groups and working groups as to financial services in Annex I, Treaty of Asuncion, and other relevant documents.

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### C. PRELIMINARY COMPARATIVE VIEW

The above set of considerations reflect that the stage of integration and focus of each effort, not to mention the relative bargaining power of the parties, have a great deal of practical and theoretical importance as to how liberalization develops. This is because there can be no liberalization in an historical, legal system, or commercial vacuum. Consequently, the above points of reference should be considered relevant to assessing the extent of legal and institutional development that may be possible in a liberalization process. This is not even a measure to ask the question whether any such liberalization is a good thing from a strictly economic policy point of view.

## VIII. NAFTA: The Core Institutions and Processes

### A. INSTITUTIONS

The main institutions of relevance here are the Secretariat that administers the dispute resolution settlement process. The NAFTA Secretariat, comprised of the Canadian, U.S., and Mexican sections, is established by the Free Trade Commission, pursuant to article 2002, chapter 20 of NAFTA.<sup>103</sup> It is responsible for the administration of the dispute settlement provisions of the Agreement. The NAFTA Secretariat also assists a separate commission in various non-dispute-related committees and working groups.<sup>104</sup>

More specifically, the NAFTA Secretariat administers the NAFTA dispute resolution processes under chapters 14, 19, and 20 of NAFTA, and has certain responsibilities related to chapter 11 dispute settlement provisions.<sup>105</sup> Each national section maintains a court-like registry relating to panel, committee, and tribunal proceedings—it is three separate nationally based institutions rather than one. Located in the United States, there is also a Commission on Labor Co-operation as to the side accord on Labor, and a Council of Ministers working on overall policy issues.<sup>106</sup>

There are also a series of joint working groups between the parties as to trade in goods, dispute resolution, and investment, including a financial services liberalization committee.<sup>107</sup> The Canadian and Mexican parties each have their own inter-group body headquarters such as the Environmental Commission and the Free Trade Commission, respectively. Overall, the Free Trade Commission is the central overseer of the twenty-five working committees and the decision making process of NAFTA.<sup>108</sup>

### B. DECISION-MAKING PROCESSES AND THE BUILDING OF LAW

The above NAFTA institutions are generally not empowered to enact any substantive legislation.<sup>109</sup> NAFTA law may in theory have direct effect within the United States.

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103. See <http://www.nafta-sec-alena.org> (last visited 7/3/02).

104. *Id.*

105. *Id.*

106. See <http://www.dfait-maeci.gc.ca/nafta-alena/instgraph-e-asp> (last visited 7/3/02).

107. *Id.*

108. See <http://www.mac.doc.gov/nafta/institutes.htm> (last visited 7/3/02).

109. The Chapter 19 dispute resolution process allows for NAFTA Secretariat to set up procedural rules for the disputes.

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NAFTA does not, however, appear to have direct effect in U.S. courts, although this does not mean it would not be applicable in the first instance in arbitration.<sup>110</sup>

The parties articulated their positions on trade in goods, in services, labor and environmental protections in the text of the agreement in detail. These provisions appear to have been carried out seriously, judging by the parties' own statements as to implementation.<sup>111</sup>

As to disputes between parties, NAFTA prescribes mechanisms for the resolution of disputes. It also provides for the resolution of disputes between private parties and governments.

The general dispute settlement mechanism of NAFTA is an arbitral procedure that refers issues to party governments for political negotiation and resolution.<sup>112</sup> However, NAFTA's anti-dumping and countervailing duty dispute settlement apparatus directly binds. Nationals of parties are entitled to pursue third party arbitration of investment-related claims at ICSID or under UNCITRAL rules, or as any relevant bilateral accords may provide.

### C. INTENTIONS AND LEGAL POWERS IN EVOLUTIONARY PROCESS

NAFTA is designed as a free trade area, primarily for goods. NAFTA prescribes the progressive elimination of tariffs and other restrictive regulations of commerce between members. Common external tariffs for goods originating outside NAFTA territory are not prescribed. With the exception of goods originating outside NAFTA, if such goods are transformed within parties so as to assume a regional character, such third country goods are subject to the payment of tariffs upon entry into each country.

NAFTA provides generally for the free movement of services and capital, and limited free movement of businesspersons, between its members. This is obviously subject to many exceptions. NAFTA also does not have a common commercial policy, although it is working on expansion through an Organization of American States-led effort to create a Free Trade Area of the Americas.

