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## Articles:

**International Financial Regulatory Standards and Human Rights:**

**Connecting the Dots**

*Motoko Aizawa, Daniel Bradley and Margaret Wachenfeld*

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# Manchester Journal of International Economic Law



*The Manchester Journal of International Economic Law is first and foremost an International Economic Law Journal. Its geographical origin breeds a sense of pride to distinguish it from other Journals in the field. Manchester, also as a city is a good symbol of globalisation; international in its racial and cultural diversity, and occupies an important place in the history of international economic relations—being the city from where came one of the original calls for free trade. Appropriately therefore the matches in international economic scholarship should result in goals from Manchester too!*

— Asif H Qureshi, Editorial, MJIEL, 2004, Volume 1, Issue 1

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financial sector contributes to making societies wealthier and contributes to their resilience, stability and the degree of equality in a society.

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regulation and supervision at the national level where human rights impacts – positive and negative – will ultimately be experienced.

The paper has a second purpose. It seeks to facilitate dialogue between financial regulators and human rights experts. The lack of serious interaction between financial regulators and the human rights community has increased the risk that the adverse human rights impacts caused by the failures of the financial sector will continue. This situation is likely to continue until both the human rights community and the financial regulators take the time to learn about the relevance of the other sector to their work. The human rights community needs to develop sufficient understanding of the financial sector and the international financial regulatory structure that they can begin to articulate more clearly and precisely how international financial regulatory standards impact on human rights. Similarly, the financial community in general and financial regulators and supervisors, in particular, need to understand enough about human rights that they come to appreciate that financial transactions and financial regulation inevitably have human rights impacts and that it is in their interest to anticipate and manage these impacts.

There are reasons to believe that the prospects for a productive discussion between human rights experts and financial sector regulators are improving. There are new regulatory initiatives designed to promote a more socially and environmentally sustainable financial system.<sup>8</sup> Some central banks and financial regulatory authorities, motivated by the consequences of the financial crisis and the recognition that increasingly unequal societies are unlikely to be stable or sustainable, are paying more attention to the distributional impacts of their policies.<sup>9</sup> Similarly, some human rights experts are researching how human rights can most effectively contribute to economic development.<sup>10</sup>

In order to make this case, this paper is structured as follows: Part 2 defines the scope of this paper. It includes brief overviews of the SSBs and the international financial regulatory standards that are the focus of this paper. It also describes the international human rights standards used in this paper. Part 3 explains why human rights are relevant to finance and financial regulation Part

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**2.1.1. Basel Comm6G 927( )TJ-0 0J9.724 0e 4(non)5( )l nkHup5(He4(nrvi3(msor724 s)7(u.73(J9l)-4(C)159l)-**

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unduly large variations between the risk weightings used by different banks for similar classes of assets.<sup>19</sup>

*Pillar 2: Core Principles for Effective Banking Supervision (CPB)*<sup>20</sup>

The CPB is aimed at banking supervisors and regulators. It provides them with a set of 29 principles to guide them and their governments in establishing an effective banking regulatory and supervisory framework. It covers such issues as the powers, responsibilities and functions of banking supervisory authorities and such aspects of prudential banking regulation as corporate governance; management of credit; concentration, market, liquidity, interest rate, and operational risk; transparency; and customer due diligence.

*Pillar 3: Consolidated and Enhanced Disclosure Framework (CDF)*<sup>21</sup>

The CDF, issued in 2017, consolidates all existing Basel discles8.6-646(s(s )-7( r)equhei)5(r)-1(em)17(en5)9(s )-

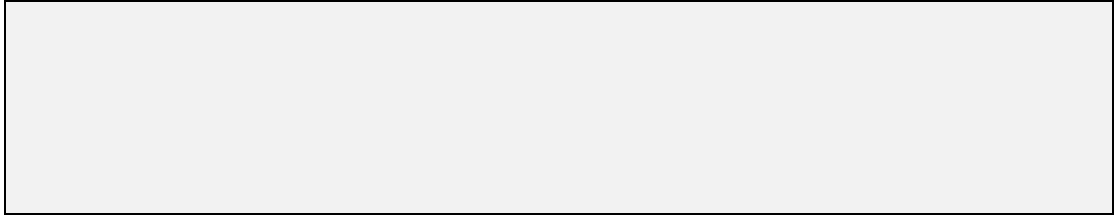
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to ensure that the standards will respect, protect and promote the fulfilment of human rights in the regulation of that part of the financial sector subject to their regulatory authority.<sup>74</sup>

