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Shoulder-to-Shoulder for Open Markets and Investor Protection

Transatlantic Principles for International Investment

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The European Union and the United States intend to cooperate to promote open, transparent, non-discriminatory global investment policies on the basis of Shared Principles for International Investment agreed in April 2012. The shared principles are designed to strengthen EU and US negotiating positions and in the process foster the establishment of an international standard in line with their wishes. But it is already apparent that the rules for free market access for foreign investors, arrangements for open and transparent investor-state dispute settlement and definition of indirect expropriation are too imprecise. The European Union and the United States need to specify these rules, in particular as they have just kicked off negotiations for a comprehensive Transatlantic Trade and Investment Partnership (TTIP), in which investment will also play an important role.

The Transatlantic agreement on Shared Principles for International Investment is welcome in three respects. Firstly, they represent an important basis for the investment chapter in a comprehensive Transatlantic Trade and Investment Partnership (TTIP). At the G8 summit in Northern Ireland on June 17, the European Union and the United States kicked off negotiations to reduce tariffs and non-tariff trade barriers. The first round of talks will begin in early July in Washington, D.C. These days, the dynamic of integration in economic relations is driven more by foreign direct investment and the Transatlantic business activities of subsidiaries of European and American corporations than by trade in goods, which makes it all the more important to pay close attention to investment rules.

Secondly, the principles could strengthen the European Union and United States in negotiations with third countries and help them disseminate their regulatory concepts internationally. Alongside market access, this means above all investor protection, as a stable legal framework is essential when investing abroad. Where protections are lacking, excessive risks quickly become a burden. Thirdly, the principles are a step towards international harmonisation of rules in the interests of unhindered foreign

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investment. Experience with the multitude of bi- and plurilateral free trade agreements (FTAs) has demonstrated the high transaction costs an international tangle of rules can create. Both the United States and the European Union are considering bilateral investment treaties (BITs) with China. One effect of shared Transatlantic principles would be to prevent EU and US companies in China being subject to different and possibly competition-distorting investment rules.

Global Investment Trends

With their shared investment principles, the Transatlantic partners are responding to several trends in global investment. Since 1990 the stock of foreign direct investment has increased tenfold. In 2011 the worldwide stock of FDI (inward) amounted to $20.4 trillion, with the upward trend forecast to continue.

The United States and the European Union are the world's largest sources and destinations of FDI. In 2011 the stock of FDI in the European Union was $7.3 trillion; the stock of European FDI abroad reached $9.2 trillion. In the same year the stock of FDI in the United States amounted to $3.5 trillion; the stock of US FDI abroad totalled $4.5 trillion (see Table 1).

The European Union and the United States are central investment partners for one another. In 2011 51.1 percent of US outward FDI flowed to the European Union, with about 30 percent of EU outward FDI going to the United States (see Figure 1).

But the dominance of the Transatlantic partners is receding (see Table 1). Striking growth is recorded in China, where the stock of FDI has grown almost thirty-five-fold since 1990 to reach $712 billion in 2011. In 2011 alone the inflow amounted to about $124 billion. But it is not only inward investment that is growing rapidly. China is increasingly investing abroad and becoming an ever more important FDI partner for both the United States and the European Union.

