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## **CETA AND FINANCIAL SERVICES WHAT TO EXPECT?**

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WHAT TO EXPECT?**

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## ABOUT THE AUTHOR



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## ACRONYMS

CETA	Comprehensive Economic and Trade Agreement (Canada-European Union)
DG FISMA	Directorate-General for Financial Stability, Financial Services and Capital Markets Union (European Union)
FSC	Financial Services Committee
GATS	General Agreement on Trade in Services
IMF	International Monetary Fund
ISDS	investor-state dispute settlement
MFN	most-favoured nation
NAFTA	North American Free Trade Agreement
OSFI	Office of the Superintendent of Financial Institutions (Canada)
TPP	Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership

## EXECUTIVE SUMMARY

The Canada-European Union Comprehensive Economic and Trade Agreement (CETA) is possibly the most ambitious regional free trade agreement that Canada and the European Union have negotiated so far. One of its main components is a chapter that seeks to liberalize trade and investment in financial services between Canada and the European Union, while ensuring that markets and their agents will be properly regulated and protected through prudential regulation. However, this chapter is unlikely to have a significant impact on the financial services sector in Canada and the European Union in the short and medium term. Although some observers fear that CETA might undermine the high quality of financial regulations in Canada or the European Union, this paper's<sup>1</sup> analysis demonstrates that such concerns are unfounded.

1 This paper developed from a presentation that the author gave at the CETA Conference, Faculty of Law, McGill University, Montreal, October 31, 2014.

## INTRODUCTION

In August 2014, Canada and the European Union concluded five years of negotiations for CETA, an agreement expected to come into force sometime in early 2017. CETA is certainly Canada's most significant regional trade agreement since the North American Free Trade Agreement (NAFTA).<sup>2</sup> For the European Union, CETA is also significant, because it is the first deal agreed with a Group of Seven country, as well as the most elaborate trade and economic agreement that the European Union has achieved so far.

CETA corresponds to what is known as a "second-generation" free trade agreement. As such, it goes well beyond reducing tariffs and non-tariff barriers for trade in goods and services. With a view to increasing trade, labour and investment flows between Canada and the European Union, it addresses a range of issues — regulatory cooperation, labour mobility, investor protection, public procurement, electronic commerce and intellectual property. Financial services are an important component of the agreement, so much so that a whole chapter is devoted to facilitating trade and investment in this sector. Apparently, the financial services chapter was one of the last chapters of CETA on which Canada and the European Union reached an agreement (Whittington 2014). The contentious issue was the extent to which the agreement could affect Canada's ability to regulate its financial services industry.

Financial services represent approximately seven percent of the Canadian economy,<sup>3</sup> whereas they represent about six percent of the European Union's gross domestic product.<sup>4</sup> In 2013, financial services, which include insurance services, accounted for close to 11 percent of Canada's total services exports, of which 15.6 percent went to the European Union.<sup>5</sup> According to a report by the Conference Board of Canada, Canadian exports

2 Some could argue that the recently concluded Trans-Pacific Partnership (TPP) could be the most significant trade agreement for Canada since NAFTA. However, the TPP deepens and extends Canada's trade relations with countries with which it already has free trade agreements: Chile, Mexico, Peru and the United States. Therefore, only for Australia, Brunei Darussalam, Japan, Malaysia, New Zealand, Singapore and Vietnam are the benefits arising from TPP completely new. As such, the TPP's impact cannot possibly surpass CETA's importance for Canada — namely, the removal of most existing barriers to trade and investment with 28 relatively rich countries that, as a whole, represent the largest economy in the world.

3 See [www.statcan.gc.ca/tables-tableaux/sum-som/101/cst01/gdps04a-eng.htm](http://www.statcan.gc.ca/tables-tableaux/sum-som/101/cst01/gdps04a-eng.htm).

4 See [http://ec.europa.eu/eurostat/statistics-explained/index.php/File:EU\\_gross\\_value\\_added\\_by\\_industry,\\_2001-2011.png](http://ec.europa.eu/eurostat/statistics-explained/index.php/File:EU_gross_value_added_by_industry,_2001-2011.png).

5 See [www.international.gc.ca/economist-economiste/assets/pdfs/Data/facts-fiches/Pfact\\_ENG\\_Services.pdf](http://www.international.gc.ca/economist-economiste/assets/pdfs/Data/facts-fiches/Pfact_ENG_Services.pdf).

of financial services almost quadrupled between 2000 and 2013, in line with global trends; the United States accounts for half of those exports, as Canadian financial institutions have followed their clients south of the border (Burt and Ai 2014).

