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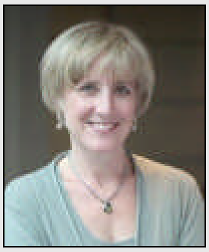

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The Emperor Has No Clothes:

A Critique of the Debate Over Reform of the ISDS "System"

by J.J. Saulino and Josh Kallmer

Current calls for a debate over reform of the Investor-State Dispute Settlement (ISDS) system are based upon a flawed premise. Specifically, they assume as a starting point that there already exists an ISDS "system" or "regime" that is capable of being reformed (let alone treated as a single entity). The reality is that there is no system or regime of investor protection or ISDS at present. There is no unified body of applicable law, only a fragmented collection of bilateral and regional treaties negotiated based on individualized circumstances over the span of several decades.

Put differently, there is no "system," only the illusion of one.

There is a simple reason why there is no global system or regime for investor protection: states have not up to this point wanted one. International Investment Agreements (IIAs) do not exist outside of the political context and the political entities that decide that they will exist and what they will contain. Any debate over reform of an ISDS system is counterproductive to the extent that it does not internalize the fact that IIAs, by definition, emanate from the policy choices of sovereign states. Going forward, those sovereign economic policy choices will continue to drive the debate over whether to create a multilateral ISDS system and what features it should have.

Efforts to modify IIAs, or to move toward a coherent multilateral system, must therefore acknowledge and work within the unique, complex, and often ugly political and policy environments characterizing the economies that negotiate the agreements. There may indeed be several good ideas for how to improve the bilateral and regional agreements that do exist, as well as how to improve the limited areas of multilateral agreement in this field—for example, the ICSID Convention. But these suggestions will be useful and practical only to the extent that they respond effectively to the valid policy preferences of governments and their populations, and not because they contribute to an independent notion of reform developed by substantive investment law experts but untethered from the political and commercial dynamics of states.

The Investment Protection "System" vs. the WTO

In order to better understand why investment protection exists as a relatively incoherent and fragmented collection of bilateral and regional agreements rather than as a unified system, it is useful to draw a comparison to a related issue – trade.

Indeed, an observer looking at the international approach to investment disputes as compared to the international approach to trade disputes might ask the basic question: Why is there a World Trade Organization (WTO), but not a World Investment Organization (WIO)?

As alluded to above, the simple answer is that the state parties that negotiate such agreements have apparently determined as a policy matter that, for the benefits of their economies and their sovereign interests, it makes sense to have a multilateral agreement dealing with trade in goods and services, whereas it does not make sense to have the same as regards investment protection.

This is not to say that there are no multilateral agreements that, among other objectives, affect the nature and extent of the legal protections that cross-border investors enjoy. They are just all limited in scope in some way. For example, the ICSID Convention's scope is limited mainly to the procedural aspects of arbitration, not to the substantive law of investor protection. The Energy Charter Treaty, likewise, is limited in scope to investments dealing in some way with investments in the energy sector. Plurilateral or regional trade agreements containing investment chapters, such as the NAFTA and the CAFTA-DR, have a limited number of state parties as signatories, and are not freely open to new entrants.

The national governments and negotiators that brought us the current WTO system (something that can appropriately be called a "system") did indeed attempt to reach agreement on investment-related issues as well, but found that they could only achieve consensus on issues that were similarly limited in scope. For example, in developing the General Agreement on Trade in Services (GATS), WTO members established strong market access expectations and protections for companies providing services in the form of an investment ("Mode 3" or "commercial presence"). Moreover, in crafting the Agreement on Trade-Related Investment Measures (TRIMs), negotiators focused on the investment-related economic distortions created by domestic content requirements, export requirements, import substitution policies, and foreign exchange balancing requirements. But beyond these two limited areas – GATS and TRIMs – WTO negotiators have not, up to now, been able to go further.

The key takeaway from the above is that the only times when state parties have been successful at achieving multilateral agreement on investment-related issues have been when they moved to the lowest common denominator on which they could agree. Procedural arbitration issues, energy investments, regional agreements, trade-related investment measures – these demonstrate how far states have been comfortable going up to now in the creation of a multilateral system, and they provide a strong indication of the limits on any multilateral agreement imposed by the sovereign and economic interests involved.

The limited subject matter scope of the multilateral agreements that do exist stands in stark contrast to the much broader scope contained in the web of individual IIAs. This is not an accident. Those IIAs, as is well known, go much farther both in the substantive protections accorded and in the types of redress that are available. They often provide not only for fair and equitable treatment, non-discrimination, and a commitment against unlawful expropriation, but also, critically, provide a direct means for individual investors to challenge state actions and seek compensation for harm. In an increasing number of cases, most notably China's new approach to its BIT negotiations with the United States, they even include meaningful market access commitments.