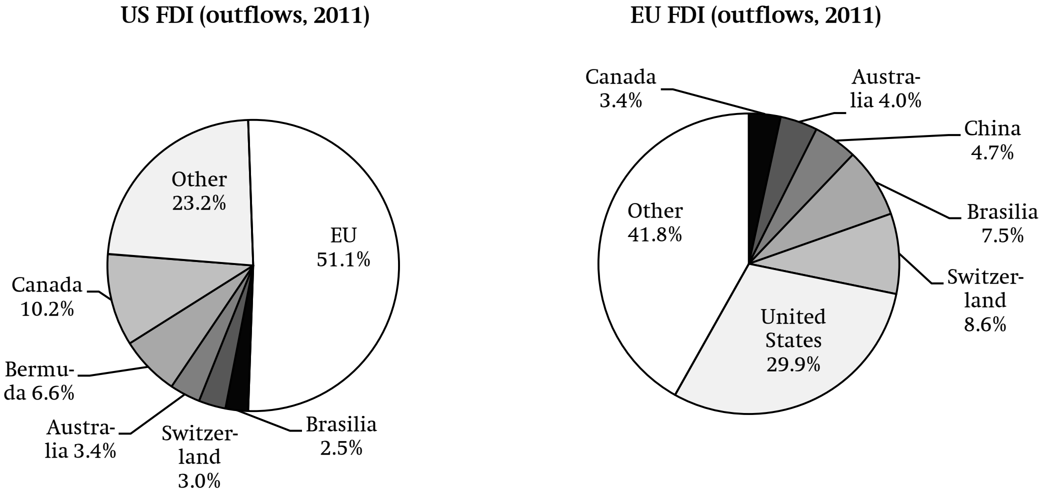
Parallel to the growing volume of FDI, a second trend can be observed: an increasing number of investment agreements guaranteeing foreign investors legal protections such as fair competition, property protection and the possibility to litigate their rights in the host country. Traditionally investment agreements have been concluded at the bilateral level, but the trend appears to be shifting. According to the UNCTAD *World Investment Report* of 2012, BITs still dominate in quantitative terms but regional agreements, such as the trilateral investment agreement signed by China, Japan and South Korea in 2012, are gaining in importance. Investment rules are also increasingly integrated in FTAs. As of 2011, 2,833 of 3,164 international investment agreements were BITs and 311 "other investment agreements".

Another observable trend is that international investment agreements are increasingly concluded among emerging economies and developing countries rather than – as previously – by industrialised countries with emerging economies and developing countries. The new FDI agreements do not always conform to EU and US regulatory ideals. For example, the agreement between China, Japan and South Korea contains many protectionist exceptions allowing host countries to limit market access or investor protection.

Unlike trade in goods and services, which is subject to the strict rules of the World Trade Organisation (WTO), foreign direct investment has no comparable multilateral rulebook, although trade-related aspects are regulated under the WTO's TRIMs agreement.

Attempts to conclude a Multilateral Agreement on Investment (MAI) under the auspices of the OECD failed at the end of the 1990s, and although investment rules were initially part of the WTO Doha Round, they were taken off the agenda in 2003 at the behest of the developing countries and emerging economies. In summer 2012 the United Nations Conference on Trade and Development (UNCTAD) launched its Invest-

Figure 1: US and EU FDI 2011



Sources: Bureau of Economic Analysis, *Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data*, <www.bea.gov/international/di1fdibal.htm> (accessed 27 November 2012); Eurostat (accessed 27 November 2012).

Table 1
Share of world trade and FDI (%)

	Share of world goods exports/a*		*Share of world goods imports*/a*		*Share of world FDI, outward stocks**/b*		*Share of world FDI, inward stocks**/b*	
	1980	*2011*	*1980*	*2011*	*1980*	*2011*	*1980*	*2011*
United States	16.4	10.6	17.9	15.6	39.2	21.3	11.9	17.2
European Union	22.7	14.1	28.4	15.6	38.8	43.5	32.1	35.6
Germany	14.3	10.0	13.1	8.5	7.9	6.8	5.2	3.5
Japan	9.7	5.9	9.8	5.9	3.6	4.6	0.5	1.1
Brazil	1.5	1.8	1.9	1.7	7.0	1.0	2.5	3.3
India	0.6	2.2	1.0	3.2	0.0	0.5	0.1	1.0
China	1.3	13.6	1.4	12.0	0.0	1.7	0.2	3.5

* Excluding trade within the European Union. ** Including foreign direct investment within the EU.
Sources:
a IWF, Direction of Trade Statistics, <http://elibrary-data.imf.org> (accessed 30 November 2012).
b UNCTAD, UNCTADstat, <http://unctadstat.unctad.org> (accessed 30 November 2012).

ment Policy Framework for Sustainable Development, to ensure that international investment agreements promote sustainable growth and development. In particular, investors are called upon to take responsibility for social and environmental standards in developing countries.