For the European Union, services exports to Canada were estimated at €16.4 billion for 2013, which represented about 2.4 percent of total extra-EU exports of services. In terms of financial services exports by the European Union to the rest of the world, they represented about 12 percent of total extra-EU services exports.<sup>6</sup> Unfortunately, there is no data available from either Canada or the European Union about the level of bilateral trade in financial services between the two economies.

Given the relative importance that financial services play in both the Canadian and European economies — as well as CETA's significance for Canada and, to a lesser extent, for the European Union, in terms of trade liberalization — it seems appropriate to assess the impact that CETA's financial services chapter is likely to have on trade and investment in the financial services sectors of Canada and the European Union.

As it stands, CETA is likely to have a marginal impact on the Canadian and European economies in terms of financial services in the short and medium term, because its provisions are for the most part aligned with those of the multilateral General Agreement on Trade in Services (GATS). Therefore, CETA does not offer much that is new in terms of increasing market access and competition. However, in the longer run, the financial services chapter provides a strong basis for Canadian financial institutions to follow their clients as they conduct more business with and in the European Union, and vice versa, as a result of CETA.

Nonetheless, Canada can take actions outside CETA to improve the access to its markets for European financial services firms, notably the cross-country integration of securities regulation and supervision. Such a move would be similar to what the European Union is trying to achieve with its Capital Markets Union project, although the European Union's progress in integrating financial integration in non-banking sectors is already far ahead of Canada's.

## CETA'S FINANCIAL SERVICES CHAPTER

CETA's chapter 15 is dedicated to financial services.<sup>7</sup> The chapter begins by defining a financial service: "any service of a financial nature" (article 2(a)). This definition explicitly includes both banking and insurance services, as well as services that are incidental or auxiliary to such services. Article 2(a) also provides a long list of activities that are considered to be financial services.<sup>8</sup>

Following GATS, "national treatment," "most-favoured nation (MFN) treatment" and "market access" have become the principles on which cross-border trade and investment in financial services between Canada and the European Union will be based. Within CETA's chapter 15, the application of the first principle — national treatment — means that Canadian and European financial services providers, as well as investors, must be treated equally (article 3). There can be no discrimination against the suppliers of financial services and investors originating from the other party. This principle also applies to clearing and payment systems, meaning that the financial institutions of one party must have access to such systems on the same basis as the other party's domestic institutions (article 12).

Second, the principle of MFN treatment ensures that neither Canada nor the European Union offers a better treatment than is found in CETA to financial service providers and investors coming from another country not party to CETA (article 4). If either CETA party offers better treatment to an investor from a non-CETA country, then it must offer this same treatment to suppliers or investors within the CETA countries. In the context of the financial services chapter, MFN treatment also applies to prudential measures, which are regulatory measures meant to safeguard the conduct of financial institutions, in particular, and financial markets, in

7 See [www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/15.aspx?lang=eng](http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/15.aspx?lang=eng).

8 According to the International Monetary Fund ([IMF] 2010, 3), banking services can be broken down into four categories of activities: commercial banking (lending and deposit-taking), investment banking (underwriting securities [bonds, shares, etc.] and advising on the mergers and acquisitions of companies), trading (brokering and dealing in securities and financial instruments) and asset management (management of mutual funds and pension funds). The IMF (*ibid.*) defines "other financial services" to include, in addition to insurance services (life insurance, property and casualty insurance and asset management), financial information and data processing, investment advice, payment and money transmission (e.g., credit cards), settlement and clearing of securities and financial instruments, and financial leasing. It is worth observing, however, that those categories are not clearly defined in practice: banks, brokerages, insurance companies and asset management firms compete with each other to offer many services that traditionally might have been associated with a particular type of financial institution. For an analysis of European financial markets and institutions and their development, see de Haan, Osterloo and Schoenmaker (2012). For a similar, if less comprehensive, analysis of the Canadian financial system, see Freedman and Engert (2003). For a more recent examination of Canada's banking system, see Leblond (2013).

6 See [http://ec.europa.eu/eurostat/statistics-explained/index.php/International\\_trade\\_in\\_services](http://ec.europa.eu/eurostat/statistics-explained/index.php/International_trade_in_services).



general. In such a case, CETA allows the recognition of non-party prudential measures by one of the parties (Canada or the European Union) but gives the opportunity to the other party to share in this recognition of non-party prudential measures through, for example, accession to the agreement or arrangement negotiated with the non-party (article 5).