## IX. The Role of Parties in the Financial Sector

One important point to consider is how each of the states' histories in the development of its own financial services conditions its legal position as to financial services liberalization in NAFTA. That is, how did each country's deposit taking banking sector, securities firms, and insurance firms (although not discussed here in any detail) evolve?

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110. See <http://www.jeanmonnetprogram.org/papers/99/990201.html> (article by Frederick M. Abbot) (last visited July 3, 2002).

111. *Id.*

112. See *supra* note 103. This is the home of the NAFTA Secretariat and core investment and trade dispute-resolving body for a detailed discussion of Chapter 19, and of Chapter 20 regarding anti-dumping and countervailing duties.

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### A. THE MEXICAN FINANCIAL SYSTEM

Mexico's banking sector has benefited from various reform efforts in the wake of the 1994 Tequila crisis.<sup>113</sup> Before this, it had been undergoing a privatization process since 1983, as many banks had been nationalized. Indeed, President Goltari in 1998 announced that the banking sector would be completely nationalized, and the 1990 Constitution was modified to affect this objective.<sup>114</sup>

As to securities sales, banks can undertake these through affiliates. Banks are limited as to investing in their customer's businesses. Also, no more than 20 percent of the capital base can be invested in the stock market.<sup>115</sup>

### B. THE UNITED STATES SYSTEM

As to the United States, the recent repeal of the Glass Steagal Act via the Gramm-Leach-Bliley bill has meant that banks can now merge with investment firms to form inter-connected financial conglomerates.<sup>116</sup> The core entity of a bank is the bank holding company through which various activities take place. These activities are based on state licenses rather than federal ones issued by the relevant banking authorities, such as the Central Bank (Federal Reserve) or the Office of the Comptroller of the Currency. The presence of state licensing, however, does not mean a bank from one state cannot acquire a subsidiary, under a single bank holding company, and set up branches thereby in the other state.<sup>117</sup>

### C. CANADA'S SYSTEM

Canada's banking system is based upon a division of types of duties, as in securities firms, trust companies, insurance, and commercial banks.<sup>118</sup> It is further grouped according to type 1 (large well-capitalized banks) and type 2 (foreign banks).<sup>119</sup> There further exist trust companies, insurance firms, and various other entities regulated by federal and provincial authorities.<sup>120</sup>

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113. Jorge Guira, *Servicios Financieros y Una Nueva Era: NAFTA*, in CE Gersovich, *DERECHO BANCARIO Y FINANCIERO MODERNO* (1999).

114. *Id.* at 357, 361; see also *NAFTA AND BEYOND* (J. J. Norton and T. L. Bloodworth, eds., 1995) [hereinafter Bloodworth].

115. *Id.* at 361-62.

116. *Id.* at 363-64. See also Joseph J. Norton and C. Olive, *Putting the GLBA (US) Into a Global Context*, 4 YB INT'L FIN L 236 (for an extended discussion of the Bill itself). See also M. Gruson, *The 1999 US Banking Law Reform and Foreign Banks*, 4 YRBK INT'L FIN L (1999).

117. *Id.*

118. *Id.* at 365.

119. *Id.* at 365-66.

120. Bloodworth, *supra* note 114, at Bryson, *NAFTA Financial Services Implications-Canadian Viewpoint* at 182.

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## X. The Financial Services Aspect of NAFTA: A Detailed Legalistic Regime and Its Interplay with Domestic Banking Law and Institutions

### A. KEY DEFINITIONS

The critical work of coming up with a common body of definitions was a formidable task in view of the above. Specifically, different financial services structures in the relevant states, and therefore different type of competencies meant that specifying what type of activity would be allowable was a first crucial hurdle. This task of harmonization was largely encapsulated as to the key terms in chapter 14 and the Annexes to NAFTA. These include terms such as financial services, financial institutions, financial services provider, and investor.<sup>121</sup> The choice made was to define these terms broadly.

