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Joint Public Hearing
Committee on Legal Affairs and the Committee on International Trade

"Transatlantic Trade and Investment Partnership (TTIP):
Regulatory Aspects, Investor to State Dispute Settlement (ISDS) and Arbitration"

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Investor-State Dispute Settlement: Alternatives and Implications

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Introduction

It is my honour to be invited to the European Parliament to make a presentation and exchange views on the very important topic of international investment rulemaking and investor-State dispute settlement (ISDS). The issue has received enormous attention, particularly in the context of Transatlantic Trade and Investment Partnership (TTIP), which is currently being negotiated between the European Union and the United States.

I assume that you all know the main issues related to ISDS. However, I would like to recall that ISDS is an *enforcement mechanism*, a tool to apply the substantive provisions of international investment agreements (IIAs). Hence, we should not look at ISDS in isolation but in conjunction with substantive investment protection rules embodied in IIAs. This intrinsic link between substance and procedure should always be kept in mind in the discussions on ISDS reform. Without a comprehensive package that addresses both the substantive content of IIAs and ISDS, any reform attempt risks to remain piecemeal.

[1] This statement is built on UNCTAD policy analysis led by the speaker, but it does not necessarily represent the views of the UNCTAD secretariat or its member States.

In my presentation I would like to:

- Identify the major challenges faced by the IIA regime;
- Provide some key facts about the current use of ISDS;
- Summarize the present debate on the pros and cons of the existing ISDS mechanism; and
- Analyze possible ISDS reform options and implications.

Let me say from the outset that the international investment regime is highly complicated, consisting over 3,260 investment treaties at the bilateral, regional and plurilateral level (Annex Figure 1). Within this regime, dispute settlement is presumably the most complex of all. There are no easy solutions or quick fixes.

I. The IIA regime: Three major challenges

The first challenge is policy space. The root of the current ISDS debate lies in the fact that IIAs grant protection to foreign investors, which can significantly impact the regulatory power of host countries. There is growing concern that IIAs, in their traditional form, could unduly restrict policy space. Broad and vague formulation of IIA provisions create a risk that investors may challenge core domestic policy decisions, for instance in the area of environmental, energy or health policies. Similarly, there are concerns regarding the (lack of) balance between the rights and obligations of States and investors.

The second challenge is how to integrate sustainable development objectives into IIAs. Most existing IIAs follow the approach of focusing more or less exclusively on investment promotion and protection, while largely neglecting the sustainable development impact of investment. Only recently, have new IIAs begun to illustrate a growing tendency to craft treaties that are in line with sustainable development objectives.

The third challenge relates to the systemic complexity and the high atomization of the IIA regime, including in respect of ISDS. Investment policies do not exist in isolation, but interact with other policy areas, such as environmental policies, trade policies, social policies, labour policies, or industrial policies. Any IIA reform needs to take this interaction into account. In addition, it would be desirable that reform has broad multilateral support so as to avoid further fragmentation of the IIA regime.

There is broad recognition of the need to address the above challenges and improve the existing IIA system. In my view, IIA reform should be systematic and comprehensive, albeit gradual and properly sequenced. This view was also expressed by the UN member States and IIA stakeholders during the IIA Conference at UNCTAD's Fourth World Investment Forum held in October of last year.

Given that most existing IIAs include international arbitration as a mechanism of settling disputes between foreign investors and their host States, improving the system for settling investment disputes should be part and parcel of a broader reform, covering both substantive and procedural aspects.

II. ISDS: Key facts

Before I turn to possible ways and means to reform ISDS, let me highlight some key facts:

The total number of known treaty-based ISDS cases reached 608 by the end of 2014 (Annex Figure 2).

Respondent States. In total, 101 governments have been respondents to one or more investment treaty arbitrations. Over 70 per cent of all known cases were brought against developing and transition economies.

Home States. The overwhelming majority of ISDS claims were brought by investors from developed countries. In particular, claimants from the European Union initiated over 50 per cent of all cases and those from the United States brought another 22 per cent (Annex Figure 3).

Putting ISDS cases into a broader perspective. Global FDI stock amounts to approximately $26 trillion and involves about 104,000 multinational companies with over 892,000 foreign affiliates worldwide. Compared to these huge numbers, the 608 ISDS cases that were filed over the last two decades look quite small. However, one must not only look at numbers. Some cases impact key policy areas way beyond investment policies per se, such as energy policy, health policy or measures related to financial crises. And some cases involve huge amounts of money.