Finally, in terms of market access, chapter 15 in CETA prevents the parties from imposing limitations with respect to the number of financial suppliers or investors, the value and number of financial services or investment that may be transacted, the level of foreign ownership and the number of natural persons that can be employed (article 6.1(a)). Furthermore, the parties cannot restrict “the types of legal entity or joint venture through which a financial institution may perform an economic activity” (article 6.1(b)); however, a party could require that certain financial services be supplied through separate legal entities belonging to a financial institution (article 6.4). The parties cannot also require that persons appointed to senior management or the board of directors be of a particular nationality (article 8). Finally, the parties must allow persons located in Canada and the European Union, as well as their nationals, wherever located, to “purchase financial services from cross-border financial service suppliers of the other Party located in the territory of the other Party,” without any requirement that such suppliers obtain a permit to do or solicit business (article 7.6).

Within this chapter, the parties to CETA have also undertaken to provide effective and transparent regulation (article 10). This means that regulatory measures shall be “administered in a reasonable, objective and impartial manner” and that laws, regulations, procedures and rulings are to be made available promptly to interested persons as well as to the other party to the agreement, and that, to the extent possible, the latter shall be given an opportunity and sufficient time to comment on such proposed measures. This article also requires the parties’ regulatory authorities to make an administrative decision on an application to invest in a financial institution or to provide a financial service within a “reasonable period,” specifically indicated to be 120 days in Canada’s case (there is no such time specification for the European Union).

Although CETA seeks to liberalize trade and investment in financial services between Canada and the European Union, it ensures that such liberalization will not take place at the expense of either the stability of each party’s financial system or the protection of consumers and investors. This is why the financial services chapter contains a so-called “prudential carve-out” (article 15). This carve-out allows the parties to adopt or maintain “reasonable” measures for prudential reasons: first, to protect investors, depositors and policy holders, as well as financial service suppliers; second, to maintain the safety, soundness, integrity or financial responsibility of a financial institution or cross-border

financial service supplier; and third, to ensure the integrity and stability of the parties’ financial systems.

As well, article 17 in the financial services chapter will lead to the creation of a Financial Services Committee (FSC), to consist of representatives from the Canadian Department of Finance and, most likely, the European Commission’s Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA). The FSC’s role will be to supervise the implementation of chapter 15. The FSC is also expected to “carry out a dialogue on the regulation of the financial services sector with a view to improving mutual knowledge of the respective regulatory systems and to cooperate in the development of international standards” (article 17.4(b)) with respect to strengthening financial stability at the multilateral (that is, international) level. Finally, it will be responsible for implementing the chapter’s provisions relating to investment disputes in financial services.

The last key element of CETA’s chapter on financial services concerns disputes between the parties themselves, as well as disputes between investors and the parties. In terms of dispute settlement between the parties, article 19 stipulates that CETA’s general dispute settlement provisions (in chapter 33) apply in the case of financial services. However, the article specifies that there has to be a separate list of arbitrators for financial services: “The individuals included on the list shall have expertise or experience in financial services law or regulation or the practice thereof, which may include the regulation of financial service suppliers” (article 19.4). Also, it is stated that in the event a panel of arbitrators finds a financial services measure to be inconsistent with CETA, then the “complaining Party may suspend benefits in the financial services sector that have an effect equivalent to the effect of the measure in the Party’s financial services sector” (article 19.5(a)). A party cannot suspend benefits in the financial services sector if a measure in another sector is deemed inconsistent with CETA (article 19.5(b)).

With respect to the process for resolving disputes between investors and the parties — commonly referred to as “investor-state dispute settlement” (ISDS) — the provisions are found in article 20 of the financial services chapter. In general, the provisions pertaining to financial services follow those of chapter 10 on investment.<sup>9</sup> The key issue in terms of ISDS in the financial services sector concerns the prudential carve-out. In the case of a complaint by an investor against one of the parties, the latter can refer to the exception under article 15.1 as a valid defence against the investor’s claim. The reference to the prudential carve-out as the basis for the defence can be done during the proceedings of the arbitration tribunal or it can be done immediately once the claim to arbitration has been submitted, by referring the matter to the FSC “for a decision as to whether and, if so, to what

<sup>9</sup> See [www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/10.aspx?lang=eng#101](http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/10.aspx?lang=eng#101).