Financial Services includes all private services. The financial service institutions are regulated and supervised bodies, doing business as financial intermediaries.<sup>122</sup> An investment by an investor includes all the resources available to the owner in placing resources into a firm or any other entity.<sup>123</sup>

### B. CORE CONCEPTS

The core idea of chapter 14 is stated in article 14—that it is the right of financial services providers in one state to invest in the other. The applicable standards relating to this right of establishment and right to national treatment are further covered in detail.<sup>124</sup>

Likewise, a parallel set of provisions apply to states whose financial service providers engage in cross-border business. This is subject to certain restrictions; each party must allow its own firms to invest across the border.<sup>125</sup> There is also a general concept in articles 1405 and 1406, whereby each party agrees to treat the others' citizens in an objectively equal fashion, although this does not necessarily mean treatment in the same way as a local firm. This appears to mean that the conditions of competition are the same based on a comparison of circumstances.

### C. MARKET ACCESS AND NATIONAL TREATMENT

It is first important to note that due to questions relating to identifying the nationality of firms, some thorny issues may arise. Specifically, the issue may arise as to whether a financial services provider qualifies as a NAFTA institution if it is owned or controlled by non-NAFTA parties.<sup>126</sup> In such circumstance, it would not appear eligible to receive

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121. Guira, *supra* note 113, at 366(citing Bachman et al., *Financial Services Under the North American Free Trade Agreement: An Overview*, 28 INT'L LAW. 291 (Spring 1994).

122. NAFTA, art. 1416.

123. *Id.*

124. NAFTA, *supra* note 74, art. 1414.

125. *See generally, id.*, art. 1101–1105.

126. Schaefer, *supra* note 99, at 289–94 for a detailed discussion of what and how control may be defined by each party.

the benefits of NAFTA, unless it otherwise qualifies under some other regional integration scheme or bilateral accord whereby it is provided with "most favoured nation" treatment.

As set out in article 1406, it is also apparent that no national may be treated worse than a NAFTA investor/financial services provider.

Two other key considerations exist, according to leading commentator Bloodworth. These are, first, that there is no limit to investment or any form of exchange control. Second, it is indicated that every firm that benefits therein may oppose national restrictions in the foreign territory of the party in which it establishes its cross-border business.<sup>127</sup>

The growth of large financial institutions is especially regulated through January 1, 2000, the final transition period, as indicated under Annex 1404.4. After that, further negotiations are scheduled to take place as to how NAFTA is to move forward in this area, as the parties deem fit. According to NAFTA Annex VII (Miscellaneous Commitments as to Financial Services) and Annex 1413.6, certain reservations are in place as to the extent of involvement allowed in each country's financial services sector.

For Mexico, this means that no more than 15 percent foreign capital in the banking sector, 12 percent in insurance, and 20 percent in investment entities is allowed. The United States sets out an extensive number of reservations, the same as to Canada's, as in the existing CFTA (the predecessor Agreement with the United States). Canada has many provisions including that no private individual of Mexico or the United States may invest more than 10 percent of individual capital in a subsidiary or 25 percent in all subsidiaries.<sup>128</sup>

Transparency is also set out in article 1411 as a requirement of laws that must be followed. This means that each country must have transparency as to what the applicable rules are, the application process to provide services, and in the functioning of chapter 14.<sup>129</sup>

#### D. DISPUTE RESOLUTION

A central Financial Services Committee (as part of the Free Trade Commission) is empowered pursuant to NAFTA article 2001 as to financial services dispute matters, as required by any party. This includes the U.S. Treasury for Banking matters and U.S. Commerce for insurance issues, the Canadian Department of Finance, and the Mexican Secretariat of Public Credit and the Hacienda. This committee is also empowered to engage in a similar review function as to disputes presented regarding private investors of a party.

The jurisdiction of the dispute resolution panel is limited as to NAFTA inter-state matters pursuant to chapter 14, and as to issues arising between private investors and the relevant party government as pursuant to chapter 11.<sup>130</sup> Under articles 2004 and 2021, it is impermissible for NAFTA, including any arbitration panel called pursuant to the above type of disputes, to have as the subject matter purely local matters or exclusively private matters.

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127. Bloodworth, *supra* note 114, at 188–90, and 192–95.

128. NAFTA, *supra* note 74, Annex VII, and Article 1409(10), and Annex 1409.1.

129. K. N. Schaefer, *supra* note 99, at 202–27.

130. See Jeffrey P. Bialos & Deborah E. Siegel, *Dispute Resolution Under the NAFTA: The Newer and Improved Model*, 27 INT'L LAW. 603 (1993).