EU and US Investment Agreements

The Lisbon Treaty of 2009 granted the European Union the power to regulate foreign direct investment as part of its trade policy (Articles 207 [1] and 3 [1] [e], Consolidated Version of the Treaty on the Functioning of the European Union). But the Commission has yet to sign an autonomous investment agreement with another state, so the BITs of the member-states are currently the valid legal framework. In all, the EU member-states have 1,765 BITs; with 136 Germany has the largest number in the European Union, indeed worldwide. BITs vary sometimes considerably between member-states.

Many EU member-states have rules for FDI in the trade in services chapters of their FTAs. On 11 September 2011 the EU Council officially authorised the Commission to include an investment chapter in FTAs to be negotiated with India, Singapore and Canada, and on 29 November 2012 gave the Commission green light for FTA talks with Japan. It is presently unclear how comprehensive the investment rules will be.

Although the European Union has not yet prepared a blueprint for bilateral investment treaties (model BIT), communications and draft regulations published since the Lisbon Treaty came into force show the direction it is taking. A draft of 21 June 2012, for example, defines how financial responsibility is to be shared between member-states and Union in the event of dispute settlement procedures. For example, if a foreign investor takes action against Germany over unfair treatment based on a European Directive, the European Union will have to cover the legal costs and any compensation. On 11 February 2013 the European Union also came out in favour of the UN's new transparency rules for investor-state dispute settlement.

The United States presently has forty-seven bilateral investment treaties. The reason for this comparatively small number is their insistence on their own model BIT, from which they are seldom willing to deviate. Increasingly, Washington negotiates investment rules within FTAs; the FTA with South Korea includes an investment chapter, and one is to be included in the Trans-Pacific Partnership currently under negotiation. Although the United States has no BIT with China, it has resumed the talks it broke off after the Tian'anmen massacre of 1989.

On 20 April 2012 Washington unveiled a new model BIT with modified rules for dealings with state-owned companies, expanded possibilities for US businesses to "participate in the development of standards and technical regulations" in the host country, new standards for transparency in governance, and tighter prohibition of performance requirements. The latter is designed to prevent a host country from placing particular requirements on foreign investors (for example access to particular technology). The model BIT also defines new labour and environmental standards, for example prohibiting states from suspending environmental and labour laws to attract foreign investors. The new US model BIT is regarded as both catalyst and basis for talks with China and India.

The Transatlantic Principles

The Transatlantic partners have agreed the following principles: 1. Open and non-discriminatory investment climates; 2. A level playing field; 3. Strong protection for investors and investments; 4. Fair and binding dispute settlement; 5. Robust transparency and public participation rules; 6. Responsible business conduct; 7. Narrowly-tailored reviews of national security considerations.

Fundamentally, the EU-US principles are to be welcomed, although certain differences between the partners remain unresolved. These include free market access for foreign investors, rules affecting investor-state dispute settlement procedures, and the definition of indirect expropriation.

Investment rules must seek to reconcile the diverging interests of investors and host countries. Usually investors are interested in the easiest possible non-discriminatory access to the foreign market, combined with great legal security and effective protection of their investment. The government of the host country wishes to preserve its regulatory powers and is interested in securing maximum national benefit from the investment. Reconciling both interests is not always easy – but should be kept in mind as the ultimate objective when honing the Transatlantic principles.

Market Access

National laws are decisive for the openness of a country's investment market. UNCTAD's annual reports on the prevalence of liberal and protectionist rules across the world reveal that the share of liberal laws fell from 94 percent in 2000 to 78 percent in 2011. The share of protectionist laws increased correspondingly from 6 percent to 22 percent, affecting especially the areas of agriculture, financial services and commodities.