extent the exception under Article 15.1 is a valid defence to the claim” (article 20.3). The FSC may also refer the matter to the CETA Trade Committee for a “joint determination” if it is unable to reach a decision by consensus.<sup>10</sup> If the joint determination by the FSC or the CETA Trade Committee concludes that the prudential carve-out is a valid defence applicable to all parts of the claim, then the investor “shall be deemed to have withdrawn its claim and proceedings shall be discontinued.” If the prudential carve-out is a valid defence applicable only to parts of the claim, the joint determination “shall be binding on the Tribunal with respect to those parts of the claim...and the investor may proceed with any remaining parts of the claim” (article 20.4). Finally, if no joint determination has been made (by the FSC or the CETA Trade Committee) within three months of the referral of the matter to the FSC, the investor may proceed with its claim; however, as already mentioned, this does not prevent the party from using the prudential carve-out as a defence against the investor’s claim during the tribunal’s proceedings. Moreover, the arbitration tribunal must not draw any inference from the fact that the FSC or the CETA Trade Committee has not agreed on a joint determination.<sup>11</sup>

## IMPLICATIONS FOR TRADE, INVESTMENT AND PRUDENTIAL REGULATION

What do the provisions found in CETA’s financial services chapter mean in practice? What can we expect in terms of CETA’s impact on the financial services sectors in both Canada and the European Union? Will CETA improve trade and investment in financial services? Will CETA make it more difficult for Canada and the European Union to regulate financial services? These are the questions that financial institutions, financial investors and policy makers might reasonably ask with respect to CETA and financial services, and which are explored below.

### Trade and Investment in Financial Services

International trade in services usually operates according to four “modes” of supply, as defined by GATS. These modes “are meant to capture the different ways in which foreign service providers can reach consumers” (IMF 2010, 2). Mode one refers to the cross-border sale of services. Mode two is associated with consumption abroad (that is, with sale of services to consumers who have travelled abroad to obtain them). Mode three is known as “commercial presence,” which refers to a foreign supplier of services setting up a subsidiary or a branch in another country in order to sell its

services to clients located in that country. Finally, mode four corresponds to the movement of people across borders in order to supply a service, such as when an architect travels abroad to design and oversee the construction of a new building in another country.

When applied to financial services, mode one corresponds to the selling of loans, mortgages or insurance across borders. It also means accepting deposits or savings from abroad. In CETA’s case, for example, a Canadian bank could offer banking services (loans, deposits, investment vehicles and so on) to Europeans via the Internet. As for mode two, CETA implies that a European could travel to Canada to consume banking services. In mode three’s case, a Canadian bank could establish a physical presence in Europe to sell its services — via subsidiaries, branches or joint ventures — to Europeans. Finally, an example of mode four trade would be a situation in which the same Canadian bank would send its bankers to Europe to offer financial planning and investment advice to individuals.

In accordance with GATS, CETA allows financial institutions and financial service suppliers to conduct cross-border activities under all four modes without fear of discrimination, given that the agreement between Canada and the European Union is based on the national treatment, MFN treatment and market access principles. As such, CETA does not represent a significant change with respect to the rules that currently govern trade in financial services between Canada and the European Union.

According to the financial services chapter’s article 7, CETA allows Canadians to purchase financial services from financial institutions located in the European Union, and vice versa. No restrictions can be imposed on such cross-border transactions. However, as stated in paragraph 6 of article 7, this obligation to allow cross-border trade in financial services under modes one, two and four “does not require a Party to permit such suppliers to do business or solicit in its territory.” In other words, Canadian financial institutions that want to sell their services to Europeans, and vice versa, will have to follow the rules and procedures for “doing business” with and soliciting clients in the other party’s territory.

For mode one trade in financial services, article 7.6’s terms mean that Canada could maintain its restriction on deposit taking for foreign banks’ representative offices. According to the Office of the Superintendent of Financial Institutions of Canada (OSFI), such “offices are not permitted to carry on any activity in Canada other than promoting the services of the foreign bank and acting as a liaison between the foreign bank and its clients in Canada.”<sup>12</sup> These representative offices cannot accept deposits in Canada. Presumably, this restriction also would apply to a European online bank that wanted to sell its services to Canadians. If, however, it wanted

10 Annex XX of the financial services chapter, which provides guidance on the application of articles 15.1 and 20, specifies that the matter is automatically moved to the CETA Trade Committee if the FSC has not reached a decision within 60 days.

11 Article 20.6 allows the arbitration tribunal to “decide as a preliminary matter whether and to what extent Article 15.1 is a valid defence to the claim,” but only if the respondent (i.e., the party) requests it.