It is therefore important to carefully assess the costs and benefits of ISDS, and design a system for investment dispute settlement that best serves the needs of investors, governments and other affected stakeholders alike.

III. ISDS debate: Summary of pros and cons

Next, I would like to summarize the main arguments that have been made in favour and against the use of ISDS. I will be brief because I think that the discussion is well known to the two Committees.

Those who are in favour of ISDS point out that it:

- Provides an additional important avenue of legal redress to covered foreign investors;
- Allows foreign investors to avoid national courts of the host State if they have little trust in them as regards their independence, neutrality, efficiency and competence in international investment law;
- Removes the “sovereign immunity” obstacle that may complicate domestic legal claims against the host State;
- Gives additional “teeth” to the substantive obligations of the treaty; and
- Dispenses with the need for investors to convince their home State to bring claims against the host State.

By contrast, those who are against ISDS argue that it:

- Grants foreign investors greater rights than are granted to domestic investors;
- Exposes host States to additional legal and financial risks, without necessarily bringing any additional benefits in terms of additional FDI flows;
- Lacks sufficient legitimacy;
- Is not transparent enough;
- Is very expensive for users;
- Fails to ensure consistency of arbitral decisions;
- Does not provide for an appeals mechanism to review erroneous decisions;
- Raises concerns about arbitrators' independence and impartiality; and
- Creates incentives for “nationality planning” by foreign investors to benefit from ISDS.

As a result, the debate is intensifying on how the existing ISDS system could be reformed, with some stakeholders arguing for the abolishment of ISDS altogether. I kindly ask for your understanding that, given the time constraints, I need to limit myself to some key observation.

IV. ISDS reform: Which way to go?

Today, the debate on ISDS issues has gone beyond the question of "to have or not to have". The question is: “What is the way forward in case we decide to drop ISDS?” And “What improvements need to be made to the ISDS mechanism in case we decide to retain it?”

1. Dispute settlement without ISDS?

Let me start with the most straight-forward option: to abolish ISDS altogether. What would remain in this case is access of investors to the domestic courts of the host country and international dispute resolution between the home and the host country of the investor.

a. Domestic dispute resolution

As regards dispute resolution before national courts, it is not really a “reform” option, since it always exists, no matter whether the host country has signed an IIA or not. There are a number of arguments that one can raise in favour of this approach. This includes that it puts foreign investors on an equal footing with domestic ones, that it usually allows for an appellate review of first instance decisions, thereby contributing to legal coherence and predictability, that court decisions may be easier to enforce and that court fees are likely to be lower than in ISDS. In addition, domestic dispute resolution can be used as a "filter" in the sense that ISDS is only permitted once local remedies have been exhausted.

But there are also important arguments that are not in favour of an exclusive reliance on national courts. Not all countries can guarantee an efficient and well-functioning domestic court system. Local courts may lack independence and be subject to political control. And local judges may lack legal expertise and competence in international investment issues. It all depends on the specific situation in the country concerned. Dispute resolution before national courts can be good, but it can also be unsatisfactory.

b. State-to-State arbitration

Now onto State-to-State arbitration: It is the "classic" way of resolving disputes under international law. It is included in virtually all existing IIAs, and it is also the approach taken by the WTO as regards to the settlement of international trade disputes. So, why not also exclusively rely on it for international investment disputes?

The obvious advantage of State-to-State arbitration is that it would considerably reduce the exposure of host countries to international arbitration. Whereas an investor would have a natural interest to pursue his or her rights, his or her home country would likely use more restraint as it would also have to consider the broader political implications of accusing another country of having violated international law.

This is indeed the big weakness of State-to-State arbitration. The investor would completely depend on the willingness of his or her government to step in. He would need to convince the home government that the alleged treaty violation is so serious as to justify potential tensions in foreign relations. Obviously, in many cases this will be an uphill battle for investors.

This consideration also points to a significant difference between the use of State-State arbitration in investment disputes, on the one hand, and State-State arbitration in trade

disputes. In the case of trade, a dispute usually has implications for the economy of a country as a whole, whereas an investment dispute typically affects only one particular investor. Therefore, States are much more likely to go to arbitration in trade matters than in investment disputes.