#### E. WTO INTERACTION AS TO GATS WITH NAFTA

The Uruguay Round that culminated in GATS on December 13, 1997 meant 102 WTO Member States enacted laws and seventy members set out lists for "improvement."<sup>131</sup> A key distinction between NAFTA and GATS begins with what the parties perceive to be financial services and how they propose to regulate entry. Specifically, NAFTA has an institutionally based approach. That is, it looks to the entity/provider affected instead of the type of activity such as banking and banking related, insurance and insurance related activity, to define the scope of allowed activity.<sup>132</sup> Although there is a clear difference in emphasis, perhaps the leading specialist commentator in this sub-field states that there is essential harmony between the commitments of individual NAFTA Member States as to their NAFTA and GATS obligations.<sup>133</sup>

#### F. NAFTA'S IMPACT ON PARTIES

Evidence of growth exists in cross border financial services provision, notwithstanding the 1995 Mexican Tequila Crisis, and any of the global shocks that have taken place in many other banking sectors.<sup>134</sup> Mexico, in particular, has embarked on a series of reform measures under the rubric of the FOBOPROA legislation to reform and modernize its banking and financial law sector.<sup>135</sup> How this set of commercial cross-border relationships will continue to evolve and the impact of the U.S. banking law consolidation measure, the Gramm-Leach-Bliley Act, will have on cross-border investment and financial services trade is a subject that deserves further monitoring. The dynamic process of change in these countries and in the region continues.

### XI. MERCOSUR

#### A. INSTITUTIONS AND LAW

MERCOSUR, in addition to its establishment and existence through the signing of the Treaty of Asuncion, was also subject to, and permitted by, the individual Member States participation and commitments to the Latin American Integration Association (LAIA). This was set out in the Treaty of Montevideo that provides Latin American states with the opportunity to engage in agreements of partial regional scope.<sup>136</sup>

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131. Schaefer, *supra* note 99, at 323.

132. *Id.* at 327-328.

133. *Id.* at 343-356.

134. Guira, *supra* note 113, at 369.

135. Joseph J. Norton, YRB'K. INT'L. LA. 1999 chapter by Thomas Slover regards the Mexican Financial crisis and later reforms, providing a detailed and thoughtful summary. See also Douglas W. Arner, *The Mexican Peso Crisis: Implications for the Regulation of Financial Markets*, 2 NAFTA L. AND BUS. REV. Am. 28 (1996); Joseph J. Norton, *The Mexican Peso Crisis and the Future of Financial Integration in the Americas*. In *THE CHANGING FACE OF LAW IN THE TWENTY FIRST CENTURY: A TRIBUTE TO THE LATE KENNETH R. SIMMONDS* 317 (Joseph J. Norton et al. eds., 1998).

136. *Supra* note 101, at Treaty of Montevideo. See also THE MERCOSUR CODES 11-12, 53-54 (Marta Haines Ferraried., 2000) [hereinafter THE MERCOSUR CODES].

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The primary purpose of MERCOSUR, as set out in the core Treaty and successor agreements, is to establish a common market. It is further to establish a customs union and free trade area encompassing, substantially, all goods. Services are intended to be the subject of liberalization as set out in article 1, chapter 1, based upon reciprocity of rights. However, early efforts did not, other than a technical committee or Working Group Four, set out to work on the project of Fiscal and Monetary Policy relating to Trade (financial services liberalization) of the Common Market Group.<sup>137</sup>

The key institutions of MERCOSUR are set out in article 2, article 8–18, and the Ouro Preto Protocol, enacted in 1994, which adds comment as to the role of MERCOSUR institutions and indicates their status after December 31, 1994, when a transitional period ended for the MERCOSUR. The Common Market Council, the Common Market Group, and the Administrative Secretariat are the key executive and legislative bodies.

The Council is the highest body, made up of the ministries of foreign affairs and economy of the state parties.<sup>138</sup> The Group is the executive body and shall supervise compliance with the treaty, as well as propose specific measures relating to the trade liberalization program including binding resolutions and decisions.<sup>139</sup> Working subgroups on various matters, including financial ones in Group Four, as previously mentioned, assists it.

