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Commentary to the Draft Investment Chapter of the Canada-EU Comprehensive Economic and Trade Agreement (CETA)

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This commentary is based on the draft CETA Investment Chapter dated February 7, 2013.[1]

The author is thankful to Diana Rosert for her valuable research and assistance as well as Damon Vis-Dunbar for his insights.

[1] The text has not been made public by the negotiating parties. The draft text is available, however, at: http://tradejustice.ca/fr/section/3.

Table of Contents

Introduction

When the Lisbon Treaty granted the European Union (EU) jurisdiction over foreign direct investment in December 2009, many thought that a window of opportunity opened for the introduction of new elements into the trade and investment regime, the development of new approaches and more systemic changes. Unfortunately, the competence shift has so far not fulfilled these expectations.

Also in 2009, shortly before the Lisbon Treaty's entry into force, Canada and the EU started negotiating a Comprehensive Economic and Trade Agreement (CETA) that was originally confined to trade issues.[2] In September 2011 the European Council expanded the mandate for the European Commission to cover negotiations on a CETA investment chapter.[3] Today, CETA negotiations are at their final stage and the conclusion of the agreement is expected for mid/end 2013.

While several crucial issues in the investment chapter remain to be decided by Canada and the EU, the chapter is at an advanced level. Worryingly, the chapter's overall design and content largely disregard the demands and concerns raised by the European Parliament and civil society.

Getting an investment text right and understanding the implications for governments and people is always important. It is even less dispensable when the host state's commitments and the dispute settlement mechanisms are integrated in a comprehensive trade and investment agreement. Mistakes can hardly be fixed in this type of complex agreement. Moreover, in the event that either the EU or Canada decide that it is necessary to terminate the agreement in the future, the draft CETA explicitly states that the provisions and dispute settlement will continue to be effective for a period of 20 years. Having to live with mistakes for 20 years *after termination* is a long time. Therefore, the finalization of the investment chapter should not be rushed, but thought through carefully.

The most worrisome element of the EU-Canada draft, with respect to investment, is the inclusion of investor-state dispute settlement (ISDS). In light of the well-developed judicial systems in Europe and Canada, to allow investors to bypass national judicial systems in favour of privatized (and largely unaccountable) tribunals seems misguided. If introduced at all, these tribunals should only function as a last resort, after local remedies have been exhausted. Indeed, this is what the European Parliament requested as one of its suggested "major changes."[4] In paragraph 31 of the resolution on April 6, 2011, the Parliament stated that "...changes must be made to the present dispute settlement regime, in order to include... the obligation to exhaust local judicial remedies where they are reliable enough to guarantee due process."[5] The EU and Canada have entirely ignored this demand.

[2] European Commission, Overview of FTA and other Trade Negotiations, April 9, 2013, available at http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf.

[3] European Council, Press Release, p. 13, 12 September 2011, available at http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/EN/genaff/124579.pdf.

[4] See Committee on International Trade (Kader Arif), Report on the future European international investment policy (2010/2203(INI)), 22 March 2011, available at http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2011-0070&language=EN.

[5] See also European Parliament resolution of April 6, 2011 on the future European international investment policy (2010/2203(INI)), available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2011-0141+0+DOC+XML+V0//EN. For a commentary, see *While the EU member states insist on the status quo, the European Parliament calls for a reformed European investment policy,* Marc Maes, Investment Treaty News, 1 July 2011, available at http://www.iisd.org/itn/2011/07/01/while-the-eu-member-states-insist-on-the-status-quo-the-european-parliament-calls-for-a-reformed-european-investment-policy/.

Only a few elements, with respect to procedural issues, can be considered improvements compared to existing EU member states' (MS) bilateral investment treaties (BITs). The draft of the CETA investment chapter also represents a step backwards compared to the treaty practices of the US and Canada, which have incorporated some procedural and substantive innovations over the last decade.

For substantive rules, the draft investment chapter lacks the necessary improvements such as qualifications to broad and vague standards, as called for by the Parliament.[6] In addition, the current draft expands market access in the area of goods and services to market access in the area of investment, prohibits performance requirements and extends national treatment commitments to the pre-establishment phase. It is important to recall that MS BITs were confined to post-establishment treatment of investment and investors. The combination of market-access and pre-establishment commitments with ISDS would create an explosive mixture that poses serious risks to governments' policy space.

This paper provides a brief commentary with respect to selected issues. Not all issues are covered. In particular, this commentary does not include comments to section six on dispute settlement. Separate comments will be provided on that.

[6] In its April 6, 2011 resolution, the Parliament "Expresses its deep concern regarding the level of discretion of international arbitrators to make a broad interpretation of investor protection clauses, thereby leading to the ruling out of legitimate public regulations; calls on the Commission to produce clear definitions of investor protection standards in order to avoid such problems in the new investment agreements" (paragraph 24). See European Parliament resolution of April 6, 2011 on the future European international investment policy (2010/2203(INI)), available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2011-0141+0+DOC+XML+V0//EN.

Summary

Section 1: Scope and Definitions/General Provisions and Definitions

- The definition of *investment* is defined too broadly, covering any kind of asset, independent of whether or not investments are associated with an existing enterprise in the host state. The definition is crucial since it will determine which investments benefit from the extraordinary investment treaty protections. An exhaustive list of covered investment, or an enterprise-based definition would better ensure that the agreements are interpreted to protect selected types of investment, rather than the vast universe.
- Canada wishes to expand the definition of investor to natural persons or enterprises that seek to make, are making, or have made an investment. This expands the scope of application of the treaty to the pre-establishment phase and therefore carries the risk, among other things, of expanded ISDS.
- A broad definition of investor opens the door to treaty shopping and misuse by mailbox investors. To avoid this, Canada proposes that enterprises without substantial business activities in the alleged home state will be excluded from the definition of investor. This is a useful clarification.

Section 2: Establishment of Investments

- Canada and the EU are about agree to extensive market access commitments, which will prohibit them from using a wide range of measures that regulate the entry of foreign investors in their operations. While the extent of liberalization commitments will depend on the carve-outs to the market access commitments, the approach taken is prone to expose Canada and the EU to longstanding commitments also in areas they did not intend to cover. The greatest risk arises from the commitments, if they are made subject to ISDS.
- Another problematic element is the prohibition of performance requirements. It eliminates the flexibility of a country to use such measures as economic policy tools, and reduces the overall scope of their policy discretion. While absent from EU treaties so far, Canada prohibited the use of performance requirements in its treaties and has been sued over such issues in the past. If included in the CETA, this provision should not be subject to ISDS as suggested by the EU.

Section 3: Non-discriminatory Treatment

- The CETA couples pre-establishment commitments with obligations to provide national and most-favoured nation (MFN) treatment. In addition to absolute prohibitions to impose limits on market access, the CETA also includes relative establishment rights incorporated through the national treatment and MFN clause. As a consequence, host states have obligations to prospective investors even before the investment is made. This could potentially significantly limit both Canada's and EU MS' policy space.
- One of the most important shortcomings of the draft relates to the formulation of the MFN provision. As currently drafted, the provision does not limit the possibility for investors to import provisions from other treaties, including investment treaties. This permits misuse by investors, and excessive expansion of certain investor guarantees through tribunals. If Canada and the EU do not get the MFN exceptions right, the provision will nullify any progress made in the CETA to modernize investment law.

Section 4: Investment Protection

- The draft CETA includes a provision to accord fair and equitable treatment to investors and investments. The provision has become a catch-all obligation invoked by investors, and in many cases is interpreted by tribunals in an inconsistent and far-reaching manner. While Canada seems to favour an approach consisting of a closed list of situations that are unacceptable from an international law perspective, the EU proposes adding elements that make the concept of fair and equitable treatment very open-ended and, as a consequence, highly problematic. To make its use in investment arbitration more predictable, the provision should remain a closed-list, as originally suggested by Canada.