In this regard, it is important to note that in many financial systems the regulatory authorities delegate the regulation of financial markets to self-regulatory organizations (SROs). This is the case for example in markets for debt and equity securities in countries as diverse as the USA and South Africa. In these cases, the state and the financial regulatory authorities cannot rely on this delegation of authority to evade their obligation to respect, protect and fulfil the rights of those individuals subject to their jurisdiction and to ensure that maximum available regulatory resources are used to realize ESC right. At a minimum, they must ensure that the SRO to whom they have delegated this authority use it in ways that are consistent with the

### 4.3. The Human Rights Responsibilities of the Regulated Entities

The financial institutions regulated by the members of the SSBs and pursuant to SSB standards are not themselves signatories to any international human rights treaties and are not subjects of international law. Nevertheless, they are organs of society and therefore have a responsibility to respect human rights. The nature of this responsibility has been elaborated in the UN Guiding Principles on Business and Human Rights (UNGPs).<sup>75</sup> This responsibility entails putting in place a human rights policy, undertaking human rights due diligence to know and show to stakeholders that they have identified and are managing the human rights risks arising from their own operations and business relationships.<sup>76</sup> These institutions also have a responsibility, pursuant to Pillar 3 of the UNGPs, to put in place processes to remedy adverse human rights impacts with which they are involved.<sup>77</sup>

In fact, most of the globally significant financial institutions either have formal human rights policies or have made public representations in their publications on their commitment

<sup>74</sup> There is one important caveat to this conclusion. The home states of the members may have all signed different human rights treaties. Consequently, the specific human rights obligations of the SSB members might vary depending on the identity of their home state. However, while this is an important caveat, it does not undercut the general conclusion that the SSB members have a responsibility to pay due regard to the human rights impacts of the international standards developed by the SSBs.

<sup>75</sup> See Box 2 above.

<sup>76</sup> A full elaboration of the human rights responsibilities of business, including financial institutions is beyond the scope of this paper. However, there are a number of international statements that discuss how the UNGPs apply to businesses in general and to the financial sector in particular. See e.g., [www.ohchr.org/Documents/Issues/Business/InterpretationGuidingPrinciples.pdf](http://www.ohchr.org/Documents/Issues/Business/InterpretationGuidingPrinciples.pdf) and <https://mneguidelines.oecd.org/rbc-financial-sector.htm> (accessed March 2018).

<sup>77</sup> See Letter to the Thun Group of Banks by the Working Group, 27 23 February 2017, available at: [www.ohchr.org](http://www.ohchr.org)





a way that the financial system only serves the interests of some of its stakeholders. For example, it may only offer savings or investment products that are targeted at individuals who have certain levels of income and wealth or at firms that meet certain risk parameters.

- x *Ensuring an effective payment system for economic/financial transactions:* This involves helping individuals, firms and institutions pay for specific transactions by moving funds from their financial accounts to the accounts of their counter-parties.

Financial sector regulators and supervisors are responsible for ensuring that the financial system sustainably performs all the above functions. This requires them, collectively, to monitor:

- x individual institutions to establish that they are safe and sound
  - x markets to make sure that they are transparent, fair and efficient
  - x both individual institutions and markets to ensure that their consumers are treated
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progressively realize the human rights to food, water, education, health care, decent employment and social security.

The third category relates to the responsibilities of both the regulatory authorities and SROs when the former delegates its regulatory responsibilities to the latter. The key issue in this regard is ensuring that the delegation does not enable the state to evade its human rights responsibilities under the human rights treaties that it has signed.

The following are examples of how human rights arise and are not adequately addressed under particular provisions of the OPSR.

7KH ILUVW H[DPSOH UHODWHV WR WKH UHJXODWRU\ DXW maximum available resources are allocated to the progressive realization of ESCR. OPSR Principle 36 requires the regulators to monitor the conduct of market actors and to have the powers necessary to effectively identify and investigate possible cases of market manipulation.<sup>114</sup> The explanation to the Principle makes clear that these powers are important because market manipulation undermines the integrity and fairness of the market and can result in distortions in the allocation of financing.<sup>115</sup> This follows from the fact that manipulations may affect key market prices ±for example interest rates<sup>116</sup>--

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of due process that is consistent with the delegating authority before imposing any sanctions on non-compliant individuals. The explanatory notes to Principle 9 state that the SRO should follow similar professional standards of behaviour to the regulator in regard to matters of confidentiality and procedural fairness.<sup>119</sup> However, it does not elaborate on what these standards should be or how much, if any, deviation can take place and still constitute similar standards. The failure to fully resolve this issue creates a risk that SROs may adopt practices and procedures in this regard that fail to fully comply with the requirements of the right to an effective remedy. Given the importance of this right, it would be helpful if the international standards clarified that the SROs must comply with the same standards of procedural fairness in performing their responsibilities in this regard as would be expected of the delegating regulatory authority. Failure to do so may, perhaps unintentionally, signal to SROs that they may provide a procedurally weaker form of effective remedy than human rights law requires or than their delegating authority would provide.