There is also a Free Trade Commission that handles certain technical questions relating to competition and trade rules that was formed to resolve these types of matters.<sup>140</sup> The Joint Parliamentary Commission formed, as part of the Member States law harmonization function, is also a constituent part of the organizational structure as is a Social-Economic Consultative Forum.<sup>141</sup>

## B. THE DECISION MAKING PROCESS AND MAKING OF LAW

Article 41 of the Ouro Preto Protocol indicates the legal sources of MERCOSUR law. These include the Treaty of Asuncion, all protocols, as well as decisions, and resolutions of MERCOSUR. Article 42 says that protocols shall be binding and shall be incorporated in member state law. This leaves an obvious question as to the enforceability of a Protocol when it is not incorporated in law through some ratification process, even if adopted by the parties. Toward this question, Ferrari notes MERCOSUR law is not supranational and instead relies on national law implementation.<sup>142</sup>

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137. Treaty of Asuncion, Annex V, Mar. 26, 1991 [hereinafter Treaty of Asuncion].

138. *Id.* arts. 9–12; Protocol of Ouro Preto, Dec. 17, 1994, arts. 3–9 [hereinafter Protocol of Ouro Preto].

139. Treaty of Asuncion, *supra* note 137, article 13–14; Protocol of Ouro Preto, *supra* note 138 at 10–15.

140. Protocol of Ouro Preto Protocol, arts. 16–21.

141. *Id.* arts. 22–30.

142. The MERCOSUR CODES, *supra* note 136, at 46–47. There are further distinctions that may be drawn that will not be covered within the context of this discussion as to whether a law is binding, including issues relating to the Constitutional dimension, as also the case with NAFTA.

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### C. THE DISPUTE RESOLUTION PROCESS

A dispute resolution process exists in which both Member States and private parties, as their national sections may allow, can engage in dispute resolution. This is first by way of negotiation and mediation in a politically oriented process, followed by a legal forum of arbitration.

The Protocol of Brasilia provides for most of the key provisions, as well as the Ouro Preto Protocol, in part. Various disputes have been in process as to trade issues through 1999, and June 2000.<sup>143</sup>

### D. THE BRAZIL REAL DEVALUATION CRISIS CASTS A SHADOW ON THE FINANCIAL LAW SYSTEM

The steep devaluation of the Real caused the financial law system in the MERCOSUR states to be the subject of extensive and intensive re-examination. This focus was on Brazil, as well as the other Member States, and focused in relevant part on constructing a solution that solved the immediate problems of actual or perceived public sector imbalance in Brazil, with other measures appropriate to containing the crisis.<sup>144</sup>

## XII. The Financial System

### A. BRAZIL

The Brazilian banking system is overseen by the Central Bank and the Brazilian SEC (Comissao de Valores Mobiliarios). The 1964 Banking Act is the key law that is looked to for guidance, as well as certain 1998 Constitutional law amendments that were to be implemented in the reform effort.<sup>145</sup>

A National Monetary Council made up of the above, as well as the Department of Finance, and Department of Planning and Budgeting engage in banking supervision and monetary policy.<sup>146</sup> Universal banking is allowed pursuant to a group umbrella as set out in Resolution No. 1524 (September 21, 1998).

The foreign banks have an overall 15 percent penetration rate.<sup>147</sup> Brazil is considered somewhat restrictive in letting foreign banks in, although it has become more relaxed, pursuant to Central Bank policy.<sup>148</sup>

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143. See *supra* note 101 for *laudos arbitrales*; see also Jorge Guira, *MERCOSUR: The Dispute Resolution Process*, NAFTA L. REV. (Fall 2000).

144. Jorge Guira, *Containing Financial Crisis: The Case of Brazil*, THE NEW INTERNATIONAL FINANCIAL ARCHITECTURE, Vol. 3 (Rosa Lastra ed., 2001).

145. *Latin America at Undue Cost and Risk: The Brave New World of Sovereign Debt Restructuring and its Private Sector Counterpart* 4 YRBK INT'L FIN LW 429, 431-432 (Joseph. J. Norton, ed., 1999).

146. Maria Celina B. Arraes, *Brazil*. In REFORM OF LATIN AMERICAN BANKING SYSTEMS 29-32 (E. Aguirre & Joseph J. Norton, eds., 2000).

147. Fernando J. Cardim de Carvalho, *THE RECENT EXPANSION OF FOREIGN BANKS IN BRAZIL: FIRST RESULTS*, U. of Oxford Center for Brazilian Studies Working Paper CBS-18-01.