As should be plain, the commitments that states make in IIAs push them much further outside of the "comfort zone" in which they have thus far been willing to operate in the multilateral sphere. By providing a private cause of action and a means to challenge the fairness and legitimacy of state actions that impact foreign investors or investments, states that agree to IIAs are giving up sovereign rights that are not so directly implicated by the multilateral agreements that they make concerning trade in goods or services.

To put it another way, protection of foreign direct investment directly challenges state sovereign prerogatives in a way that protection of foreign trade does not. It implicates state power to regulate business activities on its own territory. It encroaches directly on the regulatory and policy freedom that states normally enjoy. It opens an avenue for states to have their actions reviewed and judged by independently appointed arbitrators, with orders to pay monetary damages. The trade-offs involved in protecting and encouraging investment are quite plainly more sensitive from a state sovereignty perspective than are those involved in protecting and encouraging trade in goods or services.

IIAs, therefore, cast a much wider net, implicate a great deal more sovereign measures, and more fundamentally invade the "policy space" that states expect to enjoy on their own territories than do multilateral agreements concerning trade. Moreover, ISDS, a common feature of these IIAs, opens states up to a myriad of individual suits. For these reasons, not unexpectedly, states have only been willing to make these kind of commitments in the context of bilateral agreements with one specific counterparty or, in some cases, regional agreements with a limited number of other countries.

This fundamental difference in how states view investment versus trade is reflected in the international institutions that have been set up to oversee these activities. The WTO is a unified set of agreements that joins both substantive law with the ability to enforce those rules into one body. By contrast, the one multilateral institution in the investment sphere—ICSID—only has the power to convene arbitrations under a common set of procedural rules. The substantive law exists independently, supplied by nearly 3,000 different bilateral or regional arrangements.

Moreover, the collection of IIAs that states have agreed to over the past several decades have not, by virtue of their numerosity, evolved into a "system"—a term that implies some level of consistency, coherence, and deliberate design. Indeed, the sheer number of IIAs—as compared to the number of Multilateral Investment Agreements (which might be called "MIAs")—is indicative of the *lack* of a consensus on a unified system, not the *presence* of one. If there were a multilateral consensus, we would expect to see fewer treaties, and of a more multilateral variety. Instead, what one observes is that "MIAs" are "missing in action."

The Practical Politics of Investment Treaty Negotiations

Any debate over possible reforms to how states deal with investment protection must therefore acknowledge and account for the political realities that have led to the present state of affairs—in which states apparently prefer to deal with investment largely on a bilateral or regional, rather than a multilateral, basis. The political realities and trade-offs associated with negotiating even a bilateral agreement on investment are difficult and often ugly.

Popular perceptions of international negotiations tend to focus on the deal-making that happens between countries, implicitly assuming that countries have identifiable sets of interests that they consistently pursue. The truth is that for many kinds of negotiations, including the negotiation of IIAs, what happens *within* governments is generally much more variable – and consequential – than what happens *between* them. The final text of an IIA is frequently the product of complex, philosophically fraught debates among a wide range of domestic players and interests. These debates take place at the initial stage of selecting countries with which to pursue IIAs, as governments weigh competing sets of economic, political, and practical considerations. They take place as governments develop their negotiating positions, with ministries, legislatures, business groups, and public interest organizations all jockeying to shape the outcome. And they take place even after government-to-government discussions have begun, with negotiators constantly having to vet evolving negotiating texts with domestic stakeholders.

For example, in developing negotiating positions, where business interests are particularly influential, a country might decide to pursue relatively expansive rules on non-discrimination, fair and equitable treatment, and expropriation. On the other hand, to the extent that civil society groups influence a country's negotiating objectives, IIAs may contain broader exceptions relating to the protection of public interests such as health, safety, the environment, or worker rights. A country that has recently experienced a financial crisis may want to retain the ability to impose capital controls and therefore hesitate to provide investors with the right to transfer funds freely into and out of the country. Similarly, a government that has been taken to ISDS frequently may seek provisions that restrict foreign companies' dispute settlement options as much as possible.

