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EUROPEAN UNION POLICY IN RESPECT OF THE SETTLEMENT OF INVESTMENT DISPUTES

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Abstract

The European Union, being one of the most significant players in international investment relations, started shaping its common investment policy only recently, after acquisition of exclusive competence over Foreign Direct Investments in 2009. The specific nature of the EU, its complicated multinational structure and organization, lack of experience in participation in investor-state arbitration, as well as diversity of investment regimes developed over 50 years individually by each Member State, made this task quite challenging for the Union. This paper examines the outcome of the first reforms introduced in the context of common EU investment policy, analyses the Union's approach to the protection of FDI and investment dispute resolution and scrutinises the rules on EU involvement in investor-state arbitration under the new Financial Responsibility Regulation (FRR) of 2014. The aim is to establish whether the Regulation on managing allocation of financial responsibility between the EU and its Member States will introduce more certainty and predictability to the system of investment protection and dispute settlement, and, consequently, advantage the attractiveness of the EU as an investment destination. Several problematic aspects of the Regulation, explored in this paper, relate to the imbalance between Commission and MS rights in allocation of responsibility, the possibility of violation of exclusive jurisdiction of the Court of Justice of the EU in the process of realizing some FRR provisions, and a legal loophole that may allow the Member States to avoid arbitration under ICSID rules. The paper also provides suggestions as to improving disputable Regulation provisions that may help to avoid the negative scenario that may come into play in the process of its implementation.

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Introduction

The General Counsel of the World Bank and Secretary-General of the International Centre for Settlement of Investment Disputes (ICSID), the principal "architect of the ICSID Convention"[1] has repeatedly underlined that international investment is "universally recognized as a factor of crucial importance in the economic development of the world". Therefore, states, striving to succeed in establishing a healthier domestic investment climate, keep developing and improving standards of investor protection and systems of dispute settlement both within and outside their borders.

The European Union (EU/Union), as one of the most significant sources and destinations of foreign direct investment, has only recently started shaping its international investment policy. After the Lisbon Treaty came into force and endowed the Union with exclusive competence to decide on foreign direct investment (FDI) matters[2], the EU has emerged as a new, but forceful player in the investment world. From the very beginning, it has come to grips with its lack of experience in realizing investment policy and, in a couple of years, the European Commission (Commission) proposed several corresponding legal acts, which were later approved and adopted by other EU institutions and Member States (MS). Among these documents was the Regulation on allocation of financial responsibility (Regulation/FRR) between the EU and Member States[3], which shed light on the mode of participation by the Union in investor-state arbitration proceedings under future EU-third state investment treaties. The document is partly based on the Energy Charter Treaty, and aims to increase the attractiveness of the EU for foreign direct investment flows by ensuring a more secure, definite, prompt and less risky mechanism for dispute resolution. However, despite its high goals, the new system of dividing responsibility under the act has numerous disadvantages which might rather deter investors from investing in Member States' economy and thus harm the financial interests of the Union and its economy in general[4]. In light of the growth of cross-border investments[5], the lack of EU involvement in investor-state arbitration cannot advantage either the attractiveness of the EU as a destination for foreign capital inflows or progress in

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[1] Schreuer, Christoph H. (2009). *The ICSID Convention: A Commentary.* Cambridge University Press, at p. 2.

[2] Art. 3 (1) (e) in connection with Art. 206 and 207 TFEU.

[3] Regulation 912/2014 of the European Parliament and of the Council establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is party. OJ 2014, L 257, p. 121.

[4] Baetens F., Gerard K. & Varga A. (2014). Determining International Responsibility under the new Extra-EU Investment Agreements: What Foreign Investors in the EU should know. *47 Vanderbilt Journal of Transnational Law*: 1203-1260, at p. 1219.