The central measure to secure market access for foreign investors is the prohibition on discrimination, which comprises the principles of national treatment and most-favoured-nation treatment. The former demands that an investor from the treaty partner be treated no worse than a local investor, the latter prohibits disadvantage compared to investors from third countries.

The principle of non-discrimination can apply to the "pre-establishment phase" before the investment is actually made or only to the "post-establishment-phase" when the investor is already present. If market entry is regulated by national law without a prohibition on discrimination in the pre-establishment phase, we refer to an "admission clause" model. But if the investment agreement prohibits discrimination of foreign investors in the pre-establishment phase and contains explicit rules, for example for approval and public procurement, we speak of the "right of establishment". The latter involves considerably greater intervention in the state's regulatory powers, because the government of the host country cannot prohibit FDI. Under the "admission clause" model it can reject an investment, because the protection stipulated by the agreement only comes into effect after the investment has been made. Accordingly the host country is not obliged to abolish discriminatory laws that hamper participation in public tendering, approval and licensing of foreign investments.

The BITs of EU member-states usually adopt the "admission clause" model; most relate to the period *after* an investment has been made. However, in future negotiations the European Union can be expected to argue for pre-establishment rights.

US BITs already have a broader scope, following the "right of establishment" model. Article 3 of the US model BIT states that: "Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to its own investors [and, under Article 4, to non-parties] with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory." The same also applies to public procurement and approval.

The Transatlantic principles do not specify whether they also apply to the pre-establishment phase. They merely state: "Governments should commit, subject to limited exceptions, to provide broad market access to foreign investors and allow them to establish investments and conduct business on terms no less favorable than those available to domestic investors or other foreign investors."

The Transatlantic partners should concretise the principle of market access and agree on the "right of establishment" model. However it should, as in trade law, define exceptions that state clearly when deviations may be permitted, for example to protect national security or preserve public order. Social and ecological standards should be integrated according to UNCTAD guidelines, to allow developing countries to profit in an appropriate and sustainable manner from expanded market access.

Dispute Settlement

Open, predictable and transparent rules for settling disputes are essential to minimise investment risks. International investment agreements usually permit an investor to take disputes not only to national courts, but also to an international adjudication body. These include the International Centre for Settlement of Investment Disputes (ICSID) in New York and ad-hoc tribunals operating under the rules of the United Nations Commission on International Trade Law (UNCITRAL). The number of dispute settlement cases has risen enormously worldwide, from just thirteen known cases in 2000 to 450 in 2011. In 2011 alone forty-six new dispute settlement cases were recorded, the biggest single-year increase to date.

Especially with respect to investment talks with China, strong Transatlantic principles could be helpful. Few foreign investors have started dispute settlement cases against China under the terms of a BIT. Most fear that such a course of action could harm their business in China. If the Transatlantic Partners agree on a strong position, this could provoke a rethinking among businesses.

EU member-states' existing BITs with China contain only very weak dispute settlement principles and represent a poor negotiating basis for a possible EU-China BIT. For example, Article 9 of the Germany-China BIT of 2005 grants greater powers in investment disputes to the Chinese authorities than it does to their German counterparts. Under item 6 of the attached protocol, a German investor may only call on an ICSID panel in a dispute with China after the matter has been fully investigated under Chinese law, while Chinese investors may take their case to an ICSID panel immediately without exhausting the German national procedures. Other European states' BITs with China contain even weaker dispute settlement provisions. The United Kingdom-China BIT (1986), the France-China BIT (1985) and the Denmark-China BIT (1985) permit investor-state dispute settlement procedures only to set compensation for expropriation, and preclude the hearing of other disputes before international bodies.