- In the same section, the EU proposes the inclusion of the so-called "umbrella clause," that substantially broadens the scope of the treaty and makes it possible for investors to claim a breach of contract or other commitments as a violation of the treaty itself (elevation to a treaty breach). Canadian treaties typically do not contain an umbrella clause, and the EU Parliament has expressed concern about the use of umbrella clauses in investment treaties.
- With respect to the expropriation provisions, Canada and the EU have diverging proposals regarding indirect expropriation. On the one hand, Canada proposes to carve-out public welfare measures from the notion of indirect expropriation, to limit the expansive interpretation of the expropriation concept through tribunals. The EU on the other hand, suggests that such measures must be subject to a "necessity" and "proportionality" test in order to determine if they amount to indirect expropriation. The EU approach provides much leeway for tribunals to second-guess legitimate governmental decisions. Therefore, in light of the weak institutional structure of investment arbitration, the EU's approach is particularly inappropriate.

Section 5: Reservations and Exceptions

- The reservations and exceptions provisions state that selected substantive commitments do not apply to those existing non-conforming measures that are listed in the schedules. This means that states may not maintain pre-existing laws, regulations and other measures that do not conform with the commitments in the investment chapter, unless excluded in a schedule. This is not that easy. In order to not miss a measure that should be listed, a better approach would be to grandfather non-conforming measures across the board, ensuring that any existing non-confirming measures may be maintained, unless specifically stated otherwise. Canada set a precedent for this approach in previous treaties.
- The denial of benefits clause proposed by Canada gives a party the right to deny protection under the treaty for diplomatic or security reasons. In addition, benefits may be denied where the investor is an enterprise with no substantive business activity in the alleged home state. While this can serve to prevent treaty shopping (among other things), it is more predictable and effective to defy treaty shopping through the definition of investor (Section 1).

Section 7: Final Provisions

- Canada and the EU are each proposing to include a general exceptions clause in the investment chapter, but both clauses provide false comfort. They will not safeguard government policy space in a satisfactory manner. It is much more important to include clarifications and delimitations to the crucial substantive provisions included in the investor chapter. The Canadian proposal limits the scope of permitted measures to only three categories, subject to their necessity, which raises several problems. The EU general-exception-type clause is limited in effect because it only applies to measures regarding pre-establishment and not post-establishment, subject to the necessity test.

The ISDS mechanism, set out in Section 6 "Investor-State Dispute Settlement" and the text included in a related document as a table (dated February 1, 2013), is the most problematic element of the CETA. It will therefore be dealt with in a separate, more detailed commentary.

Section 1: Scope and Definitions

Definition of Investment

SECTION 1: [CAN: SCOPE] [EU: GENERAL PROVISIONS] AND DEFINITIONS

ARTICLE X.3: DEFINITIONS

[…]

'investment' means:

Every kind of asset that an investor owns or controls, directly or indirectly, which has the characteristics of an investment, such as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk, and a certain duration. Forms that an investment may take include:

a) an enterprise;
b) shares, stocks and other forms of equity participation in an enterprise;
c) bonds, debentures and other debt instruments of an enterprise;
d) a loan to an enterprise;
e) any other kinds of interest in an enterprise;
f) an interest arising from:
   i. a concession conferred pursuant to domestic law or under a contract, including to search for, cultivate, extract or exploit natural resources,
   ii. a turnkey, construction, production, or revenue-sharing contract, or
   iii. other similar contracts;
g) intellectual property rights;
h) any other moveable property, tangible or intangible, or immovable property and related rights;
i) claims to money or claims to performance under a contract;

[For greater certainty, "claims to money" does not include money owed solely as a result of cross-border sales of goods or services [EU: or financing of cross border trade] and any related order, judgment or arbitral award, [CAN: or trade financing]].

Returns that are invested shall be treated as investments. Any alteration of the form in which assets are invested or reinvested does not affect their qualification as investment.

[…]

The term *investment* is arguably the most critical term to define. The definition will determine which foreign capital flows will be covered by the agreement. It determines the scope of the treaty and which investments benefit from the CETA provisions.

Open-ended Asset-based Definition

Canada and the EU seem to have opted for a traditional open-ended asset-based definition of investment, as opposed to an enterprise-based definition (which requires the establishment or acquisition of an enterprise in the host state), or a closed asset-based definition (which sets out an exhaustive and limited list of situations that constitute an investment).

The EU and Canada's draft text defines investment as "Every kind of asset." It then provides an indicative list of such assets that can qualify as investment, covering enterprises, equity, bonds and debt instruments, intellectual property rights and others – independent of whether or not they are associated with an existing enterprise in the host state.[7]

The open-ended list is problematic because it allows for the most expansive interpretation by tribunals of what that definition encompasses, since the list that follows is merely indicative. This definition is therefore the least predictable for host states.

Canada appears to have abandoned its closed-list approach laid down in the 2004 Model Foreign Investment Promotion and Protection Agreement (FIPA), though that model already had elements of an open-ended approach to some extent. The EU is in large, continuing to adhere to the model included in the majority of the old-style MS BITs. The approach taken by the EU and Canada exposes EU MS and Canada, in terms of an expansion of the scope of the treaty, to areas that were not intended. This increases the risks of being sued.

Through an exhaustive list of covered assets, rather than a reference to all assets, Canada and the EU could better ensure that the agreements are not interpreted to protect the vast universe but selected types of investment. The enterprise-based definition could accomplish a similar function by limiting the investment definition to direct investments, or to investments made though a locally established enterprise.

Requiring Characteristics of an Investment

It should be added here that Canada and the EU seem to have taken note of the problems of expansive interpretation to some extent as they have set out some specification. Building on the approach taken by the US since 2004, they have required that an asset needs to have certain characteristics of an investment in order to qualify as an investment under the treaty.

> Every kind of asset that an investor owns or controls, directly or indirectly, which has the characteristics of an investment, such as the commitment of capital or other resources, the expectation of gain or profit, <u>or</u> the assumption of risk, and a certain duration.

As seen above, Canada and the EU have added as qualifications, the commitment of capital or other resources, the expectation of gain or profit, the assumption of risk and a certain duration to the definition of investment. Based on the current drafting, the criteria are not understood to apply cumulatively, as one of the parties (or perhaps both) introduced the word 'or', in the enumeration of requirements. The consequence is that to qualify for protection under the treaty, investments do not need to fulfill all listed requirements. Whether this qualification is sufficient to protect host states from bad surprises regarding the meaning of this open-end definition of investment is questionable.

[7] This "could include such tangible or intangible properties as an offshore bank account, holiday home, rights under domestic law or contract, minority shareholding in a foreign company, and a company's "goodwill." Even contracts for the sale of goods manufactured by the investor in its home country, or services performed by the investor in its home country, and then sold to consumers in the host country" (p. 11). See IISD (Nathalie Bernasconi-Osterwalder, Aaron Cosbey, Lise Johnson, Damon Vis-Dunbar), Investment Treaties and Why They Matter to Sustainable Development: Questions and answers, 2011, available at http://www.iisd.org/pdf/2011/investment_treaties_why_they_matter_sd.pdf.

Carve-outs and Interpretations

In line with Canada's practice, the EU and Canada want to specify that certain types of assets are not covered in the definition:

> [For greater certainty, "claims to money" does not include money owed solely as a result of cross-border sales of goods or services [EU: or financing of cross border trade] and any related order, judgment or arbitral award, [CAN: or trade financing]].

Given the breadth of the definition, this clarification could be expanded to go beyond excluding cross-border sales or trade financing. The question is whether the parties want to, and whether they should cover assets that are solely in the nature of portfolio investment, goodwill, market share, a bank letter of credit and other specific forms of assets. There is also a question of consistency with the law of the EU MS. For example, in many legal systems, goodwill is not normally recognised as a legal entitlement capable of being owned, transferred or assigned independently of an enterprise to which it relates. This sort of drafting could create difficulties in the treaty application, particularly when a foreign investor claims the protection of an economic interest not recognised as a legal entitlement under the law of the host state. While this issue merits further attention, it cannot be discussed in detail here.

Definition of Investment in Investment Arbitration

Two recent decisions in cases relating to Argentina's sovereign bond restructuring at the International Centre for Settlement of Investment Disputes (ICSID) shed light on the practical implications of the definition of investment. In *Abaclat and others v. Argentina*[8] (a case involving 60,000 Italian bondholders), a central question at the jurisdictional stage was whether the Argentina-Italy BIT covered sovereign bonds as investment. The majority of the tribunal ruled that bonds constituted protected investments, since the BIT contained an open-ended list of investment without any restrictions. The majority in a second bonds-related case against Argentina, *Ambiente ufficio and others v. Argentina*,[9] came to the same conclusion. Yet, Argentina disputed that it had meant to cover sovereign bonds in the BIT.