[5] According to world records, in 2013 the number of arbitrated cases was 568), and in the European Union, the largest number of investment disputes was recorded in 2013 and amounted to 56 arbitrations, whilst 40% of the claims were brought against EU MS.
UNCTAD Report. (2014). *Recent Developments in Investor-State Dispute Settlement (ISDS).* No. 1, April 2014. Available at http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d3_en.pdf. Accessed 24 April 2015.

concluding several important investment agreements (such as the Comprehensive Economic and Trade Agreement (CETA) or the Transatlantic Trade and Investment Partnership (TTIP).

In the light of the above, the relevance of studying and analysing current trends, as well as the strengths and weaknesses of recent EU investment protection and dispute resolution policy, lies in the profound effect of inward capital movement on economic growth, the business environment, transfer of skills and technology, and social welfare of the Member States. Moreover, a properly regulated investment policy, which ensures a stable, balanced and predictable investment climate, can benefit not only the three-dimensional development of the European Union, but also investors from third states, who, investing capital in MS undertakings, expect to receive proper treatment from the side of the host government. Therefore, the study of EU experience in creation and realization of an effective system of FDI protection has both scientific and practical value.

The aim of this paper is to disclose whether the newly adopted Regulation on managing the allocation of financial responsibility between the EU and the Member States will improve the attractiveness of the EU as an investment destination in the context of newly acquired exclusive competence of the Union.

For the purpose of research, the following methods will be used:

- Analysis (all sections of the article). The research is based on examination of both secondary sources, such as law books and journal articles, official reports, newspaper reviews and legal encyclopaedias and primary sources, such as international agreements and Treaties, investment legislation of the European Communities, the EU and the United States (US), EU investment agreements, including CETA and TTIP, preparatory documents, as well as case law. The analysis includes both actual legislation and legal treatises to keep the balance between scholarly opinions and interpretations, and real sociological and political implications of different legal reforms in the sphere of investment protection and dispute resolution. The research was undertaken using various online legal databases (including Westlaw International, HeinOnline, Investment Arbitration Reporter), as well as library sources.

- Comparison and analogy (sections 2 and 3). This method presents unique opportunities to learn how different events that took place within the borders of other states or entities (in this article – the US and Canada) are related to current EU realities and how the latter can benefit from their experience.

- Classification (sections 1 and 2). Classification is made with regard to international investment agreements, investment protection standards and systems of dispute settlement in order to familiarize the reader with issues of investment protection and dispute resolution and provide the necessary background for further discussion.

- Forecast (sections 3 and 4). Based on the relevant experience of the EU, Canada and the US with regard to involvement in investor-state arbitration, allocation of financial responsibility, and the role of national judicial bodies in the resolution of investment disputes, the article presents possible negative scenarios

that could come into play in the course of implementing the Regulation and their outcome.

The article will be structured in the following way:

The first part of the paper (Section 1) will contain a general theoretical overview of investment protection regimes and dispute settlement mechanisms, provide scholarly and official definitions of the key notions and introduce the reader to the relevant historical background of the problem.

In the second part of the work (Section 2), I will address the question of the FDI protection system existing in the EU and its main economic competitor, the US. In particular, here will be mainly analysed the respective chapters of the NAFTA agreement, the EU Energy Charter Treaty, various bilateral and international investment agreements of EU MS that existed before and after the Lisbon Treaty, negotiated CETA with Canada and the TTIP with the US. Finally, in this part, I will provide a general overview of the aim, scope and main aspects of new FRR and its influence on EU investment policy.

In the third part (Section 3), I will critically assess the main complications of the FRR regarding allocation of financial responsibility within the Union in the case of investor-state arbitration that could possibly harm the EU investment market. In addition, here I will consider the question of availability of the ICSID as a reliable arbitration venue for Investor-State Dispute Settlement ISDS with the involvement of EU organs and/or its MS. It is a matter of doubt whether the EU will be allowed to join the ICSID convention, as for now membership is open only to individual states. The only option is to amend the Convention provisions, subject to acceptance by all Contracting parties, which could be rather difficult to realize in practice. In the end, I will examine the US approach to regulation of financial responsibility issues and emphasize its advantages and weaknesses in comparison with the EU mechanism.