12 See [www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/wwr-er.aspx?ife=1](http://www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/wwr-er.aspx?ife=1).

to gain access to Canadian deposits without being licensed in Canada, then it would have to adopt a passive marketing approach (that is, not solicit business in Canadian territory). In other words, it would have to wait for Canadians to buy its services, in a way similar to mode two, except that it would be done virtually rather than physically. For financial services associated with insurance and securities, European firms wanting to do business with Canadians on Canadian territory would have to be licensed in each of the Canadian provinces where they sought to do business — a costly affair for European financial institutions. Presumably, Canadian financial institutions wishing to export their services to the European Union also would have to be licensed to do so in the member states where they sought to do business. The good news in that case is that being licensed in one member state allows a Canadian financial services supplier to sell its services across the European Union without additional licensing requirements, under the so-called passport system. Nevertheless, separate national operating procedures might still need to be respected.

For mode two trade in services, CETA allows Canadians to travel to the European Union, and EU citizens to travel to Canada, to purchase financial services. Canadians would have to provide the same information and follow the same rules and procedures as Europeans in the specific member state where the service is being purchased.<sup>13</sup> Similarly, Europeans purchasing financial services in Canada would have to abide by federal or provincial rules and procedures (or both).

With respect to mode three, the usual licensing rules apply, barring any separate and discriminatory requirements and procedures for the other party's financial institutions. For instance, Canadian rules about wide ownership in the banking sector remain in place: no one shareholder can own more than 20 percent of the outstanding voting shares (or more than 30 percent of non-voting shares) if the bank's equity is more than \$12 billion.<sup>14</sup> These rules mean that a European bank that wants to establish a subsidiary in Canada to sell its services can own 100 percent of its subsidiary if the shareholders' equity (or capital) is lower than \$12 billion. The same threshold applies if the bank's owner is Canadian. For their part, European banks that would prefer to sell their services to Canadians via branches rather than subsidiaries would not be allowed to accept deposits lower than \$150,000. This threshold applies to all bank branches of foreign financial institutions and is justified on the basis that these branches are not supervised by the home regulator (OSFI) but by the host regulator. Finally, Canada's Bank

Act stipulates that any acquisition of 10 percent or more of a Canadian bank's assets needs the approval of the finance minister if the bank's equity is \$2 billion or more. In the context of CETA, these thresholds would apply to European banks wishing to acquire the assets of a Canadian bank. Canadian banks wishing to establish a presence in the European Union would technically have to follow the rules of the European Parliament and EU Council's Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions.<sup>15</sup>

With respect to mode four, CETA will allow financial professionals such as personal financial advisers, investment bankers and asset managers to travel between Canada and the European Union to provide their services. In some cases, however, these professionals will have to be registered or even licensed in the territory where they seek to offer their services. For example, in Canada, personal financial advisers are licensed at the provincial level, as are insurance brokers, meaning that such individuals need to be licensed in each province where they would like to offer their services. Unlike the European Union, there are no "passport" or mutual recognition agreements among Canadian provinces that allow such professionals licensed in one province or territory to supply their advice or services across provincial borders.

In sum, CETA provisions found in chapter 15 are likely to have a marginal impact on the Canadian and European financial services sectors, for two reasons. First, these provisions closely follow those of GATS and its annex on financial services,<sup>16</sup> of which Canada and the European Union are signatories. Second, although CETA provides the possibility for the free movement of financial services and the individuals who supply them, many regulatory and licensing requirements are likely to remain in place on both sides of the Atlantic Ocean once the agreement comes into force. Nevertheless, CETA will create trade and investment opportunities in other sectors of the Canadian and EU economies. The firms that will take advantage of these opportunities will need financial services to support their business activities with or in the other party's territory. Therefore, CETA should lead to more trade and investment between Canada and the European Union in the financial services sector. The financial services chapter will simply reinforce these cross-border activities in financial services by providing a relatively clear framework for them to take place without discrimination.

Except for banking, the European Union has gone much further than Canada in terms of putting in place the architecture for creating a single internal market for financial services. In practice, however, a fair amount of

13 For EU exceptions to the cross-border supply of financial services, see chapter 15's annex X. According to the European Commission, it is up to the individual banks to determine whether to do business with non-residents: [http://europa.eu/youreurope/citizens/shopping/financial-products-and-services/index\\_en.htm](http://europa.eu/youreurope/citizens/shopping/financial-products-and-services/index_en.htm).