In both cases, the tribunals did not require the alleged investments to fulfill specific characteristics (as outlined above), arguing that neither the BIT nor the ICSID Convention prescribed these.

The first case against the 2012 Greek debt restructuring has now been filed with ICSID.[10] Two other disputes, one with Greece and another with Cyprus, could also lead to investment arbitration.[11]

[8] *Abaclat and Others (Case formerly known as Giovanna A Beccara and Others) and The Argentine Republic, Decision on Jurisdiction and Admissibility*, ICSID Case No. Arb/07/5. See Damon Vis-Dunbar, Mass claim in Argentine bond dispute is granted ICSID jurisdiction, Investment Treaty News, October 7, 2011, available at http://www.iisd.org/itn/2011/10/07/awards-and-decisions-5/.

[9] *Ambiente Ufficio S.p.A. and others (Case formerly known as Giordana Alpi and others) v. Argentine Republic, ICSID Case No. ARB/08/9*, Decision on Jurisdiction and Admissibility.

[10] *Poštová banka, a.s. and ISTROKAPITAL SE v. Hellenic Republic*, ICSID Case No. ARB/13/8.

[11] Notices of disputes have been filed by Cyprus Popular Bank against Greece and by Marfin Investment Group against Cyprus. See Sebastian Perry, Bondholders pursue Greece over debt haircut, Global Arbitration Review, May 7, 2013, available at http://globalarbitrationreview.com/news/article/31563/.

Definition of Investor

SECTION 1: [CAN: SCOPE] [EU: GENERAL PROVISIONS] AND DEFINITIONS

ARTICLE X.3: DEFINITIONS

[...]

investor means [CAN: a Party] a natural person or an enterprise of a Party but not a branch [or a representative office] that [CAN: seeks to make, is making or] has made an investment in the territory of the other Party;

Canadian Alternative Proposal:

investor means [CAN: a Party] a natural person or an enterprise of a Party that [CAN: seeks to make, is making or] has made an investment in the territory of the other Party. But "investor" does not mean:

a) an enterprise of a Party if the enterprise is owned or controlled by an investor of the other Party or of a non-Party and the enterprise has no substantial business activities in the territory of the Party under whose law it is constituted or organized; or,

b) a branch [or representative office] of an enterprise of a Party or a non-Party.

[...]

Alongside the definition of investment, the definition of investor circumscribes the scope of the agreement. It determines which investors are protected, and may also exclude certain types of investors - either to prevent opportunistic use of the agreements or to target investors with real operational investment.

Addressing the Issue of Treaty-shopping

The broad definitions of investor in BITs open the door to treaty shopping. By registering their office in a country that has a large treaty network, investors can make use of that BITs network without having substantive business activities in that country. They can strategically choose a home country for their investment to sue the host country through ISDS.

To avoid this type of situation and limit treaty shopping, Canada proposes that enterprises without substantial business activities in the alleged home state be excluded from the definition of investor. It is not clear whether the EU has agreed to this addition.[12]

> But "investor" does not mean:
>
> a) an enterprise of a Party if the enterprise is owned or controlled by an investor of the other Party or of a non-Party and the enterprise has no substantial business activities in the territory of the Party under whose law it is constituted or organized

This is a useful addition to avoid misuse of the Canada-EU CETA by mailbox investors.

[12] In light of denial of benefits clause proposed by Canada in Section 5, it appears that the text is still under consideration.

Extending the Scope to Investors Seeking to Make an Investment

Canada wishes to expand the definition of investor to cover not only the investors that have made an investment in the territory (referring to the post-establishment phase of an investment), but also those who seek to make or are making investments, implying pre-establishment coverage.

This is in line with US and Canadian practice, and would have direct implications on the scope of the treaty and potentially on the application of ISDS. If, as seen below, the EU is reluctant to subject pre-establishment national treatment to ISDS, it should also recognize that an investor might still be able to resort to ISDS for the violation of certain guarantees in the pre-establishment phase due to the definition of investor.

Section 2: Establishment of Investment

Market Access

SECTION 2: ESTABLISHMENT OF INVESTMENTS

ARTICLE X.4: MARKET ACCESS

1. Neither Party shall adopt or maintain [EU: with regard to establishments or investors of the other Party], either on the basis of its entire territory or on the basis of the territory of [CAN: a sub-national government], measures that:

(a) impose limitations on:

(i) the number of [EU: establishments] [CAN: covered investments,] whether in the form of numerical quotas, monopolies, exclusive suppliers or the requirement of an economic needs test;

(ii) the total value of transactions or assets in the form of numerical quotas or the requirement of an economic needs test;

(iii) the total number of operations or the total quantity of output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test [[2]] EU;

(iv) the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment;

(v) the total number of natural persons that may be employed [in a particular sector] or that a covered investment may employ and who are necessary for, and directly related to, the performance of economic activity in the form of numerical quotas or the requirement of an economic needs test.

(b) restrict or require specific types of legal entity or joint venture through which an investor may perform an economic activity.

[...]

[2] Subparagraphs 1(a) (i), (ii) and (iii) do not cover measures taken in order to limit the production of an agricultural product.

While the CETA creates commitments for Canada and the EU with investments and investors once they are established (post-establishment) in the foreign country, the market access article also lays down state obligations at the admission and entry phase of the investment (pre-establishment).

Market Access Commitments

Partly modeled on the basis of the General Agreement on Trade in Services (GATS) Article XVI Market Access, this article of the CETA prohibits limitations on the number of investments (such as quotas) on the total value of transaction or assets, the number of operations, caps on the participation of foreign capital, or the number of persons employed.

The CETA approach stands in contrast to the approach taken in MS BITs which only covered post-establishment issues, while the CETA extends to the pre-establishment phase and includes market access commitments related to investment (Article X.4: Market Access). The CETA approach also contrasts the approach taken in investment treaties and chapters negotiated by the US and Canada, as the CETA draft contains absolute market access commitments in addition to relative commitments. Relative commitments depend on how the parties treat their own investors (national treatment), or the investors from third countries (MFN treatment). The combination of absolute and relative market access commitments have a strong investment liberalization effect and could potentially significantly limit both Canada's and EU MS' policy space. To the extent that there is a coherent policy justification for including market access commitments in the agreement in the first place, it can be realized by relative market access commitments. There can be no justification for allowing foreign investors to evade conditions that legally apply to investments made by domestic investors in a given sector.

Negative Listing Approach

Much will depend on the carve-outs to the market access commitments. In the CETA draft market access and pre-establishment requirements are to be negotiated in combination with the so-called negative list approach. So the actual scale of investment liberalization will depend on what the EU and Canada list as exempt from liberalization. While this sounds quite straightforward, it is not. In fact, identifying what needs to be excluded requires extensive consultation and expertise. Whatever is omitted from the list (intentionally or not), will be subject to market access or pre-establishment requirements. It is hardly possible to foresee all contingencies. By contrast, positive lists explicitly state the areas/sectors that are covered and automatically exclude the others. In the past, the EU has generally used positive lists to circumscribe market access commitments, rather than submitting to the negative list approach. Until now, it appears that Canada has not included absolute market access commitments in investment chapters of Free Trade Agreements (FTAs) or BITs. Clearly, these commitments have migrated into the CETA from past EU practice.

Should Market Access Commitments Be Subject to ISDS?

The CETA text does not make clear whether market access commitments are subject to ISDS. It appears that the EU wants to exclude these market access provisions from ISDS. In previous EU treaties, these commitments were only subject to state-state dispute settlement (SSDS), so the rejection of ISDS in this context would be a continuation of EU practice. Moreover, since MS BITs did not have market access provisions, there is no history of ISDS in this at the member state level either. It remains to be seen what Canada and the EU will finally agree on. The exclusion of ISDS for Canadian market access issues would not be against state practice either, since it is a new area for Canada. However, Canada might want to treat this like its national treatment pre-establishment commitments (see below), which have been subject to ISDS in the past.