The new US model BIT contains no requirement to exhaust national procedures in investor-state disputes. Under Article 25 disputes between parties must be resolved by ICSID procedures.

Yet investor-state dispute settlement (ISDS) procedures are not uncontroversial. States increasingly fear their regulatory powers are too strongly curtailed. The reality of such worries is demonstrated by cases brought by Philip Morris against national tobacco legislation in Australia and Uruguay and by Vattenfall against Germany's decision to shut down its nuclear programme. Certain states, like Bolivia and Ecuador, have already withdrawn from the ICSID for that reason, and Australia has announced that future investment agreements will no longer contain ISDS clauses.

The Shared Principles for International Investment state in this respect: "Governments should provide access to effective dispute settlement procedures, including investor-to-state arbitration, and ensure that such procedures are open and transparent, with opportunities for public participation." The Transatlantic partners should expand this principle to abolish the obligation to exhaust national procedures in investor-state disputes, and should urge more transparency in settlement procedures. In the process of concretising the principle leeway for national regulation should be preserved, for example to protect health or the environment.

Indirect Expropriation

Alongside fair and non-discriminatory treatment of investments, protection against expropriation is one of the most important purposes of BITs. One known case concerns the Spanish oil and gas corporation YPF, which was expropriated by the Argentine government in April 2012.

In December 2012 YPF submitted a complaint against Argentina to the ICSID.

Expropriation of a foreign investor by the host country is permitted by BITs, but only in return for appropriate and realisable compensation. A distinction can be made between direct and indirect (creeping) expropriation. The definition of indirect expropriation is particularly contested, as the term is elastic and permits a great deal of room for interpretation. An indirect expropriation and a right to compensation can, for example, be asserted if an amendment to legislation reduces the value of an investment or investor. This broad interpretation is controversial because it severely curtails the regulatory freedom of the government of the host country. For example if it prohibits the manufacture of a product for health or environmental reasons, this can be interpreted as an expropriation-like act if the ban leads to business losses.

The magnitude of the interpretation problem is currently seen in the negotiations on the Trans-Pacific Partnership, where the United States demands maximum investor protection against indirect expropriation. Annex B, Article 4 of the US model investment treaty states that "indirect expropriation" should be assessed on a case-by-case basis, taking into consideration factors such as economic impact, reasonable expectations and character of government intervention. Other negotiating partners support a definition of the type found in the FTA between China and Peru (2009) or between China and New Zealand (2008). These offer lesser protection against indirect expropriation, grant the host country government greater flexibility, and permit the host country to cite the public good as a justification. The investment agreements of EU member-states often treat the definition of "indirect expropriation" even more loosely. The Germany-China BIT of 2005 contains no definition at all, while British and French BITs often lack precise definitions. Alongside the question of free market access, the precise meaning of "indirect expropriation" could become one of the toughest challenges in talks with the Chinese.

The topic is skated over in the Shared Principles for International Investment, which state only: "Governments should provide the highest possible level of legal certainty and protection against discriminatory, arbitrary, and otherwise unfair or harmful treatment to all investors and investments in their territories, both tangible and intangible, such as intellectual property rights. This includes the right to prompt, adequate, and effective compensation in the event of a direct or indirect expropriation or nationalization."

It would be desirable to concretise the meaning of indirect expropriation. A compromise needs to be found that protects investors from indirect expropriation, while leaving governments room to regulate in the public interest.

There Is Still Much to Do

The Transatlantic investment principles are a step in the right direction. But there is still a deal of honing to do if the joint project of supporting open markets and investor protection is to take off. This will certainly not be a simple matter, especially given that the European Union has not yet presented a model investment treaty of its own. If the European Union wishes to negotiate with the United States on equal terms and agree meaningful rules on market access, protection of foreign direct investments, and dispute settlement, it is high time for it to define its own ideas on the critical points. In view of its strong investment activity abroad and the multitude of BITs already concluded, Germany has a special interest in a strong European position in the talks.

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