The fourth part (Section 4) will introduce the reader to the powers and functions of the Court of Justice of the EU (CJEU/the Court) in the context of the new EU investment policy and, in particular, the FRR. Moreover, in this section I will analyse potential problems regarding the Court's exclusive jurisdiction that could arise in case of disagreement between the MS and the Commission concerning allocation of responsibilities in investor-state arbitration and interpretation of the Regulation.

Section 1
Theoretical Background to FDI Protection and Dispute Settlement Mechanisms

1.1 Content and Nature of FDI, Investment Agreements, Investment Protection Standards and Modes of Dispute Settlement

In this chapter, I will introduce the reader to the most important concepts used in this article and present key definitions, theories and classifications related to foreign direct investment protection and dispute resolution. First, it is necessary to frame the notion of foreign direct investment (FDI). The authors of the Encyclopaedia of Public International Law[6], offer the following formulation of FDI:

> FDI is a transfer of funds or materials from one country (called capital-exporting country) to another country (called host country) to be used in the conduct of an enterprise in that country in return for a direct or indirect participation in the earnings of that enterprise.

The International Monetary Fund characterizes FDI as:

> a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy[7].

Finally, the United Nations Conference on Trade and Development (UNCTAD) describes direct investment as:

> an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy … in an enterprise resident in an economy other than that of the foreign direct investor

and distinguishes three elements of FDI, which are equity capital, reinvested earnings and intra-company loans[8]. The investment is usually performed through crediting or acquisition of shares of foreign enterprises[9], creation of common enterprises or establishment of company branches and agencies. Thus, deriving from the wording of these three definitions, the actors involved in the process of FDI transfer are:

- the home or investing country;
- the host or receiving country;
- impacted third states and non-state actors;

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[6] Bernhardt, Rudolf. (1985). *Encyclopedia of Public International Law,* Vol. 8. North-Holland, at p. 246.

[7] International Monetary Fund. (2008). *Balance of Payments and International Investment Position Manual*. 6th ed., IMF, par. 6.8.

[8] UNCTAD (2007). *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development.* United Nations, New York and Geneva, 16 October 2007, at p. 245. Available at http://unctad.org/en/docs/wir2007_en.pdf. Accessed 20 May 2015.

[9] Kozak U. (2007). *International Finances.* Kyiv: Center of Academic Literature, at p. 520.

- investors, who may be either natural or legal persons[10].

The manner in which the notion of FDI is formulated in a certain investment agreement determines the scope of its application. It is argued that due to the extended definition of "investment" in some IIAs, the line distinguishing actual investments from ordinary commercial transactions is becoming blurred, which accordingly leads to amplification of the subject of potential investment disputes[11]. However, some scholars contend that the parties "have a discretion[12]. For example, in *Machinery LTD v. The Arab Republic of Egypt[13],* the tribunal established that:

> there is a limit to the freedom with which the parties may define a freedom in describing their transaction as an investment"[14], the ICSID has restrained investment if they wish to engage the jurisdiction of ICSID tribunals.

The conditions for defining a transaction as FDI were *inter alia* the existence of an element of risk, a certain duration and significance of contribution to an investment project, regularity of profit and return, amongst others.[15]

Apart from FDI, there exist portfolio investments, which are merely financial assets in the form of stocks and shares in a foreign undertaking, which does not presume control of the company by the investor. According to the OECD, investments are classified as a portfolio if the investor holds less than 10% of the shares in the company and does not have a right to carry out effective control over it[16].