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In conclusion, I don't think that discarding ISDS altogether and relying exclusively on non-ISDS dispute resolution mechanisms can solve the problem. But we need to address legitimate concerns as regards the current functioning of ISDS, should the decision be to maintain ISDS.

2. Options for ISDS reform

Let me now come to options for reform of ISDS. Over the last years, UNCTAD has worked intensively on this issue and we have come up with five reform options (see Figure 1).[2] They include:

- Limiting investors' access to ISDS and improving procedures in existing international conventions dealing with ISDS, such as the Convention on the Centre for Settlement of Investment Disputes or the UNCITRAL Arbitration Rules;
- Tailoring the existing ISDS system through revisions in individual IIA provisions dealing with ISDS;
- Creating a standing international investment court;
- Introducing an appeals mechanism; and
- Promoting alternative means of dispute resolution, namely conciliation and mediation.

In the following, I will focus on the three reform options: one, a standing international investment court, two, an appeals mechanism, and three, alternative dispute resolution. This does not mean at all that the other two reform options - limiting access of investors to ISDS and modifying existing provisions in individual IIAs - would be unimportant. Quite the contrary, these options are particularly promising because they provide for limited, well-defined reform steps that are relatively easy to implement. An increasing number of recent IIAs already go in this direction.

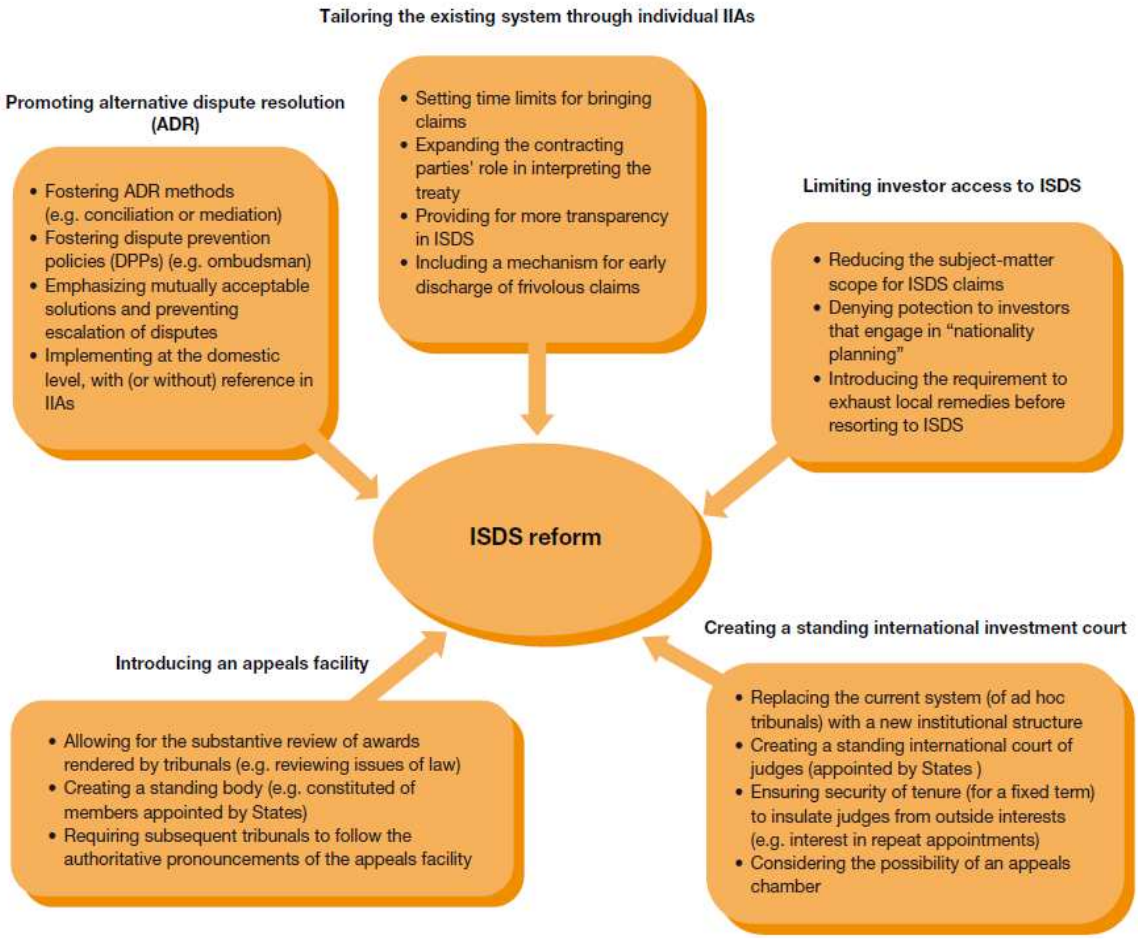
The reason why I focus on the other three reform options is that they have been less explored so far and that, *if they could be successfully implemented*, could go a long way in addressing the current concerns with ISDS.