By agreeing to include market access commitments in the CETA, Canada and the EU are significantly limiting their power to regulate and control the entry of foreign investors when they could just as well open markets unilaterally. Subjecting such commitments to ISDS would be one step further that has never been taken before.

Clarifications on the Scope and Meaning of Market Access Commitments

Acknowledging some of the dangers of broad interpretations of market access commitments, Canada and the EU have made some clarifications to scope of the commitments by noting that measures such as zoning, competition measures, measures ensuring sustainability of natural resources, and some others, are understood to be in conformity with the market access commitments.

SECTION 2: ESTABLISHMENT OF INVESTMENTS

ARTICLE X.4: MARKET ACCESS

[...]

2. [For greater certainty, the following [EU: measures] are consistent with paragraph 1 of this article [EU: provided that they are not applied in a manner which would constitute a disguised restriction on establishment]:

a) Measures concerning zoning and planning regulations affecting the development or use of land, or other analogous measures.

b) Measures requiring the separation of the ownership of infrastructure from the ownership of the goods or services provided through that infrastructure to ensure fair competition, for example in the fields of energy, transport and telecommunications.

c) Measures restricting the concentration of ownership to ensure fair competition.

d) Measures ensuring the sustainability of natural resources, including limitations on the number and scope of concessions granted.

e) Measures limiting the number of authorizations granted because of technical or physical constraints, for example telecommunications spectrum and frequencies.

f) Measures requiring that a certain percentage of the shareholders, owners, or partners in an enterprise be qualified or practice a certain profession such as lawyers or accountants.]

Both Parties require further internal consultation on paragraph 2.

Performance Requirements

SECTION 2: ESTABLISHMENT OF INVESTMENTS

ARTICLE X.5: PERFORMANCE REQUIREMENTS

1. Neither Party may impose, or enforce any of the following requirements, or enforce any commitment or undertaking, [EU: or condition the receipt or continued receipt of an advantage,] in connection with the establishment, acquisition, expansion, management, conduct or operation of all investments in its territory to:

(a) export a given level or percentage of goods or services;

(b) achieve a given level or percentage of domestic content;

(c) purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from natural persons or enterprises in its territory;

(d) relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment;

(e) restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings;

(f) transfer technology, a production process or other proprietary knowledge to a natural person or enterprises in its territory; or

(g) supply exclusively from the territory of the Party a good produced or a service provided by the investment to a specific regional or world market.

[...]

Performance requirements establish conditions that investors have to satisfy before they are allowed market access or at the expansion or operation phase of their investment. They are a policy tool used by countries to achieve higher competitiveness and encourage the transfer of technology or employment, among others.

The CETA text incorporates an article prohibiting states from using performance requirements as a condition of entry or operation. States thereby commit to not apply such requirements to investors.

The prohibition of performance requirements rests on the North American model and has so far been absent from EU MS treaties as well as from EU FTAs. It eliminates a country's flexibility to use such measures as economic policy tools and reduces their scope of policy discretion.

An important question is whether this provision will be subject to ISDS, or only state-state dispute settlement. If market access is excluded from ISDS, prohibitions on performance requirements should also be excluded. In the US and Canadian agreements, these prohibitions are subject to ISDS. In the past, Canada has been sued over related issues by investors. Two US oil companies initiated ICSID proceedings against Canada over research and development (R&D) performance requirements in 2007,[13] after a Canadian regulatory agency had introduced guidelines with a R&D expenditure benchmark for offshore oil projects. The ICSID tribunal decided in 2012 that the guidelines violated the prohibition of performance requirements contained in the North American Free Trade Agreement (NAFTA).

The draft CETA text seems to indicate that the EU wishes to exclude these prohibitions from ISDS, as a note at the end of the provision states:

> Text without prejudice to placement and EU position on non-application of ISDS to this provision.

[13] Mobil Investments Canada Inc. and Murphy Oil Corporation v. Canada, ICSID Case No. ARB(AF)/07/4, Decision on Liability and on Principles of Quantum.

Section 3: Non-discriminatory Treatment

National Treatment and Most-Favoured Nation (MFN) Treatment

SECTION 3: NON-DISCRIMINATORY TREATMENT
ARTICLE X.7: NATIONAL TREATMENT

1. Each Party shall accord to investors of the other Party and to covered investments, treatment no less favourable than the treatment it accords, in like situations to its own investors and to their investments with respect to the establishment, acquisition, [CAN: expansion], conduct, operation, management, maintenance, use, enjoyment and sale or disposal of their investments in its territory.

ARTICLE X.8: MOST-FAVOURED-NATION TREATMENT

Subject to agreement by EU on inclusion of an MFN obligation regarding 'establishment, acquisition, expansion of an investment:

1. Each Party shall accord to investors of the other Party and to covered investments, treatment no less favourable than the treatment it accords in like situations, to investors and to their investments of any third country with respect to the establishment, acquisition, [CAN: expansion], conduct, the operation, management, maintenance, use, enjoyment and sale or disposal of their investments in its territory.

[...]

National treatment essentially means that host states will treat foreign investors no less favourably than they would treat domestic investors. This obligation protects foreign investors against discriminatory treatment with domestic investors, for instance when a law or regulation has the impact of according less favourable treatment to the foreign investor. This may also include state actions that were not taken with the intent to discriminate between investors.

MFN treatment means that the investor from the treaty partner should be treated no less favourably than investors from other countries. In recent years, investment arbitration expanded the meaning of the MFN provision beyond its original confines, creating uncertainty and sparking concern in the states. In particular, tribunals have allowed investors to import guarantees under other investment treaties into investment disputes.

The national treatment and MFN obligations may also be extended to potential investors, creating *pre-establishment rights or rights of establishment* that give foreign investors the right to enter a host country and make an investment on terms no less favourable than those faced by a domestic investor, or third country investors that might be considering the same type of investment.

Expanding National Treatment and MFN to Pre-establishment

Like the majority of investment chapters, the CETA text includes non-discrimination commitments. The provisions on national treatment (Article X.7) and MFN treatment (Article X.8) are placed in Section 3 on non-discriminatory treatment, separate from Section 2 on Establishment of Investments. In reality, the provisions incorporate important elements relating to market access and pre-establishment. This becomes manifest in the language which extends the national treatment and MFN obligations to the "*establishment*, acquisition, conduct, operation, management, maintenance, use, enjoyment and sale or disposal" of investments, thereby covering both pre- and post-establishment activities. This is very common in Canadian and US BITs. Due to the manner in which pre-establishment commitments have been drafted and placed in treaties, the extension of non-discrimination to the pre-establishment phase has in the past sometimes been overlooked by experienced negotiators, especially in developing countries.

The CETA draft text indicates that the EU has agreed to extend the national treatment obligation to the pre-establishment phase but that it has not yet agreed to extend the MFN obligation to the establishment, acquisition and expansion phases.

The inclusion of pre-establishment rights is a new development when compared with MS BITs which only cover the post-establishment phase and grant investors rights once they were admitted to the country, based on the country's national laws and other access policies. The US and Canada have led this trend in expanding BITs to pre-establishment issues.

But the approach has not been completely absent in the EU either, as EU FTAs traditionally also include national treatment clauses relating to establishment. The main difference between the US and the EU approach to date has been the manner in which the limits on national treatment were set out: in the EU national treatment establishment commitments are set out in a positive list (according to which, national treatment is only granted in sectors listed). Moreover, these commitments are not subject to ISDS. The US and Canada, by contrast, have subjected pre-establishment national treatment and MFN to a negative list and ISDS.

It is not clear whether and how the EU and Canada will finally resolve this issue. What is clear is that extending national treatment to the pre-establishment phase limits government policy space to regulate the entry of foreign investors in addition to the limitations set out in section 2 which sets out absolute market access commitments. Further consideration should be given to the risks associated with negative listing (with which the EU and EU MS have little experience), as well as the consequences of subjecting the commitments to dispute settlement, and ISDS in particular. Finally, it should be noted that while the World Trade Organization (WTO) provides exceptions to non-discrimination obligations, the exceptions provided in the CETA draft text appear weak and insufficient (see discussion further below).