The rules of investment protection and dispute settlement are established by the states through conclusion of inter-state investment treaties (agreements). In general, an international investment agreement (IIA) is defined as a legal document that regulates relations between the actors involved in investment activity. IIAs usually take the form of either Free Trade Agreements (FTAs) or Bilateral Investment Treaties (BITs) between two or more states. For a clear understanding of the nature of these two types of IIAs, it is necessary to draw the line between them. A FTA is an agreement concluded for the purpose of trade liberalization, i.e. removal of barriers in trade between the contracting states, while a BIT is an arrangement between two countries on the specific rules of investment protection and settlement of investment disputes. Before the emergence of IIAs with arbitration clauses, states had to address customary international law to determine the scope of investors' and states' rights in case the host state expropriates, nationalizes or otherwise does harm

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[10] Fontagné, Lionel. (1993). Foreign Direct Investment and International Trade: Complements or Substitutes? *Vol. 3. OECD Science, Technology and Industry Working Paper,* at p. 13. Available at http://www.keepeek.com/. Accessed on 20 April 2015.

[11] Voitovich S. (2004). International Customs and General Principles of Law in Practice of ICSID. *International Public and Private Law,* № 6: 8-14, at p. 10.

[12] Pollan T. (2006). *Legal Framework for the Admission of FDI.* Eleven International Publishing, at p. 35.

[13] Joy Mining Machinery Limited v. Arab Republic of Egypt. Award on Jurisdiction on 6 August 2004. ICSID Case No. ARB/03/11, para. 49.

[14] Schreuer C. (2001). *The ICSID Convention: A Commentary.* Cambridge University Press, at p. 125.

[15] *Ibid*, para. 53.

[16] Rogach O. (2005). *International Investments: Theory and Practice of Transnational Corporations' Business.* Kyiv: Lybid, at p. 347.

to foreign investments. Customary international law did not acknowledge the legal personality of natural persons, which is why only states, as political entities, could lodge investment claims against host governments through diplomatic channels.

Although there is no record of any legal act in the investment sphere that would cover the whole globe, the data from UNCTAD show that to date there exist 2923 Bilateral Investment Treaties, of which 2240 are in force[17]. Moreover, protection of foreign investors is ensured by regional IIAs, among which are:

- NAFTA for the North American region
- Energy Charter Treaty for Central and Eastern European countries
- CEFTA covering the countries of Central Europe
- ECCAS Treaty for Central African states
- LAIA Treaty for states of Latin America
- SAFTA Treaty for South Asian States
- Organization of the Islamic Conference Investment Agreement covering the territory of 57 Arabic States.

In addition, currently three "megaregional agreements" which are expected to reshape the rules of international trade[18], are under negotiation:

- Regional Comprehensive Economic Partnership of Asia and the Pacific (RCEP);
- Trans-Pacific Partnership (TPP) between the countries of the Asia-Pacific Region and the United States;
- Trans-Atlantic Trade and Investment Partnership (TTIP) between the European Union and the United States[19].

It should be noted that some scholars and social justice NGOs argue that the IIA regime is asymmetrical, as it only provides rights and does not impose responsibilities on investors, and can hinder a state's freedom to manage certain matters of its public policy, such as the environment and sustainable development. Nevertheless, the majority of states, organizations and scientists consider that the benefits of clear and predictable rules on FDI protection in the treaties outweigh the constraints raised by IIA critics[20]. These rules exist in the form of core guarantees for foreign investors, provided by the majority of modern IIAs. Among these guarantees are:

- national and Most-Favoured-Nation Treatment principles;
- prohibition of illegal and ungrounded expropriation and nationalization of foreign property;
- fair and equitable treatment as well as full protection and security;

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[17] UNCTAD Division on Investment and Enterprise. (2015). *International Investment Agreements Navigator.* Available at http://investmentpolicyhub.unctad.org/IIA. Accessed on 28 April 2015.

[18] UNCTAD. (2014). *World Investment Report 2014: Investing in the SDGs: An Action Plan,* at p. 5. Available at http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf. Accessed on 11 May 2015.

[19] *Ibid,* at p. 16.

[20] Gallagher K. (2010). *Handbook on Trade and the Environment*. Edward Elgar Publishing, at p. 278.

- freedom of capital transfer.