*Function 3: Managing risk in the financial system*

The international standards that are relevant to this function are the BCA, CPB, ICP, OPSR, CPMI and the Recommendations. The risk weightings of the BCA influence the risk management approaches that banks adopt, including the form and nature of the assets in which they will invest and the identify of those to whom they will extend credit.<sup>120</sup> The CPB, ICP and OPSR create the regulatory framework that determines the approach that the regulated entities should take in managing the risks to which they are exposed. They also affect the approach that the regulatory authorities take towards supervising the risk management approaches of their regulated entities.<sup>121</sup>

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management purposes by the financial regulatory authorities. All the international financial regulatory standards considered in this paper discuss risk issues but none of them make clear whether human rights risks should be considered as potential material risks for regulatory purposes. The failure to explicitly address these risks does not mean that human rights risks do not exist<sup>2</sup> as indicated above finance and financial regulation always and unavoidably have human rights impacts, some of which will pose reputational, operational or credit risks to financial institutions. There are many examples that demonstrate the relevance of human rights risk to finance.<sup>124</sup> One recent example is the Dakota Access Pipeline project in North Dakota.<sup>125</sup> In this case, the failure to adequately address human rights risk contributed to the controversies over the financing of the project. These controversies reached such intensity that some of the banks funding the project decided to withdraw from the project rather than to continue bearing the reputational, operational and credit risks associated with the project.<sup>126</sup>

Financial institutions and their regulators are beginning to recognize that the failure to internalize human rights risk merely means that they have implicitly decided to allow the financial actors that may be contributing to the risk to avoid having to accept responsibility for the risk. Financial institutions themselves have adopted standards, such as the Equator Principles<sup>127</sup>, and formed groups such as the Thun Group<sup>128</sup> to address at least aspects of this issue. At least one national banking supervisor recognized how human rights risks to individual banks could ultimately

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requirements under Pillar 3.

*Function 4: Promoting liquid, transparent and efficient financial markets*

The international standards that are relevant to this function are the CPB, CDF, ICP, OPSR, and CPMI. The CPB, ICP and OPSR create the regulatory frameworks that determine the approach that the regulated entities should take in their participation in financial markets and that the supervisory authorities should take in supervising the activities of their regulated entities.<sup>136</sup> The CDF seeks to promote market discipline through regulatory disclosure requirements. The CPMI is implicated because the settlement and payment systems have an impact on the efficiency and liquidity of markets.<sup>137</sup>

There are three categories of human rights issues that can arise in regard to this financial function. The first category are the four common human rights discussed above-- non-discrimination, privacy, access to information and right to an effective remedy. The second category includes the responsibilities of SROs and other non-state actors who are exercising delegated regulatory responsibilities. This issue was discussed in regard to the investment and risk management functions and so will not be repeated in connection with this function.

The third category is the definition of the factors that the SSBs treat as having a material influence on the transparency and efficiency of markets. As has been discussed above, human rights considerations can affect confidence in the integrity and fairness of financial markets. This in turn will influence their efficiency and liquidity. Consequently, one would expect the SSBs to pay some attention to human rights issues in the disclosure requirements in their international financial regulatory standards. However, as shown in the following two examples, these issues are not explicitly addressed in the international standards.

The first example deals with disclosures by banks. The current version of the CDF does not provide guidance on how banks should deal with human rights risks. As discussed above this is surprising because many major international banks have recognized that human rights is relevant to their performance and have human rights policies or public statements on their approach to human rights.<sup>138</sup> The failure of the BCBS and its members to discuss these risks means that it is failing to provide guidance to the banks, their supervisory authorities and the public about how it thinks banks should handle human rights risks in their disclosure statements

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to the size of the institution (in terms of assets, operations and volumes of transactions) and its systemic importance, and the relative lack of attention to the number of clients served by an institution. Institutions serving poorer communities can have large number of customers, which makes them extremely important for the welfare of some communities even though they are small institutions in terms of assets and other financial indicators. The social, human rights and political consequences of the failure of such a bank can be profound, even if its economic and financial consequences may be relatively small. This suggests that the application of international standards to smaller institutions requires discretion and care. The SSBs should also pay more attention to international soft law standards like the Principles on Responsible Investing, those proposed by the Alliance for Financial Inclusion, and the Global Reporting Initiative in developing standards and explanations applicable to this situation. It also suggests that there is a need for the SSBs to provide more guidance on the meaning of the principle of