148. Law No. 4728 (July 14, 1965); See also Joseph J. Norton, *supra* note 146, Eva Holz, *Legislative Asymmetry and the Integration of Banking in MERCOSUR: a preliminary approach*.

## B. ARGENTINA

Argentina features a peso-to-dollar convertibility facility as one of its unique aspects.<sup>149</sup> The use of the foreign currency, the dollar, is allowed in domestic transactions.<sup>150</sup> The Central Bank is charged with preserving the value of the currency and price stability, and it has a highly restricted lender of last-resort function. Unlike Brazil, banking functions are divided into investment banks and commercial banks, as historically in the U.S. system.<sup>151</sup>

Financial Institutions Law 21382 (1976) as amended and restated by Decree 1853 is to regulate foreign investment and guarantee national treatment for foreign banks, subject to ownership restrictions. Article 1 of Decree 146/94 modifies the rules, so branches of foreign institutions are treated the same. The Central Bank must determine whether to allow an Argentine bank to establish itself abroad.

## C. URUGUAY

The executive branch and the Central Bank require approval for a bank charter, pursuant to the law.<sup>152</sup> There are annual quotas on the number of charters that may be granted, generally 10 percent of the existing banks. Investment banks are charged with receiving foreign deposits, and overseeing capital market operations by contrast to commercial institutions. The market there is small but relatively sophisticated.

## D. PARAGUAY

Paraguay's banks may be deemed universal banks, foreign financial institution branches, or restricted official banks.<sup>153</sup> Foreign banks may follow their own law but it may not conflict with 861/96 Paraguay's national law. Foreign banks must receive charter-licensing approval from the bank. Foreign branches are treated the same as domestic banks for capital adequacy purposes.<sup>154</sup>

# XIII. The Process of Financial Services Liberalization and the Tentative First Steps

## A. THE PRIMACY OF TRADE IN GOODS AS INTERNAL OBJECTIVE

The overwhelming focus on trade in goods in MERCOSUR appears due in significant measure to its own unique historical experience as markets are to some extent isolated from the global trading economy.<sup>155</sup> This isolation was due region-wide to the

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149. This is pursuant to FIL 928. Marcelo R. Tavorone, *The Argentine Monetary and Financial Framework*, 5 NAFTA L. & BUS. REV. AM. 136 (1999).

150. *Id.* at 141, citing Law 23,928, Mar. 27, 1991 [1991-A] A.L.J.A. including the Art. 1 reform of Argentine Civil Code 619.

151. FIL Law No. 21,526 (Feb. 14, 1977, 1977-A) A.L.J.A. (arts. 21 and 22).

152. Holz, *supra* note 148, at 122-23. Art. 6, Decree No. 15322.

153. *Id.* at 115-18.

154. *Id.*

155. MERCOSUR: REGIONAL INTEGRATION, WORLD MARKETS (Riordan Roett, ed., 2000).

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specific problems relating to the general inability to compete globally as to trade in manufactured goods, or to establish solid niches.

The clear agenda was such that an ambitious schedule of 85 percent of all member state goods were to be subject to MERCOSUR, with certain sensitive sectors excepted, as indicated in the Ouro Preto Protocol Annex. Further, a common market goal of all aspects of free movement of factors of production was to be implemented in the future with a 2006 implicit deadline.<sup>156</sup>

#### B. THE SECONDARY ROLE OF FINANCIAL SERVICES LIBERALIZATION

A key idea that has held MERCOSUR back from producing substantive financial services liberalization is the concept of ensuring that a robust financial system is in place prior to such liberalization on a region-wide scale. This does not mean, for example, that individual foreign banks might not be allowed, or even encouraged, to come in as discussed with respect to Brazil or Argentina. Rather, it simply means that there was recognition that reform in the financial services sector was prudent.<sup>157</sup> This was especially true as any kind of capital account liberalization could help produce a devaluation crisis and thus the establishment of cross-border banking would have to be closely watched.

Moreover, the lack of stability created impediments of member state firms expanding into each other, for the most part, as their focus was on more basic issues of survival and positioning themselves to thrive amidst the difficult domestic and international climate. The idea of greater Argentine banks in Brazil or vice versa could also present the conditions for more problems, as spillovers in the trade sector amply demonstrated in the 1997–1999 period.