Historically, under customary international law, there existed two basic approaches to the investment protection system, called the Hull Rule and the Calvo doctrine[21]. The former theory was created by the 47th United States Secretary of State, Cordell Hull, in the course of a dispute between Mexico and the United States in 1932 on Mexican expropriation of property owned by American citizens. In his correspondence with the Foreign Minister of Mexico, Hull claimed that the host state should promptly, adequately and effectively compensate the sum of expropriated investments to the foreign investor irrespective of the purpose or legality of such expropriation[22]. The latter doctrine had been developed by Argentinian lawyer, Carlos Calvo in 1868, and laid in allegation that no foreign investor should receive more favourable treatment than the residents of the host state[23]. He also stated that any claim brought by a foreign investor must be heard by national courts of the capital-receiving country and such investor has no right to seek diplomatic protection or address its home state courts as well as any other judicial or arbitration organ to protect his rights. This view was supported by General Assembly Resolution 3171 of 1973 according to which:

> … application of the principle of nationalization ... implies that each State is entitled to determine the amount of possible compensation and the mode of payment, and that any disputes which might arise should be settled in accordance with the national legislation ...[24]

Nevertheless, neither of these doctrines was accepted by a majority of capital-exporting states as it undermined the interests of its nationals who invested their capital in third states. Therefore, in order to evade their application and create their own rules and conditions of investment protection and dispute settlement, states started to conclude investment treaties with Investor-State Dispute Settlement (ISDS) clauses.

At this point, I will pass on to the final part of this chapter and address the question of the dispute resolution mechanism in the sphere of FDI. According to Article 25 of the ICSID Convention, an investment dispute is "any legal dispute arising directly out of an investment"[25]. Such disputes can be resolved through either State-State or Investor-State dispute settlement mechanisms. The first was created for resolution of disagreements concerning treaty interpretation and application, while the second is meant to be used purely for the settlement of investment

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[21] Neumayer E., Laura S. (2005). Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries? *33 (10) World Development:* 1567-1585, at p. 1569.
[22] Sornarajah M. (2010). *The International Law on Foreign Investment*. Cambridge University Press, at p. 414.
[23] Alvarez J. (2011). *The Public International Law Regime Governing International Investment.* Martinus Nijhoff Publishers, at p. 80.
[24] UN General Assembly. (1972). Permanent sovereignty over natural resources. 17 December 1973, A/RES/3171.
[25] It is important to notice that neither NAFTA nor the US Model BIT 2012 offer a formal definition of an investment dispute; thus under these acts it remains up to the arbitration tribunal to decide whether a conflict qualifies as an investment dispute. (Crawford J., Lee K. & Lauterpacht E. (2005). *ICSID Reports: A Publication of the Research Centre for International Law, University of Cambridge.* Cambridge University Press, at p. 58).

disputes. For this reason, in the majority of modern investment treaties, SSDS and ISDS mechanisms coexist. However, historically, the state to state dispute resolution instrument precedes investor-state arbitration, as the latter was not used until 1969, when the clause providing for such kind of arbitration was included in the Chad-Italy Bilateral Investment Treaty (BIT)[26]. Thus, before 1970, private parties were precluded from direct involvement in the settlement of investment disputes, as states held exclusive authority to participate in dispute resolution procedures.

Today, the ISDS mechanism is of weight in modern international commercial relations and ISDS provisions can be found in more than 3000 International Investment Agreements[27]. Furthermore, successful usage of the ISDS system is confirmed by the immense number of awards rendered by arbitration tribunals every year. To date the highest arbitral award was rendered in 2014 and amounted to 50 billion USD[28].

Opponents of the ISDS system, especially those who disagree with the proposition to include an ISDS clause in the TTIP Agreement between the US and the EU present the following limitations of its usage:

1) the legal system of the host state can be undermined by an investor's claims;
2) the state risks spending a large amount of its budget on procedural expenses and arbitral awards where foreign investors win an arbitration;
3) it provides for more favourable treatment towards foreign investors;
4) the system poses a risk of investor misconduct, fraudulent claims, corruption and other forms of abuse of the arbitration process[29].