14 Since GATS' entry into force in 1995, the rules that apply to bank licensing are no longer tied to foreign ownership.

15 See <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32006L0048>.

16 See [www.wto.org/english/tratop\\_e/serv\\_e/10-anfin\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/10-anfin_e.htm).

fragmentation exists in the European Union's financial services markets, at the retail level in particular.<sup>17</sup> Accordingly, the European Commission's DG FISMA is now trying to push financial integration further with an action plan, the Capital Markets Union project.<sup>18</sup> Canada should examine closely what the European Union is doing and has done, if it wants to integrate its own market for financial services other than banking. This process would require working closely with the provinces, without any guarantee of success, however, as the difficulties with the creation of a Canadian securities commission at the federal level have demonstrated (Johnson 2013). It seems reasonable to expect that the potential benefits for trade and investment in financial services that CETA offers might not come to the fore until both Canada and the European Union have truly created single markets for financial services within their own jurisdictions.

## Prudential Regulation

As already mentioned, CETA's chapter on financial services created much anxiety during the negotiations, so much so that it was one of the last pieces of the agreement to be concluded. The fear, on both sides, was that investor-state disputes would either weaken the regulation of financial institutions, thereby endangering the stability of financial systems as well as consumer protection, or result in governments having to pay millions of dollars to complaining institutions to compensate them for lost profits incurred as a result of "overbearing" regulation. For instance, using the provisions found in article 20, a European financial institution could challenge the "fair and equitable treatment" nature of certain regulatory rules and procedures that apply in Canada, arguing that they prevent it from competing on an equal footing with an already established Canadian competitor.

To deal with this fear, the European Union is reported to have favoured the traditional approach to ISDS during the negotiations, whereby the decision as to what is "fair and equitable treatment" is left to the special tribunals set up to deal with such investor-state disputes. Canada, for its part, reportedly argued in favour of the FSC deciding such matters, leaving aside tribunals altogether (Scofield 2013). In the end, as indicated in the previous section, the two sides reached a compromise, whereby the FSC and CETA Trade Committee would act as a filter mechanism for the application of the prudential carve-out before the investor-state dispute moves to a tribunal. This way, the parties give themselves the opportunity to reject frivolous claims made

by financial institutions, as long as both sides reach the same conclusion.

The big question when it comes to the application of the financial services chapter's prudential carve-out is how the FSC or the CETA Trade Committee or a tribunal will interpret the meaning of "reasonable measures for prudential reasons" (article 15.1). To help deal with this issue, Canada and the European Union have provided guidance for these decision-making instances in annex XX of the financial services chapter, in the form of several "high level principles." According to these principles, a regulatory measure is "deemed to meet the requirements of Article 15.1 where it (i) has a prudential objective; and (ii) is not so severe in light of its purpose that it is manifestly disproportionate to the attainment of its objective."<sup>19</sup> Furthermore, such a measure is deemed to meet the provisions in article 15.1 if it is "in line with our common international prudential commitments; or in pursuance of the resolution of a financial institution that is no longer viable or likely to be no longer viable; in pursuance of the recovery of a financial institution or the management of a financial institution under stress; or in pursuance of the preservation or the restoration of financial stability, in response to a system-wide financial crisis."<sup>20</sup> A regulatory measure does *not* satisfy the requirements of article 15.1 if "it is a disguised restriction on foreign investment or an arbitrary or unjustifiable discrimination between investors in like situations."<sup>21</sup>

What can be made of these high-level principles in the application of the prudential carve-out by the parties (via the FSC or the CETA Trade Committee) and tribunals in ISDS? To begin with, it seems logical to conclude that a "reasonable" prudential measure is one that does not represent an "arbitrary or unjustifiable discrimination between investors in like situations." However, such an interpretation is essentially an application of the national treatment and market access principles. Next, consider the high level principle that says that a regulatory measure must have a "prudential objective" and not be "manifestly disproportionate to the attainment of its [prudential] objective" in order to be reasonable and, thus, a valid defence against a claim. But this principle is not more useful than the one above, because specifying that a measure has to have a prudential objective circles back to article 15.1: if a measure does not meet one of the three prudential reasons listed in article 15.1, then it does not have a prudential objective by definition and, therefore, cannot be deemed reasonable. As for the part about a measure not being disproportionate

17 For an analysis of financial integration in the European Union, see Grossman and Leblond (2011). For a comparison of the European Union's financial architecture with that of Canada, see Leblond (2011a).

