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## Articles:

### **International Financial Regulatory Standards and Human Rights: Connecting the Dots**

*Motoko Aizawa, Daniel Bradlow and Margaret Wachenfeld*

**Regulatory Standards and Human Rights**



# 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 is vital to understanding its distinction 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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Issue 1

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**Contents**

**Editorial:**

**Communication Flows in International Economic Law**

*Asif H Qureshi* 1

**Articles:**

**International Financial Regulatory Standards and Human Rights:  
Connecting the Dots**

*Motoko Aizawa, Daniel Bradlow and Margaret Wachenfeld* 2

**Legitimate Expectation in Investor-State Arbitration:  
Re-contextualising a Controversial Concept from a Developing  
Country Perspective**

*Yenkong Ngangjoh-Hodu and Collins C. Ajibo* 45

**Liminal Spaces:**

**Special and Differential Treatment as an Incompletely  
Theorised Agreement**

*Stephanie Switzer* 62

**Application of MFN to the Substantive Standards:  
Why Should We Re Investigate the Uncontested?**

*Tanjina Sharmin* 85

**& RORPELD ¶ V / DQG 5HVWLWXWLRQ 3URJUDPPH DQG , QWH  
Normative Tensions and Possible Convergences Concerning Investor  
Diligence**

*Rafael Tamayo-Álvarez* 114

**Book Review:**

***Public Private Partnership for WTO Dispute Settlement:  
Enabling Developing Countries***

By Amrita Bahri

*Reviewed by Mohammed El Said*

135

**Guidance for Contributors**

138







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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transactions and for notifying the relevant authorities about any suspicious transactions or customers. The FATF recommendations have achieved a degree of success in meeting their objective. However, the recommendations have also had some unintended human rights consequences. FATF did not anticipate that some banks would decide not to service customers seeking to remit relatively small amounts to their families in another country while other banks would decide to increase their charges on these transactions. The result was that the Task Force's recommendations led to some banks refusing to service these customers, leaving them unable to send remittances to meet their food, housing, health and education needs. In one particularly striking example, the Somali community in England was forced to ask the UK government to intervene with British banks in order to help them preserve access to at least one bank that could send their remittances to their families in Somalia.<sup>5</sup> On the positive side, the Task Force came to understand that their recommendations had an impact on money laundering arising from human trafficking, and issued a guidance on how to address such money laundering (and hence human trafficking).<sup>6</sup>

As this example shows, international financial regulatory standards affect how human beings interact with and are affected by the financial system. The way in which the standards are formulated can influence the precise nature and extent of these impacts but they cannot avoid having an effect on the human beings who use, or would like to use, the financial system. Consequently, the international standards inevitably raise human rights issues. This raises the question of whether a human rights analysis would add value to the quality of financial regulation.

This paper seeks to answer this question in regard to the international financial standard setting bodies (SSBs) and their international financial regulatory standards. Its hypothesis is that incorporating a human rights analysis into the standard-making processes of the international SSBs would improve the quality of their standards.<sup>7</sup> This analysis could be integrated into other internal processes such as a regulatory impact analysis or it could be carried out as a bespoke human rights impact assessment. It would make the actual and potential positive and negative human rights impacts of proposed international standards more visible. This knowledge would enable these bodies to formulate their standards with a better understanding of their full costs and benefits and how these costs and benefits will be allocated among their various stakeholders. It will also help mitigate the risk of unintended consequences, including the risk that the costs fall on those least able to bear them.

Improved international standards that tend to guide national financial regulatory and supervisory authorities around the world in developing their own national financial sector regulatory frameworks. Consequently, improved international standards at the apex of the system should lead to better financial

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<sup>5</sup> The Guardian, *Somali community in England asks UK government to intervene with British banks to help them preserve access to at least one bank that could send their remittances to their families in Somalia*, [www.theguardian.com/global-development/2013/jun/24/somalis-barclays-remittance](http://www.theguardian.com/global-development/2013/jun/24/somalis-barclays-remittance) (accessed March 2018).