Moreover, opponents of the investor-state dispute settlement mechanism adduce historical examples confirming the existence of sufficient drawbacks in the system. Upon conclusion of the NAFTA agreement in 1992, the number of ISDS proceedings against both the US and Canadian governments increased several times, as investors from both states started actively investing in undertakings located in the partner host state, which resulted in numerous investor-state arbitrations. ISDS opponents argue that this American experience can be a lesson for the European Union, which will most likely face the same situation and be exposed to the danger of involvement in a multitude of arbitration proceedings upon the conclusion of a FTA with the United States (TTIP)[30]. However, in spite of this caution, the EU is more inclined to include ISDS provisions in all its future IIAs: the European Parliament in its Resolution on the future European international investment policy emphasized that "in addition to

[26] Newcombe A. & Paradell L. (2009). *Law and Practice of Investment Treaties: Standards of Treatment.* Kluwer Law International, at p. 42.
[27] Latek M. (2014). Investor-State Dispute Settlement (ISDS): State of play and prospects for reform*. European Parliamentary Research Service (EPRS),* at p. 1. Available at http://www.europarl.europa.eu. Accessed 27 April 2015.
[28] *Supra* note 8.
[29] Brown C. & Miles K. (2011). *Evolution in Investment Treaty Law and Arbitration*. Cambridge University Press, at p. 190.
[30] Clodfelter M. (2013). The Future Direction of Investment Agreements in the European Union. *Santa Clara Journal of International Law:* 159-182, at p. 172.

state-to-state dispute settlement procedures, investor-state procedures must also be applicable in order to secure comprehensive investment protection".[31]

For the reason that the present study is limited in scope, I will not consider other methods of alternative dispute resolution apart from arbitration, although it should be admitted that mediation and conciliation present a no less simple, flexible and convenient tool for resolution of various disagreements. They ensure direct and confidential contact between disputants, prompt familiarization with mutual claims and positions and usually provide a beneficial solution for both parties to the dispute. Investors and states tend to choose these alternative techniques to preserve business relations and maintain future contacts with their partners.

Summarizing all the above, today there is no uniform definition of FDI, although, in general, it is described as a transfer of assets from an investor's home state to the host country in exchange for a certain degree of control over the enterprise located in the host country. In order to ensure the security of foreign investments in the host country, states conclude investment treaties, which provide mutual rights and obligations of the parties, as well as standards of treatment and rules of dispute settlement. The latter usually exist in the form of interstate or investor-state arbitration, which significantly differ from usual commercial litigation and arbitration in costs, complexity and legal/political consequences. After outlining the theoretical framework of foreign direct investment protection and methods of dispute resolution, we should move to historical analysis of the development of FDI protection and dispute resolution systems.

1.2 Historical Evolution of FDI Protection System, Standards of Treatment and Resolution of Investment Conflicts

In order to comprehend the nature of the contemporary mechanism of investment protection, its standards, system of dispute settlement and state responsibility, it is necessary to look at and analyse the tendencies of its historical development. Yet, before moving to a historical overview, an important remark should be made with regard to standards of investment treatment. Generally, the system of investment protection rules is split into two big groups:

- absolute or non-contingent standards;
- non-absolute or contingent standards.

The former class includes standards of fair and equitable treatment and full protection and security, originating in customary international law. The second group comprises most-favoured-nation treatment, national treatment and non-discrimination standards that first appeared in treaty provisions[32]. In Article 4 of the Draft Article on MFN Clauses, the International Law commission emphasized that "A most-favoured-nation clause is a treaty provision ...". In Article 7 it elaborated on this statement as follows:

[31] European Parliament. (2011). Resolution of 6 April 2011 on Future European International Investment Policy, 2010/2203(INI), para. 32.