MFN and the Importation of Provisions and Guarantees in Other Treaties

SECTION 3: NON-DISCRIMINATORY TREATMENT

ARTICLE X.8: MOST-FAVOURED-NATION TREATMENT

Subject to agreement by EU on inclusion of an MFN obligation regarding 'establishment, acquisition, expansion of an investment:

[…]

4. For greater certainty, the "treatment" referred to in Paragraph 1 and 2 does not include investor-to-state dispute settlement procedures provided for in other international investment treaties and other trade agreements.

In recent years, and independently of the pre-establishment issue, the MFN provision has raised problems regarding the importation of rights from other treaties, including investment treaties, into ongoing investment disputes. The CETA draft text addresses this problem clarifying that the clause cannot be used to import broader or less restrictive ISDS provisions from others agreements with investment provisions.

This is a direct response and counter-action to the findings of some tribunals and prevents an expansive interpretation of the clause by investors and tribunals, insofar as it disallows the importation of procedural rights related to ISDS. Yet, substantive guarantees can still be imported and investors can potentially pick more favourable provisions from the other treaties that the host country has signed. This moves away from Canada's 2004 Model which has a broader carve-out covering all issues covered under existing agreements, including investment treaties. It reads, "Article 4 (MFN) shall not apply to treatment accorded under all bilateral or multilateral international agreements in force or signed prior to the date of entry into of this Agreement," (Annex III). Without an exceptions clause along these lines, any careful drafting of substantive provisions in the CETA becomes useless because investors will be able to import other variations of substantive rights from existing treaties.

For example, the clause in the CETA does not prevent investors from invoking more favourable fair and equitable treatment clauses from older treaties through the MFN clause in the CETA. Similarly, it would not prevent a tribunal from ignoring an environmental or health exceptions clause, if the investor shows that other investors can benefit from old-style treaties that contain no such exceptions. This means that if there are no exemptions from MFN for treatment provided under other investment treaties (including both substance and process), it will not make a difference whether CETA provisions are drafted in a clear and precise way that safeguards policy space. A Canadian investor can look at any other treaty that, for example, Germany has signed and use the MFN clause in the CETA to import a more favourable fair and equitable treatment clause, while an EU investor can import rights under older treaties signed by Canada. This would nullify any progress made in the CETA to modernize investment law and respond to an excessive expansion of certain clauses through investment tribunals. Getting the MFN provision and its exceptions or clarifications right is therefore essential.

Section 4: Investment Protection

Minimum Standard of Treatment (Fair and Equitable Treatment)

SECTION 4: INVESTMENT PROTECTION

ARTICLE X.9: [CAN: MINIMUM STANDARD OF] TREATMENT [EU: OF INVESTMENT]

1. Each Party shall accord [in its territory] to investors and to covered investments of the other Party fair and equitable treatment and full protection and security.

2. In conformity with paragraph 1, to comply with the obligation to provide fair and equitable treatment, neither Party shall adopt measures that constitute, [EU: notably, but not exclusively]:

2. The "fair and equitable treatment" obligation in paragraph 1 includes the following treatment that is unacceptable from an international law perspective:

a. Denial of justice in criminal, civil or administrative proceedings;
b. Disregard of the fundamental principles of due process;
c. Manifest arbitrariness;
d. Targeted discrimination on manifestly wrongful grounds, such as nationality, gender, race or religious belief; or
e. Abusive treatment of investors, including coercion, duress and harassment.

[EU: f. A breach of legitimate expectations of investors arising from a government's specific representations or investment-inducing measures; or

g. A disregard of the principle of effective transparency in any applicable administrative or judicial procedures.]

3. [CAN: Treatment not listed in paragraph 2 a)-e) can also constitute a breach of "fair and equitable treatment" if the claimant provides evidence of a general practice of States accepted as law in support of the new element.

4. In determining whether the "fair and equitable treatment" obligation has been violated based on one of the elements provided in paragraph 2, the Tribunal may consider the legitimate expectations of investors arising from specific representations made by a Party in order to induce the investment and that were subsequently repudiated.

5. In conformity with paragraph 1, to comply with the obligation to provide full protection and security, neither Party shall adopt measures falling below the minimum standard of treatment in relation to the physical security of investors and investment.]

3. [EU: Neither Party shall in its territory impair by arbitrary measures the activity of investors of the other Party with regard to the operation, management, maintenance, use, enjoyment and sale or disposal of their investments.]

5. [EU: Each Party shall observe any obligation it has entered into with regard to an investor of the other Party or an investment of such an investor.]

6. A breach of another provision of this Agreement, or of a separate international agreement, does not [EU: in itself] establish that there has been a breach of this Article.

The fair and equitable treatment obligation requires host states to accord fair and equitable treatment to investors. It is the most widely invoked standard in investment treaty arbitration. Due to the broad and vague wording, tribunals have delivered widely differing interpretations of this obligation, such that it is difficult to predict when the actions of a state will violate the standard. The fundamental uncertainty regarding the meaning of the obligation has prompted states to explore options to prevent an expansive reading of the standard.

Two Approaches to Fair and Equitable Treatment

The CETA provides that each Party shall accord "fair and equitable treatment and full protection and security." The 2004 Model FIPA and treaties state that Canada qualifies the fair and equitable treatment with a reference to customary international law, safeguarding a state's policy space by providing that fair and equitable treatment goes no further than customary international law on the treatment of aliens. By contrast, EU MS BITs generally only provide that fair and equitable treatment should be granted, without further qualification.

This provision is crucial when it comes to investment arbitration, since investors invoke it in many cases and the interpretation of the scope has been inconsistent and far-reaching by tribunals. Claims of violation of fair and equitable treatment can potentially cover a wide array of policy measures, many of which a state would not expect to be covered. As a consequence, the provision has become an all-encompassing obligation. Arguably, while looking at case-law, the linkage to customary international law has been able to provide some guidance to tribunals as to the scope of the fair and equitable treatment obligation. Nevertheless, the concept of customary international law is also evolving, which brings in uncertainty and unpredictability, though to a lesser extent than the non-qualified version.

It appears that the EU wants to distance the CETA approach altogether from the notion of minimum standard of treatment which is the concept used in relation to customary international law. While Canada prefers the title *minimum standard of treatment*, the EU (in line with its consistent practice on this issue) is proposing the title *treatment of investment*, indicating a stand-alone approach for investment. The latter is anchored primarily in treaty practice and therefore an arbitrator-elaborated standard, rather than one coming out of state practice. In light of Canada's history in its treaty-making and arguing cases as a respondent state, it would appear to be in contradiction to its principles if it was to agree to the concept of treatment of investment, since the past approach guaranteed a minimum of policy space and predictability.

A New Approach?

While positions of the EU and Canada on a new title appear irreconcilable (*minimum standard of treatment vs. treatment of investment*), the parties seem to agree that a new approach is necessary to increase clarity and predictability, which is lacking in existing MS BITs, and to a lesser extent, also in the current Canadian Model. The provision in the CETA text contains language of such a new approach. However, the options proposed by Canada on the one hand, and the EU on the other, are still difficult to reconcile. Canada seems to favour an approach consisting of a closed list of situations that are unacceptable from an international law perspective (paragraph 2, elements (a)-(e)). This closed list seems very reasonable and also useful to provide the investor with clear protection from unacceptable treatment by the state. The areas listed are:

a. Denial of justice in criminal, civil or administrative proceedings
b. Disregard of the fundamental principles of due process
c. Manifest arbitrariness
d. Targeted discrimination on manifestly wrongful grounds, such as nationality, gender, race or religious belief
e. Abusive treatment of investors, including coercion, duress and harassment

This list seems in line with what might be covered by customary international law, but provides more clarity than a simple reference to customary international law.

The EU, on the other hand, proposes an option that expands Canada's proposed option, adding elements that make the concept of fair and equitable treatment very open-ended. The EU proposes to add more instances that would amount to a violation of fair and equitable treatment:

f. A breach of legitimate expectations of investors arising from a government's specific representations or investment-inducing measures

g. A disregard of the principle of effective transparency in any applicable administrative or judicial procedures.