[2] See UNCTAD, "Reform of Investor-State Dispute Settlement: In Search of a Roadmap", IIA Issues Note (2013, No. 2), available at http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d4_en.pdf.

a. Standing international investment court

This reform option implies that the current system of *ad hoc* arbitral tribunals would be replaced with a standing international investment court. The court would consist of judges appointed by States on a permanent basis. It could also have an appeals chamber, thereby combing two of the reform options.

Figure 1. Five options for ISDS reform



Source: UNCTAD.

This body would, in principle, have the global competence for all investment disputes arising from IIAs. Such an institution could significantly contribute to improving the legitimacy and transparency of the ISDS system, and enhancing predictability and coherence in the interpretation of treaty provisions. It would provide guarantees of independence and impartiality of judges.

The problem is that establishing such a court would be a huge challenge. It would require a complete overhaul of the current regime through coordinated multilateral action. Acceptance would not need to be universal, but given the thousands of existing IIAs, a broad participation of countries would be essential. While today, this option seems to lack sufficient political support, it nevertheless merits attention from a conceptual perspective.

Furthermore, it is questionable whether a new court would be fit for the fragmented and highly atomized global IIA regime. This option would work best in a system with a unified body of applicable law, i.e. in conjunction with a multilateral treaty, such as the WTO framework.

Chances for establishing a permanent investment court may be better in a regional, or even bilateral treaty context, such as the TTIP, given the smaller number of participating countries and the fact that it would only have to interpret one regional IIA. Still, no existing regional investment treaty (such as NAFTA or the ASEAN Comprehensive Invest Agreement) has gone so far as to establish a permanent court. A case apart is the EU Court of Justice. It has jurisdiction over EU-internal investment issues covered by the EU Treaty, such as the right of establishment or the principle of non-discrimination. However, the EU Treaty is an atypical IIA and in most cases, only EU member States - and not individual investors - can bring investment-related claims before the European Court of Justice.[3] It is doubtful that countries would be ready to bear the costs of establishing and maintaining a bilateral or regional court in view of the presumably limited number of investment disputes that would arise out of one particular treaty.

Governments therefore face a dilemma: A permanent investment court would be best suited for a multilateral context, but in such a context it would be very difficult to realize. A permanent investment court would be easier to set up in a bilateral context, but there it might not justify the costs. However, it may make sense in a regional context, provided that there is a critical number of participating countries.

b. Appeals facility

The idea of an appeals body in ISDS is not new. Indeed, there are already a few bilateral IIAs that, while not going so far as to actually establishing it, include a provision, according to which the contracting parties will consider setting up an appeals facility in the future. Examples are the Chile-US Free Trade Agreement, the Dominican Republic-Central America-US FTA (CAFTA) and the Comprehensive Economic and Trade Agreement (CETA), between Canada and Europe.

[3] An important exception are antitrust cases in as far as they fall under the regulatory competence of the EU Commission.

There are several arguments that speak in favour of such a mechanism. Most importantly, it could review decisions of first-level tribunals and, if necessary, correct them. Thereby, it could help improve predictability and coherence of arbitral decisions. All this could significantly contribute to enhancing the political acceptability of ISDS.

But there are also problems with an appeals mechanism. In a legal system that consists of more than 3,000 IIAs, it would be impossible for an appeals facility to achieve absolute coherence, because each individual treaty needs to be interpreted in its own specific context. Even if an appeals body is established only with regard to one particular IIA, achieving coherence and predictability would remain a challenge, as long as the appeals facility is established on an *ad hoc* basis. In this case, there would be a risk that different *ad hoc* bodies come to different conclusions as regards to the same legal questions. Therefore, similar to an international court, a multilateral approach would be preferable.