At the heart of much of the debate has been the idea there might be some type of dollarization initiative that MERCOSUR might take, as set out in Decision 6/99. This manifested itself in the idea that there should be efforts toward macroeconomic convergence, including the setting out of certain standards, and performance criteria toward the common goal of harmonizing regional Member States finances. This was logically undertaken to diminish regional problems caused by the Brazilian devaluation, as well as potentially setting the ground for monetary union in the long term.

Interestingly, in terms of the degree of liberalization that exists regarding non-member State banking operations, Argentina already has 50 percent foreign bank penetration, as measured by capitalization.<sup>158</sup> Brazil has allowed a major foreign bank expansion program, but this preserve is jealously protected.<sup>159</sup>

Another major issue to constrain the degree of liberalization is the question of proper banking supervisory standards, the type of banking structures (universal or segmented). Asymmetries in size of banking institutions are an obvious concern, not just as to the Big 2, but, more importantly, as to the smaller members, Uruguay and Paraguay.<sup>160</sup>

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156. Decision 6/95.

157. E. M. Goberna, "The Integration Process in MERCOSUR," Second High Level Meeting on the Reform of Financial Systems In Latin America and the Caribbean, Oct. 25–27, 1997, especially at 7–12.

158. John Barham, *A Deal But No Direction*, *LATIN FINANCE*, Feb. 2001, at 3, 11.

159. *Id.*

160. P. Abreu, *Financial Integration in the MERCOSUR countries*, *INTEGRATION AND TRADE*, Jan.–Apr. 1997, at 79.

MERCOSUR has a financial services liberalization group involved in ongoing WTO GATS negotiations.

C. MERCOSUR INTERACTION WITH MACROECONOMIC CO-ORDINATION  
IN ACHIEVING FINANCIAL STABILITY WITHIN THE REGION

As discussed above, it is the emphasis on achieving financial stability that is one of the core challenges to liberalization within the region that remains persistent through the 1990s. There is no reason to think that the instability of the past will not loom as a shadow over further liberalization efforts, and thus condition the term of future debate as to MERCOSUR overall, including the future pace of any reforms in this sector, as well as liberalization.

Consequently, the expectations for sustained liberalization in financial services should be a secondary factor to the overall MERCOSUR agenda, including Macroeconomic co-ordination. Still, it is clear that efforts to share cross-border capital flows information and other goals to improve financial reporting across the region are vital tools in the financial law reform process that liberalization is either the long-term beneficiary of, and otherwise encourages.

D. TRADE IN SERVICES GENERALLY

In Decision 13/97, the Protocol of Montevideo laid out that WTO's GATS model as relevant MERCOSUR law on services liberalization. This provides for the idea that MERCOSUR signatories should stick to certain basic concepts such as market access, most-favored-nation, and national treatment for Member States. This is to be followed with a sectoral approach by Annex. Decision 9/98 sets down a specific schedule of commitments. There are certain conflicts, however, that may be inherent here with the Brazilian Constitution, articles 2 and 4, such as national public policy carve-outs of special protection in certain sectors like financial services.

In addition, there may be some conflicts that arise with MERCOSUR's investor protection in the Protocol of Colonia and in the Argentine-Brazil Bi-National Companies Act.<sup>161</sup> The key idea behind Colonia is to provide non-discriminatory treatment for investment, including a dispute resolution mechanism for any such misunderstandings. An investor is defined as a natural person from a member state, and such investor is to be accorded national treatment, including guarantees against limits on repatriation of capital, and no expropriation.<sup>162</sup> Both states and investors have rights to participate in the MERCOSUR arbitral process.

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161. THE MERCOSUR CODES, *supra* note 136, at 32. See also Ferrari for a discussion of the Bi-National Companies Act, and <http://www.mercosur.org> for the text of the Protocol of Colonia.

162. Protocol of Colonia, Jan, 17, 1994, arts 2, 4-5, 8-10.

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## **XIV. Comparison of NAFTA and MERCOSUR**

### **A. THE LEVEL OF CLOSE U.S. AND CANADIAN RELATIONSHIPS MAKE LIBERALIZATION SEEM AN OBTAINABLE OBJECTIVE**

Perhaps the most fundamental insight would seem to be that for an agreement to work the members involved must be compatible, in some fundamental ways. Canada and the United States enjoy close cultural affinity, including a shared Anglo-Saxon based common law legal culture, and a history of working together on trade, security, and even on the sale of cross-border securities in a single market.