<sup>6</sup> The guidance was not driven by a human rights imperative but it prompted banks to look out for signs of human trafficking in certain financial transactions. See *Task Force on Money Laundering, Recommendations of the FATF* (2012), at para. 32. See also *Task Force on Money Laundering, Recommendations of the FATF* (2012), at para. 32.

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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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 fair and open access. The explanatory notes refer to risk-related requirements<sup>156</sup> for participating in the FMI but does not explain what risks are covered. However, the general discussion of 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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of relevant stakeholders. ¶<sup>59</sup> 7 KLV DSSHUV WR EH DSSOLFDEOH WR ERWK governance and the selection of the individuals who work in these structures. The principle refers to the need to take the public interest into account in these governance arrangements. However, neither the principle nor its accompanying explanatory note clarifies what is included in the definition of the public interest for this purpose. The explanatory note indicates that the FMI should place a high priority on the safety and efficiency of its operations and explicitly support financial stability and other relevant public interests ¶but does not clarify what is meant by pther relevant public interests ¶<sup>60</sup> Some indication of what might be meant by this phrase can be deduced from the explanatory list of the criteria that should be used in selecting the members of the board of directors of the FMI. They include their independence, skills, experience and knowledge of FMIs.<sup>161</sup> While these are all important and relevant criteria, there is no suggestion that the criteria should include an ability to understand the broader societal and human rights implications of FMI activity. Without more specific direction to members about what the public interest entails, it is unlikely that factors such as these will be taken into consideration.

An example of a situation that could have a negative human rights impact under these standards is if the FMI decides to exclude certain foreign financial institutions from participation because it is not confident that they are being effectively regulated by their home country regulators. As a result, the cost of clearing or settling transactions increases for all the customers of the excluded institutions even though many of them may not have done anything wrong. In the extreme if there are no other FMIs available to the excluded financial institutions, the result could be that all the citizens of a particular country could be excluded from accessing the FMI.<sup>162</sup>

This unfortunate outcome could be avoided, or at least mitigated, if the CPMI clarified that the public interest ¶ LQFOXGHG WKH VRFLDO DQG KXPDQ U L J K W V L One way to do this might be to require greater diversity and broader representation of all stakeholders in the governance of the FMIs. Failure to do so increases the risk that the interests of some stakeholders, such as institutions serving the poor or small businesses, receive inadequate attention in the governance of the FMIs. This could result in them being effectively excluded from the payment system because it is too expensive or onerous for them to meet the conditions for participation in the system.

### 6. REFLECTIONS AND SUGGESTIONS

The preceding parts sought to illustrate the multiple points of intersection between human rights

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<sup>159</sup> CPMI (2012), *supra* note 35, PFMI Principle 2.  
<sup>160</sup> CPMI (2012), *supra* note 35, PFMI Paragraph 3.2.2, at 27.  
<sup>161</sup> CPMI (2012), *supra* note 35, PFMI Paragraph 3.2.10, at 29.  
<sup>162</sup> , 0) μ 5 H F H Q W 7 U H Q G V L Q & R U U H V S R Q G H Q W % D Q N L Q J 5 H O D W L R Q V K L S V available at: [www.imf.org/~media/Files/Publications/PP/031617.ashx](http://www.imf.org/~media/Files/Publications/PP/031617.ashx) (accessed March 2018). Samuel M. Maimbo (ed. μ 5 H P L W W D Q F H V D Q G ( F R Q R P I L F W O H I B I I O R S A P I T A Q D Y M K N Q A P E R P C D O I L D ¶ *Prevention and Reconstruction (CPR)*, Paper No. 38, November 2006, available at: [http://siteresources.worldbank.org/INTCPR/Resources/WP38\\_web.pdf](http://siteresources.worldbank.org/INTCPR/Resources/WP38_web.pdf) (accessed March 2018).









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 Economic, Social and Cultural Rights, the International Covenant on Civil and Political 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 indivisible. The rights and freedoms set forth in these instruments are interdependent and indivisible.

The rights and freedoms set forth in these instruments are interdependent and indivisible.

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