Efficiency and cost are another problem. There are fears that an appeals mechanism could prolong dispute procedures - although this could to some extent be controlled by putting in place timelines.

c. Alternative dispute resolution

Amongst all possible options for dispute resolution, ADR - i.e. non-binding conciliation or mediation - has value because it can help resolve disputes at an early stage, thereby avoiding that they severely and permanently damage the relationship between the investor and its host country. ADR is also flexible – the purpose is not to apply the law in a rigid manner, but to find a solution that would be acceptable to both parties. Furthermore, if successful, ADR can help to save time and money.

On the negative side, there is no guarantee that ADR procedures will lead to the resolution of a dispute; an unsuccessful procedure would actually increase the costs and time involved. Also, depending on the nature of the policy measure challenged by an investor, ADR may not always be acceptable to the host country, in particular, where the case relates to legislative measures. In addition, ADR cannot solve all ISDS-related problems, since it could not become the exclusive means of dispute resolution. And, finally, a mediated outcome of the dispute cannot be enforced. Therefore, if one party does not respect the compromise solution reached by ADR, binding arbitration may still become unavoidable.

Concluding remarks

First, the complexity of the situation calls for a systemic and holistic approach. There are no easy and quick fixes to the existing ISDS mechanism. Any reform of ISDS needs to be put into the broader context. This means going beyond ISDS and considering the overall structure and content of the treaties. And it also means to not only looking into IIAs, but also looking into existing multilateral treaties and conventions dealing with ISDS:

Second, it is clear that there is no single approach or alternative that can effectively and sufficiently address ISDS-related challenges. Instead the way forward could consist of a combination of different approaches and alternatives.

Third, it is therefore time to take on board *all* the options and analyse the pros and cons of each and every one of them. This can help identify the best possible mix of approaches/alternatives so as to maximize the benefits and minimize the potential risks. The objective is to find a solution that best serves the needs of investors, governments and other affected stakeholders alike. These needs may be different from case to case. For instance, what is best in the framework of the TTIP may not be optimal with regard to other investment treaties.

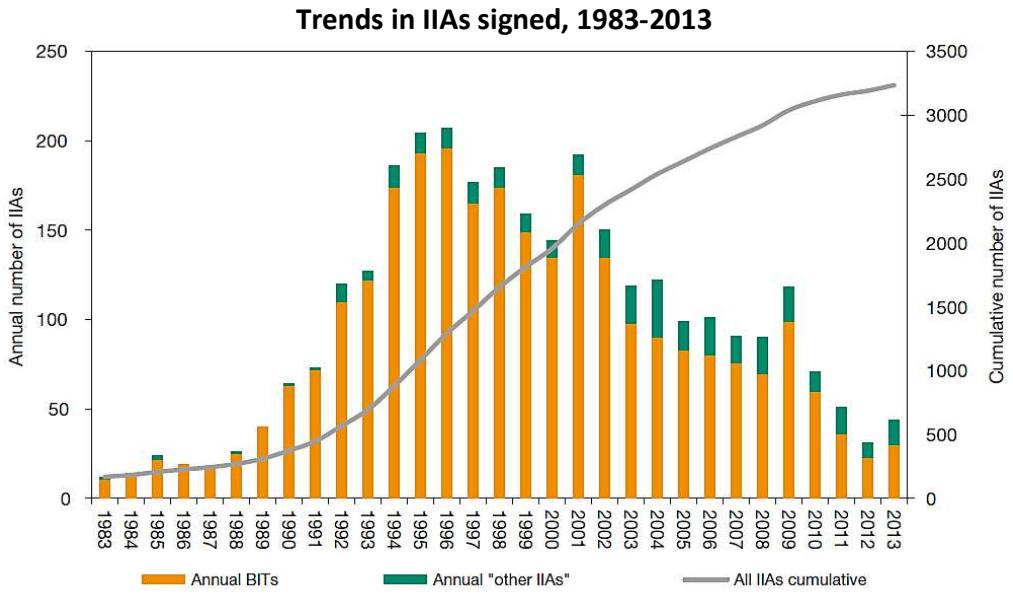
Finally, whatever the formula and approaches, we need to bear in mind that the guiding principles are sustainable development and inclusive growth. In short, what we need is a new generation of IIAs that addresses the challenges of investment policies in the 21st century.