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facilitate unduly risky or illegal activity. This is harder to implement than to state because of the number of transactions passing through any payment system and the way in which transactions are aggregated in the payment system. Consequently, the regulatory authorities need to strike a balance between requiring adequate information to identify risky or illegal activity and the individuals engaging in it and demanding so much information that compliance with the regulations becomes unduly invasive, burdensome and expensive. If the balance is incorrect there is a risk that the safety and efficiency of the system can be undermined either because it is abused by some users or because using it becomes too costly.

An example of the importance of the PFMI dealing with the right to non-discrimination is Principle 18 which sets out the requirement that there should be fair and open access to the financial market infrastructure.<sup>155</sup> The Principle does not however clarify which criteria should be considered for participation in the FMI but does not explain what risk-related requirements<sup>156</sup> for participating in the FMI but does not explain what risks in the PFMI only mentions risks related to the safety, efficiency and stability of the FMI, such as legal risk, systemic risk, credit risk, liquidity risk, general business risk and operational risk.<sup>157</sup> While these are important and relevant considerations, they do not deal with all the relevant factors.

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and optimize the positive impacts, thereby improving the quality of the standard.

- x Second, a human rights perspective can also improve the capacity of the SSBs to comprehensively assess the risks to the safety and soundness of individual financial institutions, the fairness and efficiency of markets and to contribute to the stability of the financial system. This follows from the fact that a human rights approach by making transparent the impacts of proposed standards on individual savers, investors and consumers of financial services will make it easier for the SSBs and their members to understand the likely response of the various stakeholders to the proposed standards. This will enable them to adjust the standards to optimize its impact. It will also enable them to better assess how well the financial system is performing all its functions and the sustainability and stability of the system.
- x Third, a human rights approach should allow all affected stakeholders to better understand the potential impacts on them of the proposed standard. This can help promote greater engagement and exchange of views about the content of the standards, thereby ensuring that the standards are as responsive as possible to the needs of the SSB members, the regulated entities and their customers. This increased engagement may also provide the SSBs with new information that makes it easier for them to identify and address any unintended consequences of the proposed standard.
- x Fourth, if the SSBs and their members have a good understanding of the human rights impacts of their proposals, they will be able to identify the potential linkages between what they are proposing and the responsibilities of other governmental agencies. The potential impact can be communicated to other parts of the government that can consider introducing regulatory measures to mitigate their negative impacts or optimize their potential positive effects. The human rights approach thus helps government agencies communicate and coordinate when there is otherwise little incentive for them to do so. For example, once the FATF recognized that its know-your-customer recommendations were making it easier for banks to identify potential customers engaged in human trafficking, it could begin working with law enforcement agencies to reduce the exposure to human trafficking within the communities in which their regulated entities operate.
- x Fifth, in order to conduct an effective human rights analysis, the SSBs will need to be more transparent and more open to participation by all stakeholders. This in turn should increase confidence that the international standards are responsive to all stakeholders in the financial value chain. It should also enhance their legitimacy and credibility, thereby making the standards more robust.

### *The Costs of the Human Rights Approach*

It is clear that the cost of developing international financial regulatory standards will increase if the SSBs begin to incorporate a human rights approach into the formulation of their standards.



Similarly, while close attention to financial inclusion will address some human rights issues, it does not address all of them. In particular, it may not deal with the possibility that the techniques used to promote financial inclusion can also create violations of human rights, such as lack of privacy, extreme indebtedness, discrimination, and marginalization.<sup>166</sup> While these impacts are no doubt unintended, they can be identified and mitigated most effectively through a human rights analysis.

### 6.3. Are there Unintended Consequences for Human Rights?

This study has argued that incorporating a human rights analysis into financial regulation will add value to financial regulation, even though it will impose some costs. In this section, we explore the risks to human rights from being incorporated into the formulation of international financial regulatory frameworks and standards.

Human rights are universal and inalienable; indivisible; interdependent and interrelated.

Among other things, human rights are indivisible, interdependent and interrelated. The rights and freedoms set forth in the International Declaration of Human Rights, the International Covenant on Civil and Political Rights, the International Covenant on Economic, Social and Cultural Rights, and the African Charter on Human and Peoples' Rights are a single and indivisible system of rights and freedoms. The rights and freedoms set forth in these instruments are interdependent and interrelated. The rights and freedoms set forth in these instruments are a single and indivisible system of rights and freedoms.

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