Thus, a given country's negotiating objectives can vary over time and based on circumstances—both external and internal. Where IIAs have been successfully concluded, it has been because the negotiators recognized the need to internalize their counterparts' objectives and constraints just as they do their own. They cannot just care about bringing home a good agreement to their own stakeholders; they have to help their counterparts bring home a good agreement to theirs. Of course, this means finding a "landing zone" (to use the hackneyed diplomatic term) that protects or at least does not harm either side's interests. For example, where the other side objects to making market access commitments because of resistance from its telecommunications and energy sectors, negotiators may develop exceptions for these sensitive areas. Where the other side's finance ministry wants to retain the ability to impose capital controls to combat a balance-of-payments crisis, negotiators may agree to extend time periods in the investor-State arbitration process, to provide sufficient breathing room for genuinely short-term measures. Where the other side seeks to exclude ISDS on the basis that it invites non-meritorious and opportunistic claims, negotiators may develop protections against frivolous claims and other procedural safeguards that reduce the exposure of host governments.

The political realities associated with negotiating high-standard investment agreements not only explain why states have not yet united around an ISDS "system" but illustrate the difficulties involved in ever getting to the point where there could be a such a system.

The Future of International Approaches to Investment Protection

It is interesting that many of the proposals currently floated as part of a "roadmap" for reform seem designed to alleviate the concerns of states. For example, the UNCTAD Issues Note that sought to focus the present debate identified such options as "limiting investor access to ISDS" and "creating a standing international investment court" with judges appointed only by states.[1]

If states are unhappy with their IIAs as currently constructed, they can, should, and will negotiate new ones. They do not need a reform movement in order to persuade them to do so. If history is any guide, they will renegotiate these agreements with their sovereign interests in mind and while making carefully considered trade-offs. Hard-nosed politics, both domestic and international, will no doubt play no small part.

But one should not fall into the trap of seeing the web of agreements that states have already negotiated as a "system" in need of reform so as to better protect states from the hazards of ISDS. There is no multilateral investment protection system because, up to now, the parties who would make such a decision to create one—namely, sovereigns—have apparently not wanted one.

If they want one in the future, it will be because something changes in their calculus of their sovereign interests as they relate to their desire to promote foreign direct investment. In other words, states will need to come to the conclusion that a uniform multilateral investment system is preferable to a collection of bilateral agreements tailored to the particular circumstances of the bilateral relationship implicated. This change in calculus would have to be strong and sustained enough to overcome the substantial bureaucratic and diplomatic inertia associated with "muddling through" with something resembling the status quo. But there is little evidence that such a fundamental change in state priorities is occurring at the present moment.

Instead, what one sees is further fragmentation in the approaches that states are taking toward ISDS. With its new competence over investment under the Lisbon Treaty, the European Union, for example, is at the very beginning of what will be a multi-year process of deciding "what it believes" when it comes to negotiating investment agreements as a bloc. Though it is seeking to minimize the disruptions to, and departures from, the more than 1,000 existing member state IIAs, it will invariably confront a much more complex and chaotic political debate over investment policy than any individual member state has ever faced. Much like the debate the United States went through more than a decade ago, business groups and civil society organizations are already poised to contest how the EU strikes the all-important balance between protecting investors and preserving regulatory authority. With the European Council and European Parliament also pursuing their interests, the process could be even more complex.

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[1] United Nations Conference on Trade and Development, *Reform of Investor-State Dispute Settlement: In Search of a Roadmap*, IIA Issues Note No. 2, June 2013, *available at*: www.unctad.org/diae.

Beyond the EU, many countries are undertaking genuine soul-searching over where this balance should lie and whether to continue to pursue high-standard IIAs. In light of recent IIA challenges to its health regulations in the area of tobacco, Australia has decided no longer to pursue ISDS provisions in its IIAs (though that position may change under its new government). India, after losing at least one recent investor-State case as a result of alleged deficiencies in its domestic judicial system, is considering whether ISDS creates unacceptable legal exposure. And the Czech Republic, which has been subject to a disproportionate number of investor-State claims in recent years, is seeking to amend its agreements to reduce investor protections and tighten safeguards for governments. Ecuador and South Africa are simply seeking to terminate many of their agreements.

This is not at all a bad thing. Much as U.S. politicians are fond of referring to state governments as "laboratories of democracy," the evolving approaches to IIA protection and ISDS are clearing space for states to try out new approaches as they continue to develop their policy toward protection of foreign investment.

Paradoxically, this experimentation could eventually move the topic of investment protection out of strictly bilateral negotiations and more into multilateral fora. Such a shift would move us closer to what one might one day plausibly call a "system." The Trans-Pacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP) are important steps forward in this regard. Because the negotiations cover such a broad scope, with many opportunities for "horse trading," they offer the prospect of a kind of grand bargain where states might determine that it is in their self-interest to swallow objections they might otherwise have had to a uniform approach to ISDS in order to access the benefits of a wider trade and investment framework.

One day, these multilateral agreements may eventually merge into a more global "system" of investment protection disciplines. But saying that such a system already exists and is simply in need of "reform" does no service to those who want to ultimately achieve such a goal.

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