18 See [http://ec.europa.eu/finance/capital-markets-union/index\\_en.htm](http://ec.europa.eu/finance/capital-markets-union/index_en.htm).

19 "High Level Principles" section in annex XX of the financial services chapter ([www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/15.aspx?lang=eng](http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/15.aspx?lang=eng)), paragraph 4(a).

20 *Ibid.*, paragraph 5.

21 *Ibid.*, paragraph 4(b).

to the attainment of its prudential objective in order to be deemed reasonable, it leaves open the interpretation as to what is deemed “disproportionate.” It seems safe to argue that any prudential measure that is aligned with international standards will be considered proportionate.

Thus, it appears that the high-level principles provided in paragraph 5 of annex XX are the ones that should matter in the application of the prudential carve-out for ISDS. In other words, the prudential carve-out should be a valid defence against a claim by an investor if the regulatory measure in place is in accordance with international standards set by bodies such as the Financial Stability Board, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions or the International Association of Insurance Supervisors. It should also be a valid defence if adopted during a financial crisis as a means to manage the crisis (for example, a forced recapitalization of a financial institution that leads to a significant dilution of existing shareholders’ equity).

As a result, there is little or no basis for fearing that CETA will lead to the weakening of prudential regulations in Canada or the European Union. The agreement is unlikely to prevent Canada or the European Union from regulating their financial systems and the institutions that operate within them as they see fit, as long as those regulations follow international standards.<sup>22</sup> As such, the importance attributed to international standards by CETA removes the pressure on Canada and the European Union to cooperate closely within the FSC in setting common financial regulatory measures in order to make the financial services chapter effective. Such cooperation will therefore be able to continue at the multilateral level, with eyes focused on what the United States does (Leblond 2011b).<sup>23</sup>

22 For an interesting discussion of CETA’s impact on regulatory convergence and cooperation between Canada and the European Union, see Labrecque and Idebdou (2015).

23 In light of the absence of provisions on regulatory cooperation in financial services within CETA, it is interesting to observe that it is this particular issue that has plagued the TTIP negotiations on financial services between the European Union and the United States. The European Union wants to explicitly include cooperation on financial regulation in the TTIP whereas the United States refuses to do so, for fear of undermining the quality of its regulatory framework, let alone of having to revisit the Dodd–Frank Wall Street Reform and Consumer Protection Act (Donnan 2014). The United States argues that such cooperation should take place multilaterally, as with CETA. For the European Union, formalized regulatory cooperation within the TTIP would provide greater certainty that European financial institutions operating in the United States would be able to pursue their activities on terms equal to American ones and, therefore, not be negatively affected by US regulations protected under the prudential carve-out. Although Inu Barbee and Simon Lester (2014) argue that such fears are overstated—which this analysis of CETA also demonstrates—the European Union has nevertheless threatened the United States with the removal of financial services altogether (i.e., in terms of market access) from the TTIP if financial regulatory cooperation is not included in the negotiations. At the time of writing, it appears this issue has not yet been resolved.

## CONCLUSION

One of CETA’s key chapters seeks to liberalize trade and investment in financial services between Canada and the European Union, while ensuring that markets and their agents are properly governed and protected through prudential regulation.

In light of CETA’s overall ambition, it is unlikely that its impact on the financial services sector in Canada and the European Union will be significant, at least in the short and medium term. Existing barriers to trade and market access are not high to begin with, due to the parties’ commitments under GATS, whose provisions on financial services are similar to those found in CETA’s financial services chapter.

Increased trade and investment in financial services between Canada and the European Union are more likely to occur in the longer run as a result of greater domestic market integration. In the European Union, the creation of a single market for financial services remains a work in progress, most especially at the retail level; however, EU institutions have been working hard over the last 15 years to remove all types of barriers to trade and investment in financial services and to encourage institutions, investors and consumers to conduct their financial affairs across borders within the European Union. For Canadian financial institutions, such an integrated policy framework provides opportunities to supply financial services to the largest economy (and one of the richest ones) in the world.

For EU financial institutions, the Canadian market for financial services represents more of a challenge. Canada does not have internal free trade for some financial services—for example, insurance, securities brokerage and personal financial advice. Therefore, EU suppliers that would like to offer financial services in those areas need to follow the different rules and procedures established by the provinces and territories. As a consequence, European suppliers are likely to restrict their activities to the richest and most populous provinces, leaving the others with less competition and variety in terms of financial services, especially at the retail level. Therefore, federal, provincial and territorial governments should work together to find ways to remove those barriers and integrate markets for all financial services across the country, just as they have done for banking. However, the saga of the efforts to establish a national securities commission, from which Quebec and Alberta have sidelined themselves, bodes ill for such success.