These two additions are highly problematic, as they introduce more uncertainty and open the door for misuse. The introduction of paragraph f., "breach of legitimate expectations," can lead to investors challenging legitimate policy measures. What should really be targeted are measures that are clearly arbitrary, discriminatory, or taken in violation of due process. Such measures are already covered in paragraphs 2 (a) to (e). Similarly, the inclusion of paragraph g., "disregard of the principle of effective transparency in any applicable administrative or judicial procedures," brings in elements of uncertainty because the principle of effective transparency is by no means a well-established concept. As a lack of transparency amounts to a violation of due process in particular circumstances, this element is covered by paragraph b., and therefore unnecessary.

Canada appears to respond to the EU's concerns regarding 'legitimate expectations' and proposes to add:

> 4. In determining whether the "fair and equitable treatment" obligation has been violated based on one of the elements provided in paragraph 2, the Tribunal may consider the legitimate expectations of investors arising from specific representations made by a Party in order to induce the investment and that were subsequently repudiated.

Canada's suggestion provides some guidance to the tribunals without introducing the same uncertainty inherent to the EU's approach.

A further concern consists in the fact that the EU is proposing an open – not a closed – list of situations amounting to a violation of fair and equitable treatment, by proposing to add the words "notably, but not exclusively." This would defeat the purpose of trying to clarify the concept of fair and equitable treatment, and should therefore not be included.

Canada is also re-introducing some uncertainty referring back to customary international law without naming it, and clarifying that it is up to the claimant to provide evidence of state practice:

> 3. [CAN: Treatment not listed in paragraph 2 a)-e) can also constitute a breach of "fair and equitable treatment" if the claimant provides evidence of a general practice of States accepted as law in support of the new element.

This is a response to some decisions by tribunals where arbitrators appeared to be satisfied with looking at arbitrator practice and the decisions of tribunals, rather than state practice. Overall, this new wording would arguably represent an improvement and clarification compared to Canada's previous treaties.

Finally, when addressing tribunals expanding the obligation of full protection and security, Canada proposes to clarify that this concept is linked to the minimum standard of treatment relating only to the physical security of investors and investment, as opposed to also including the legal security, as some tribunals would have it.

> 5. In conformity with paragraph 1, to comply with the obligation to provide full protection and security, neither Party shall adopt measures falling below the minimum standard of treatment in relation to the physical security of investors and investment.

An Umbrella Clause Proposed by the EU?

Under this article on fair and equitable treatment, the EU proposes to include a so-called "umbrella clause" (EU, paragraph 5). This clause allows investors to have recourse to the ISDS mechanism for breaches that might normally be resolved elsewhere. It also covers the obligations that the investor and the host country entered into on an individual basis.

This clause is very problematic, because it substantially broadens the scope of the treaty and makes it possible for investors to claim a breach of contract or other commitment as a violation of the treaty itself (elevation to a treaty breach). The role of ISDS should not be to provide a parallel forum to litigate contractual disputes. Contractual parties already have the option to nominate a forum for the resolution of disputes under their contracts. Most investor-state contracts specify a forum for the resolution of contract disputes, and this agreement between the parties should be respected. Giving a foreign investor (but not the state) an option to renege on such forum selection clauses can also create technical legal problems in disputes arising under contracts. Problems such as the application of principles of res judicata and estoppel.

Expropriation

Two Very Different Approaches to Indirect Expropriation

SECTION 4: INVESTMENT PROTECTION
ARTICLE X.11: EXPROPRIATION

1. Neither Party may nationalize or expropriate a covered investment either directly, or indirectly through measures having an effect equivalent to nationalization or expropriation (hereinafter referred to as "expropriation"), except:

   (a) for a public purpose;
   (b) under due process of law;
   (c) in a non-discriminatory manner; and
   (d) against payment of prompt, adequate and effective compensation.

For greater certainty, this paragraph shall be interpreted in accordance with Annex X.9.1 on the clarification of [CAN: indirect expropriation.

[...]

[CAN: Annex X.11.1 Indirect Expropriation

The Parties confirm their shared understanding that:

1. Indirect expropriation results from a measure or series of measures of a Party that has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.

2. The determination of whether a measure or series of measures of a Party constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:

a) the economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred;

(b) the extent to which the measure or series of measures interferes with distinct, reasonable investment-backed expectations; and

(c) the character of the measure or series of measures.

3. Except in rare circumstances, such as when a measure or series of measures is so severe in the light of its purpose that it cannot be reasonably viewed as having been adopted and applied in good faith, non-discriminatory measures by a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations.]

[Annex [ ]: Expropriation

The Parties confirm their shared understanding that:

1. Expropriation may be either direct or indirect:

a) direct expropriation occurs when an investment is nationalised or otherwise directly expropriated through formal transfer of title or outright seizure.

b) indirect expropriation occurs where an action or series of actions by a Party has an effect equivalent to direct expropriation, in that it deprives the investor substantially of the possibility to own, use, or dispose of the property, although the means used fall short of those specified in subparagraph (a) above).

2. The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:

(i) the economic impact of the government action;

(ii) the extent to which the government action interferes with the possibility to own, use or dispose of the property;

iii) the duration of the action or series of actions by a Party or of its effects.

3. Subject to the principle of proportionality, non-discriminatory measures of general application taken by a Party that are designed to protect legitimate public policy objectives do not constitute indirect expropriation if they are necessary and are applied in such a way that they genuinely meet the public policy objectives for which they are designed.]

Expropriation provisions in investment chapters and treaties determine in which situations a state will have to compensate the affected rights holder. While generally allowing states to expropriate, investment treaties require that any expropriation must be compensated. In addition, investment treaties require that an expropriation be for a public purpose, non-discriminatory and in accordance with the due process of law. Thus, the crucial question is: What qualifies direct or indirect expropriation in the first place? Especially with regard to the interpretation of indirect expropriation, tribunals have applied fundamentally different concepts to their assessment of the issue. In some cases, only the impact of the measure on the investor - not its purpose - was considered relevant, while in others, non-discriminatory measures taken in good faith for public welfare reasons were deemed to not constitute expropriation.

Canada's Proposal

Canada is proposing to follow its long-standing approach to indirect expropriation, which it first adopted in its 2004 Model FIPA. It was used in Canada's negotiated investment treaties and retained in the 2012 version of Canada's (provisional) Model FIPA. Similar approaches have been incorporated (with some variation) in the US Model text and treaties, as well as in Asian and African agreements. Under this approach, both direct and indirect expropriation are covered by the treaty and subject to compensation, but measures taken to protect the public good, such as the environment and health, are carved out from the scope of indirect expropriation.

This approach found its way into more modern investment treaties, when countries, including Canada, recognized that the interpretation of what constitutes an indirect expropriation creates considerable legal uncertainty for both investors and countries as to which government measures are permissible without requiring compensation. In an expansive interpretation of the expropriation standard, governments may be liable for measures that were taken on a non-discriminatory basis to protect the public good. For example, tribunals might qualify measures to protect public health or the environment as an expropriation, subject to compensation if the measure has a significant impact on an investor.

In order to avoid such interpretations, the Canadian approach specifies, in an annex, what characteristics should be looked at when determining what constitutes an indirect expropriation - including economic impact, the expectations of the investor and the character of the measure. More importantly, the annex specifies that certain measures do not constitute an indirect expropriation subject to compensation in the first place. In particular, it carves out from the definition of indirect expropriation, "non-discriminatory measures … to protect legitimate public welfare objectives, such as health, safety and the environment." These non-discriminatory measures will in principle not be compensable because they cannot be viewed as indirect expropriation:

> 3. Except in rare circumstances, such as when a measure or series of measures is so severe in the light of its purpose that it cannot be reasonably viewed as having been adopted and applied in good faith, non-discriminatory measures by a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations.

As can be seen from the text above, there may be some "rare circumstances" in which such measures will qualify as indirect expropriation nevertheless. An example of such would be a situation where a measure cannot be reasonably viewed as a good faith measure.