The IIA reform is a global challenge and UNCTAD is the United Nation's focal point for all investment-related matters. Facilitating the reform process and assisting governments in finding the right solutions is therefore a high priority for us. We pursue this goal through the three pillars of our work, namely policy research and analysis, technical assistance and providing a discussion forum for inter-governmental dialogue.

Ladies and Gentlemen, it has been an honour and a pleasure for me to be with you today. I thank you very much for your attention and I am at your disposal for any questions that you might have.

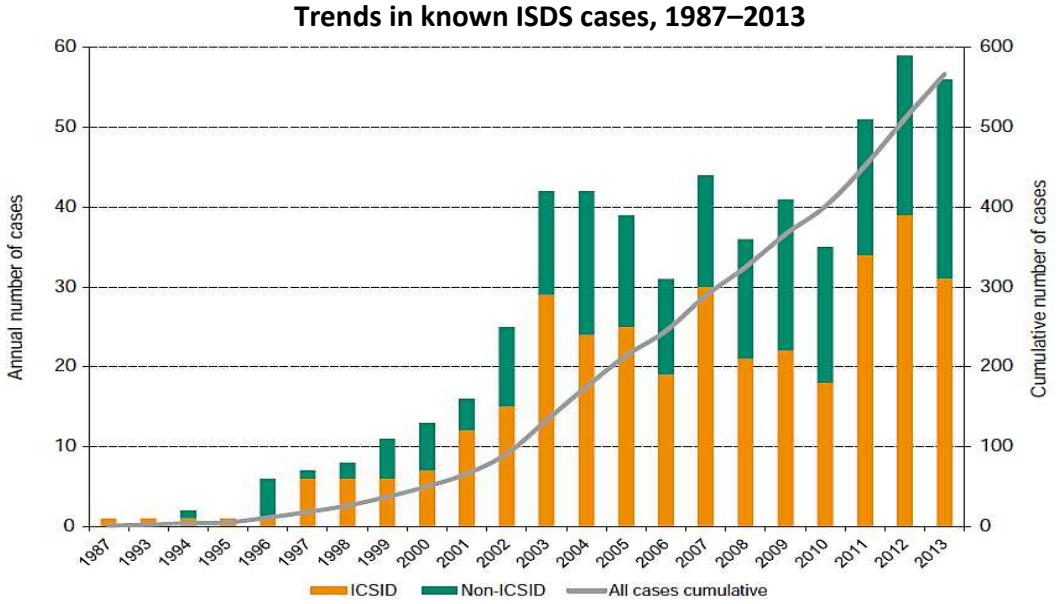
Annex:

Figure 1:



Source: UNCTAD, IIA database.

Figure 2:

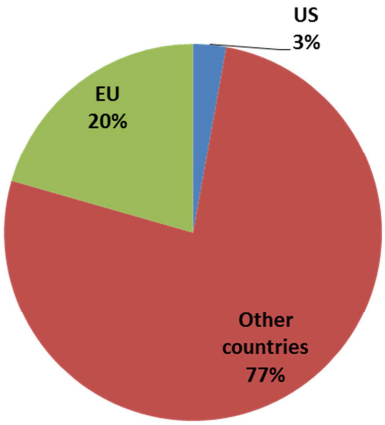


Source: UNCTAD, ISDS database.

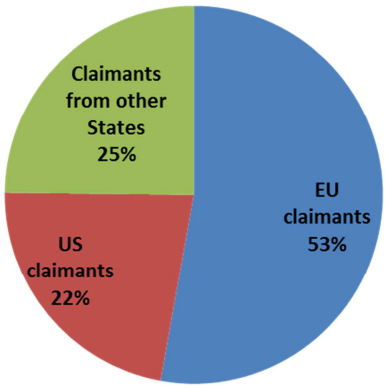
Figure 3:

ISDS cases involving the US and EU Member States

Cases brought against the US and EU Member States



Claimant investors' home States, including the US and EU Member States



Source: UNCTAD, ISDS database.