As such, it is not surprising that NAFTA allowed liberalization on the agenda due to the relative confidence that the United States and Canada would have in each other's financial and legal system. The consequent tie to strengthen cross-border relationships between contractually consenting business parties would override any narrow concern over protectionism.

This is so because Canada's banks are strong and therefore generally have nothing to fear, except perhaps some occasional cross-border arrangement. As to Mexico, NAFTA likewise poses no threat to its sovereignty because few U.S. institutions would be expected to rush in and build up the domestic side of the retail commercial banking business there, and the securities business is not that extensive. Moreover, even if market access was expanded, this does not mean that national treatment means equal treatment, potentially deterring some investors from setting up banks.

The dispute resolution mechanism is somewhat untested as to arbitration, but that of Mexico's domestic system is sometimes considered less than reliable in delivering objective justice. These interests explain why the NAFTA was signed, with the U.S.-Canada relationship explaining most of its commercial interest, ironically due in large part to the strength and similarity of legal systems.

### **B. THE DEGREE OF FINANCIAL INSTABILITY WITHIN THE STRONGEST IN MERCOSUR WEAKENS THE CAPABILITY TO LIBERALIZE ACROSS THE REGION SAFELY**

Brazil's financial crisis meant that despite its internal efforts to liberalize as to foreign banks, it was not exactly keen on cross-border expansion. Unsurprisingly, for the MERCOSUR Member States, domestic issues relating to financial stability, rather than enhancing liberalization prospects for their neighbors in this sector was given higher priority. Liberalization in this sector to firms, does not make a great deal of commercial sense at the present time, and thus the impetus for agreement is not as high as other areas.

### **C. EACH COUNTRY'S UNIQUE HISTORICAL SITUATION, SOUNDNESS OF LEGAL SYSTEM, AND THEIR INTER-RELATIONSHIPS TO EACH OTHER CONDITION THE APPROPRIATE DEGREE OF LIBERALIZATION AS WELL AS HOW MUCH LIBERALIZATION TAKES PLACE**

As the above shows, the pace of liberalization seems dependent upon a confluence of economic and legal system factors that are paramount. This applies equally in looking at other banking systems' capability to engage in a process of regional integration.

It is therefore critical to realize that the receptiveness to opening this sector is based on serious and legitimate concerns about national autonomy, or at least its perception in this sphere. There are, as well, major concerns about how foreign banks may cause disruptions to less mature banking law systems than those of more developed states. Moreover, the relevant authorities in the more developed countries always engage in a detailed examination of the banking system of any foreign bank seeking to apply for a license. It should not be expected that concerns about protecting the banking sector, notwithstanding any modernizing effects due to efficiency gains, would not be relevant.

D. NO ONE LEGAL MODEL SEEMS TO OFFER A BETTER APPROACH—KEY IS TO MAINTAIN ROBUST FINANCIAL AND FINANCIAL LAW SYSTEMS AS PRE-CONDITIONS

What seems further evident is that the relative strength of financial law systems is crucial to serious liberalization. No one set of factors exist that set one level of response apart, such as MERCOSUR's go-slow approach, or NAFTA's more detailed and comprehensive process, as the "better way."

Rather, it seems that certain core commercial and legal system considerations are critical. From a legal system point of view, these include the level of transparency, the degree of information sharing, and robustness of the financial law system in terms of overall soundness of supervision and regulation, as well as quality of dispute resolution. Commercial and economic factors, the closeness of the economies to each other, the sovereign debt, the general creditworthiness, the exposure to foreign currency losses, and the overall state of the economy are also critical to ensure that the timing is correct as to any liberalization process.

With this set of factors in mind, and the NAFTA and MERCOSUR experiments as useful guides as to what factors may affect the liberalization process, a further note of caution is in order. That is, foremost, that market access and national treatment be supported not only by the possibilities of the market, but also by a minimal efficacy of the financial law system. Specifically, a pre-condition to liberalization is ensuring safeguards for a financially stable banking law system.<sup>163</sup> And it is this tentative thought

163. The following is a list of additional resources used by the author:

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about *how* the law must operate that is at the heart of regional integration institutions' role in any financial services liberalization regime.

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