The wording "except in rare circumstances" has been criticized by some as potentially undermining the character of the "carve out" for police measures, as the reference leaves it to the tribunal to decide the issue, instead of formulating a clear definition. The wording has been left out to make the exception more operational in recent texts, including in a number of Asian and African agreements (both regional and bilateral).

The EU Proposal

In contrast to the Canadian approach, the EU is proposing an entirely different one. The EU suggests introducing a proportionality and necessity test to determine whether measures qualify as an indirect expropriation that must be compensated. Like Canada, the EU proposes to provide some indication of what indirect expropriation means. This is a step forward compared to EU MS BITs that do not provide any guidance to tribunals. However, the guidance given by the EU does not reconcile what Canada is proposing. The EU suggests in Article X.11 – Annex, paragraph 3:

> 3. Subject to the principle of proportionality, non-discriminatory measures of general application taken by a Party that are designed to protect legitimate public policy objectives do not constitute indirect expropriation if they are necessary and are applied in such a way that they genuinely meet the public policy objectives for which they are designed.

Canada suggests that non-discriminatory measures "designed and applied to protect legitimate public welfare objectives," are in principle not indirect expropriation except in rare circumstances, such as measures taken in bad faith. By contrast, the EU suggests that non-discriminatory measures of general application designed to protect legitimate public policy objectives are only carved out from qualifying as a compensable expropriation if (i) they are proportional and (ii) they are necessary and applied in a way that they 'genuinely meet' the objectives.

Both approaches take into account the host state's regulatory purpose. However, in this context, the EU suggests introducing a "proportionality" test which requires that the means (the measure) is proportional to its objective. Introducing a proportionality test into the investment law context carries the great risk that the analysis by tribunals will not be sufficiently deferential to the democratic and legitimate decisions by state authorities. This is particularly problematic in light of the weak institutional structure of the investment arbitration system.

Even more problematic is the idea of introducing a so-called necessity test into the expropriation analysis. This test is well known in the trade context, but the concept is complex and controversial. It has at times been interpreted as requiring governments to demonstrate that the measures chosen had the least trade-restrictive effect. Transposed into investment law, the test could require that the government must prove that it has chosen the measure with the least effect on investors. This may put governments in difficult positions, since decision-making in the public interest involves many other considerations, such as what effects the measure might have on a wider range of stakeholders (not just on specific investors), what costs the measure implies, and the technical and logistical feasibility. A more practical problem with the necessity test is that arbitral panels are not appropriately qualified to make fine-grained technical and scientific judgments about the feasibility of alternative regulatory proposals that a state might have adopted in place of the challenged measure. For example, if a foreign investor challenged the introduction of a new regulatory regime governing the use of cyanidation processes in gold mining, a necessity test would require the tribunal to consider if some less restrictive regulation of cyanidation processes were possible.

The necessity test and its utilization by panels in the WTO dispute settlement mechanism is still a controversial topic today. The Appellate Body has partly responded to criticism and concerns, and has shown itself more deferential to governments, but the investment arbitration community has not been involved in the debate. Given its institutional structure, and the impossibility to streamline interpretational approaches, it cannot be expected that investment tribunals will follow the more deferential path laid out by the Appellate Body.

The Two Approaches and the Issue of Deference

The Canadian approach is not perfect either, given the loophole inherent to the "in rare circumstances" wording. However, it is likely that tribunals will be significantly more deferential to governmental public welfare measures than they would be under the EU approach.

Several recent texts have closed that loophole by deleting the reference to "rare circumstances." For example, the 2009 regional investment agreement amongst ASEAN countries provides:

> 4. Non-discriminatory measures of a Member State that are designed and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, do not constitute an expropriation of the type referred to in sub-paragraph 2(b) (Annex 2).

Section 5: Reservations and Exceptions

Reservations

SECTION 5: RESERVATIONS AND EXCEPTIONS

ARTICLE X.15: RESERVATIONS [CAN: AND EXCEPTIONS]

1. Articles X- (National Treatment), X- (Most-Favoured-Nation Treatment), X- (Market Access), X- (Senior Management and Boards of Directors) and X- (Performance Requirements) do not apply to:

(a) an existing non-conforming measure that is maintained by:

(i) the European Union, as set out in its Schedule to Annex I;

(ii) a national government [of a Party], as set out in its Schedule to Annex I;

(iii) a provincial, territorial, or regional government [of a Party], as set out in its Schedule to Annex I; or

(iv) a local government of a Party.

(b) the continuation or prompt renewal of any non-conforming measure referred to in subparagraph (a); or

(c) an amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment, with Articles X- (National Treatment), X- (Most-Favoured-Nation Treatment), X- (Market Access), X- (Senior Management and Boards of Directors) and X- (Performance Requirements).

2. Articles X- (National Treatment), X- (Most-Favoured-Nation Treatment), X- (Market Access), X- (Senior Management and Board of Directors) and X- (Performance Requirements) do not apply to measures that a Party adopts or maintains with respect to sectors, subsectors or activities, as set out in its Schedule to Annex II.

[EU to revert to the application of Annex II reservations to established investments.]

3. In respect of intellectual property rights, a Party may derogate from Article X.3 (National Treatment), Article X.4 (Most-Favoured-Nation Treatment) [CAN: and subparagraph 1(f) of Article X.8 (Performance Requirements)] where permitted by the TRIPS Agreement, including any amendments to the TRIPS Agreement in force for both Parties, and waivers to the TRIPS Agreement adopted pursuant to Article IX of the WTO Agreement.

[CAN: 4. Articles X.3 (National Treatment), X.4 (Most-Favoured-Nation Treatment) and X.7 (Senior Management and Board of Directors) do not apply to:

(a) procurement by a Party or a state enterprise; or

(b) subsidies or grants provided by a Party or a state enterprise, including government-supported loans, guarantees and insurance.]

Some treaties contain explicit reservations and feature exceptions to preserve the rights of the signatory states to take measures that will intentionally (or foreseeably) discriminate against a foreign investor. They can be designed to protect particular sectors, sub-sectors and/or particular measures.

Scope of Reservations and Exceptions

This article sets out the framework for reservations and exceptions with respect to national treatment, MFN market access, senior management requirements, and prohibition on performance requirements. Exempt from these obligations completely or in part are:

- Certain non-conforming measures
- Measures relating to sectors listed as exempt from market access, national treatment, and MFN (in negative list described above)
- Certain intellectual property-related rights where derogation is permitted under TRIPS
- Public procurement and subsidies or grants (requested by Canada)

These provisions are of very high importance but cannot be discussed in detail here. They will require additional negotiation in terms of exact coverage and other issues.

Non-conforming Measures

The provision on non-conforming measures states that selected substantive investor guarantees (such as national treatment, MFN treatment, market access and performance requirements) do not apply to certain existing non-conforming measures identified in schedules.

The CETA text is structured in a way that only measures listed as non-conforming in Annex 1 will be exempt from national treatment, MFN and market access commitments (negative list approach). This means that non-conforming measures may not be maintained unless listed in a schedule.

The parties could instead, consider adopting a general sentence that effectively grandfathers all non-conforming measures, such as included in the China-Canada FIPA:

> 2. Articles 5, 6 and 7 do not apply to (a) (i) any existing non-conforming measures maintained within the territory of a Contracting Party (Article 8).

Pursuant to this approach, parties need not worry about listing an existing non-conforming measure they would like to keep, since all of them are grandfathered. This would not exclude the possibility to repeal certain measures on a unilateral basis. Since Canada has done this before, there is a precedent for grandfathering non-conforming measures. This approach is much simpler than listing all non-conforming measures, as Canada and the EU would not have to examine all their laws and regulations to see which should be excluded.

Denial of Benefits

SECTION 5: RESERVATIONS AND EXCEPTIONS

[CAN: Article X.16: Denial of Benefits

1. A Party may deny the benefits of this Chapter to an investor of the other Party that is an enterprise of that Party and to investments of that investor if:

   a) investors of a non-Party own or control the enterprise; and

   b) the denying Party adopts or maintains measures with respect to the non-Party that:

      i. are related to maintenance of international peace and security or the protection of human rights; and

      ii. prohibit transactions with the enterprise or would be violated or circumvented if the benefits of this Chapter were accorded to the enterprise or to its investments.