Adopting an even longer perspective, if Canada and the European Union were to move beyond the current limits imposed by CETA in terms of regulatory cooperation in financial services and to harmonize their financial regulatory architecture to create something more akin to a single market for financial services, then one could expect a much bigger impact on Canada-EU trade and investment in this sector. Unfortunately, there is

currently nothing in the cards to suggest that such cooperation is possible. The two parties have decided, for the time being, to limit their cooperation in financial regulation to information sharing within the context of CETA; otherwise, any cooperation is to take place at the multilateral level internationally. As long as Canada and the European Union have not managed to create an internal single market for financial services within their own borders, it seems pointless to try to create a transatlantic one. Until then, the only scenario that could change this logic is if the TTIP between the European Union and the United States were to include provisions pushing for deep regulatory cooperation across the Atlantic in matters of financial services, which also seems highly unlikely at this stage.

Finally, the fears that CETA would undermine the high quality of financial regulations in Canada or in the European Union appear to be unfounded. The prudential carve-out provisions and the high-level principles that guide their application in case of an investor-state dispute are such that regulatory measures aligned with recognized international standards should provide a valid defence against an investor's claim to an unfair loss of profit as a result of the application of these regulatory measures.

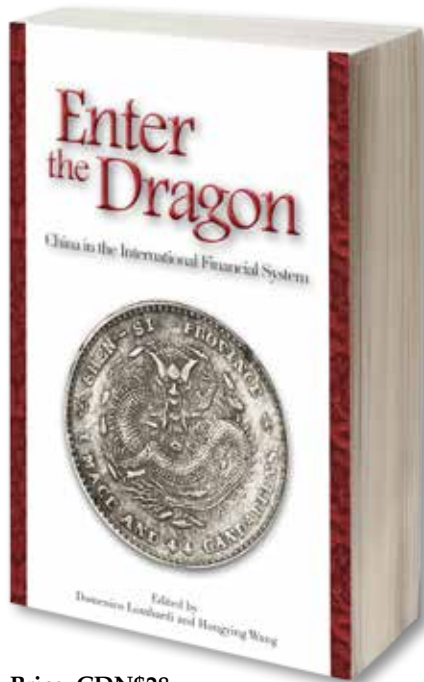
In sum, the entry into force of CETA sometime in early 2017 should not represent a major shock to financial services markets in Canada and the European Union. If financial service suppliers and their clients take advantage of the trade and investment provisions offered by CETA, they are likely to do so in the long term rather than in the short or medium term. In addition, the fact that European financial institutions and individuals have yet to recover fully from the banking and debt crises that the region experienced between 2008 and 2015 does not help. The European Union is not currently a very attractive destination for supplying financial services. This situation also means that EU financial service providers are much less concerned with international expansion than with consolidating their domestic positions and strengthening their balance sheets.

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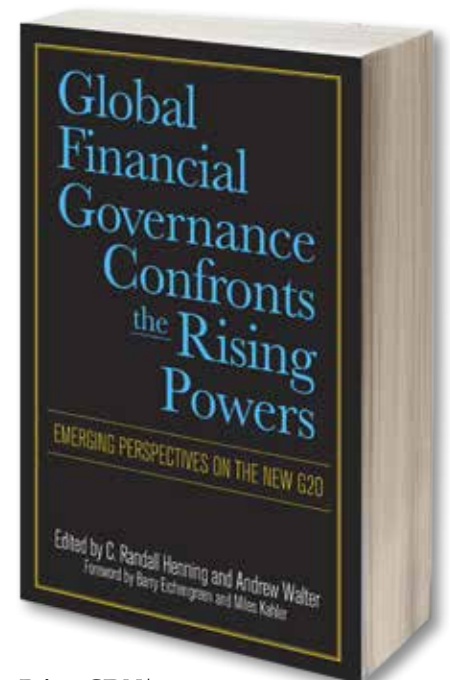
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This policy brief recommends that to diminish the potential for holdup, uncertainty around patent rights should be reduced. Patents should be easily searchable, more easily understood by non-legal experts, narrower and more clearly demarcated. To the extent that patents' welfare costs seem to outweigh their benefits, requirements for obtaining a patent should be tightened. Further, patents should be less broad and their duration reduced, concomitant with shortened product life cycles.



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