2. A Party may deny the benefits of this Chapter to an investor of the other Party that is an enterprise of that Party and to investments of that investor if investors of a non-Party or of the denying Party own or control the enterprise and the enterprise has no substantial business activities in the territory of the Party under whose law it is constituted or organized.]

Subject to further internal consultations by the Parties on how to address the Denial of Benefits in connection to Definitions (regarding par. 2 see alternative draft proposal by CAN on the definition of 'investor').

Denial of benefits clauses allow the parties to the agreement to deny the application of the treaty to investors and their investments under certain circumstances.

Denial of Benefits and Relation to Definition of Investor

This article (suggested by Canada) says to give a Party the right to deny investors protection under the treaty if the enterprise is owned or controlled by investors from a third country, not one of the contracting parties and/or if the Party has security or other measures in place against the third country that "prohibit transactions" (e.g. no diplomatic relations, embargo). In contrast to the second paragraph (described below), benefits can even be denied when the investor has a substantial business activity in the alleged home state.

Paragraph 2 of the denial of benefits clause allows the host state to deny benefits of the treaty to an investor that is an enterprise of the alleged home state if investors of a non-Party or of the host state own or control the enterprise and the enterprise has no substantial business activities in the alleged home state. This allows benefits to be denied to shell and mailbox companies in the alleged home state. This paragraph appears to achieve the same goals as the definition of investor as proposed by Canada in Section 1: Scope and Definitions. However, tribunals have approached the interpretation of the denial of benefits clause very differently from the investor definition. It is clearly more predictable to defy treaty shopping through the investor definition rather than only in the denial of benefits clause.

Section 7: Final Provisions

General Exceptions

SECTION 7: FINAL PROVISIONS

[EU: Article X.19: General exceptions

1. Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on establishment or cross-border supply of services, nothing in this Part shall be construed to prevent the adoption or enforcement by either Party of measures regarding the establishment, acquisition and expansion of an investment:

(a) necessary to protect public security or public morals or to maintain public order3;

(b) necessary to protect human, animal or plant life or health;

(c) relating to the conservation of exhaustible natural resources if such measures are applied in conjunction with restrictions on domestic investors or on the domestic supply or consumption of services;

(d) necessary for the protection of national treasures of artistic, historic or archaeological value;

(e) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Chapter including those relating to:

(i) the prevention of deceptive and fraudulent practices or to deal with the effects of a default on contracts;

(ii) the protection of the privacy of individuals in relation to the processing and dissemination of personal data and the protection of confidentiality of individual records and accounts;

(iii) safety;

2. This Article does not apply to obligations arising out of Articles X [Treatment of Investment] and X [Expropriation] of the Chapter on Investment regarding treatment accorded to investors of a Party in so far as they affect investors and their investments with respect to the operation, management, maintenance, use, enjoyment and sale or disposal of their investments in the territory of one of the Contracting Parties.]

[CAN:

1. For purpose of the Investment Chapter:

(a) a Party may adopt or enforce a measure necessary:

(i) to protect human, animal or plant life or health,

(ii) to ensure compliance with domestic law that is not inconsistent with this Agreement, or

(iii) for the conservation of living or non-living exhaustible natural resources;

(b) provided that the measure referred to in subparagraph (a) is not:

(i) applied in a manner that constitutes arbitrary or unjustifiable discrimination between investments or between investors, or

(ii) a disguised restriction on international trade or investment.]

[Parties to consult with Services Group].

[3] The public order exception may be invoked only where a genuine and sufficiently serious threat is posed to one of the fundamental interests of society.

[4] Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Party under its taxation system which:

(i) apply to non-resident investors and services suppliers in recognition of the fact that the tax obligation of nonresidents is determined with respect to taxable items sourced or located in the Party's territory; or

(ii) apply to non-residents in order to ensure the imposition or collection of taxes in the Party's territory; or

(iii) apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or

(iv) apply to consumers of services supplied in or from the territory of another Party in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Party's territory; or

(v) distinguish investors and service suppliers subject to tax on worldwide taxable items from other investors and service suppliers, in recognition of the difference in the nature of the tax base between them; or

(vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Party's tax base.

General exceptions are usually considered to set out broad exceptions from the agreement as a whole, designed to protect particular aims and objectives. Yet, exceptions clauses often fail to provide any effective safeguards for the measures they refer to.

Exceptions Clauses Provide False Comfort

Both Canada and the EU are proposing to include a general exceptions clause in the investment chapter. At first glance, both appear at least inspired by the General Agreement on Tariffs and Trade (GATT) Article XX. But a closer look reveals a very different approach.

It must be understood that these general exceptions provide false comfort. They will not safeguard government policy space in a satisfactory manner. It is much more important to include clarifications and limitations to the crucial substantive provisions included in the investor chapter. In particular, it is essential to ensure that fair and equitable treatment, MFN treatment, national treatment and expropriation clauses are properly drafted, to provide guidance to investment tribunals in case of a dispute. In short, exceptions clauses will not let the parties off the hook for getting the individual host state commitments right.

If they are used nevertheless, the focus should be on which types of measures are excluded from the obligation to pay compensation, rather than on setting out exceptions to commitments.

Canada's Proposed General Exception

Canada's proposed text appears to be based on the language used in Canada's provisional 2012 Model FIPA text. That clause reads as follows: a Party may adopt or enforce a measure necessary:

(i) to protect human, animal or plant life or health,

(ii) to ensure compliance with domestic law that is not inconsistent with this Agreement, or

(iii) for the conservation of living or non-living exhaustible natural resources [...].

It limits the scope of the measure to three categories. What about measures that do not fall in one of the four narrow groupings? Are states not allowed to adopt those measures? Is this article introducing new obligations on the host state? These questions become even more relevant when we consider that the measures listed as permitted are subject to a necessity test, which raises a number of concerns.

Finally, borrowing from WTO language, the measures described above may only be adopted provided they are not:

(i) applied in a manner that constitutes arbitrary or unjustifiable discrimination between investments or between investors, or

(ii) a disguised restriction on international trade or investment.

The EU Proposed General Exception

The EU proposes a different formulation of the general exceptions clauses. In addition to this general clause in section 7, the EU is also proposing a second type general exception clause. These appear in bracketed text scattered throughout the investment chapter.

The exceptions clause proposed by the EU in section 7 is partly modelled along the lines of GATT Article XX "General Exceptions" and GATS Article XIV "General Exceptions." The clause is limited in scope in a different way than the proposed Canadian text. First, the general exception clause only applies to measures regarding the establishment, acquisition and expansion of an investment (and therefore do not apply to measures regarding post-establishment). Like the Canadian approach, the clauses apply to limited types of measures, such as those necessary to protect public security, health, conservation of natural resources and cultural heritage. Although the list is slightly longer than in the Canadian text, most of the protected measures are also subject to a necessity test. The EU also clarifies that fair and equitable treatment obligations are excluded from the general exceptions clause.

A related EU suggestion is to include a paragraph mentioning the "right to adopt and enforce… legitimate policy objectives" that, at first glance, may appear to be a public policy exception:

> [EU: 2. Consistent with the provisions of this Chapter, each Party retains the right to adopt and enforce measures necessary to pursue legitimate policy objectives such as social, environmental, security, public health and safety, promotion and protection of cultural diversity.]] (Section 1: Scope and Definitions)

Unfortunately, this clause is weak since it only applies where "consistent with the provisions of this Chapter." This reference wipes out any significance that the clause might otherwise have.

Conclusions

Both Canada and the EU have moved away from previous treaty practice. Unfortunately, their CETA approaches do not go into the right direction. While Canada takes back the procedural and substantive innovations that it incorporated in its 2004 Model FIPA (and ensuing investment agreements), the EU combines the traditionally broad MS BIT provisions with wide-ranging market access and related commitments.

A critical change compared to earlier EU FTAs is that the EU seems to have been convinced to shift from a positive to a negative list approach. Furthermore, the previous EU FTAs market access and establishment rights were not subject to ISDS. Now that the EU is negotiating market access and investment protection as part of the CETA and has agreed to incorporate ISDS, the question is whether the ISDS coverage will be limited to post-establishment treatment or also cover market access.

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