[32] McLachlan C., Shore L., & Weiniger M. (2007). *International Investment Arbitration: Substantive Principles.* Oxford International Arbitration Series, at p. 207.

> Nothing in the present articles shall imply that a State is entitled to be accorded most-favoured-nation treatment by another State otherwise than on the basis of an international obligation undertaken by the latter State.[33.]

In contrast, the drafters of early international commercial agreements rarely included the FET and FPS provisions in treaty texts, as these standards were regarded as implied rights provided by international customary law norms.

Overall, the investment protection system has been developed in two stages. The first period continued until the emergency of the ISDS mechanism and was characterized by the application of a diplomatic protection scheme for investment conflict resolution operating under customary international law. Apart from this option, especially when states did not have any kind of investment agreement, an investor could try to defend their rights by addressing claims to the local courts[34]. The obvious disadvantages of such litigation were the risk of a biased judgment and absence of procedural transparency. Therefore, the most adequate method of shielding against the arbitrariness of the host state at that time was a diplomatic protection scheme enforced by the investor's home state, which defended the rights of its national by referring claims to the host state on its own behalf.

The legal framework for diplomatic protection was represented by Establishment Treaties and Treaties of Friendship, Commerce and Navigation. These documents usually provided for protection of investments against discriminatory treatment and illegal expropriation. Moreover, such agreements included a fair and equitable treatment clause, such as Article 2 of the Friendship, Commerce and Navigation Treaty between the US and Ireland of 1950, stating that

> Nationals of either Party within the territories of the other Party … shall receive the most constant protection and security, in no case less than that required by international law.[35]

In spite of the fact that diplomatic protection has been the most effective and, more importantly, available means of investment protection, it has a number of drawbacks. First, the diplomatic protection mechanism was oriented to safeguarding state interests rather than the investor's rights. A dissatisfied investor should address their home state for diplomatic representation of their interests. As a precondition, it was required to prove that all local remedies had been already exhausted.[36] Although the rule of local remedies exhaustion helped to filter claims, it significantly complicated and delayed the whole process of dispute resolution. Another negative aspect of the diplomatic protection scheme was that the investor's home state had

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[33] International Law Commission. (1978). Draft Articles on Most-Favoured-Nation Clauses, 2(2) YB ILC 16.

[34] Camponovo C. (1996). Dispute Settlement and the OECD Multilateral Agreement on Investment. *UCLA Journal of International Law and Foreign Affairs*: 181-213, at p. 199.

[35] Treaty of Friendship, Commerce and Navigation between the United States of America and Ireland. Dublin, 21 January 1950.

[36] Article 44 of the Draft Articles on Responsibility of States for International Wrongful Acts:
"The responsibility of a State may not be invoked if:
(a) the claim is not brought in accordance with any applicable rule relating to the nationality of claims;
(b) the claim is one to which the rule of exhaustion of local remedies applies and any available and effective local remedy has not been exhausted".

discretionary power to grant diplomatic protection, commence the dispute resolution procedure, and settle the claim, and, even in case the state agreed to act on behalf of its national, it was not guaranteed that the investor would eventually get any compensation for the damage to their investments.

These weaknesses of the DP system can be illustrated by the example of the *ELSI* case[37]. In this case, the Italian government seized the plant and other assets of Raytheon-Elsi S.p.A. (previously Elettronica Sicula S.p.A.), which was owned by two US companies, Raytheon and Machlett. In its turn, the United States commenced a suit in the International Court of Justice against Italy claiming that the latter had violated the fair and equitable treatment clause of the bilateral Friendship, Commerce, and Navigation Treaty of 1948 by not allowing the US to manage, organize and control its enterprises located in Italy. Before considering the subject matter of the case, the ICJ referred to the preliminary issue of local remedies exhaustion. As it happened, the FCN Treaty (Treaty of Friendship, Commerce and Navigation) itself did not explicitly provide an obligation to address local courts before going to the ICJ, and the US argued that it constituted a tacit waiver of such obligation. The ICJ did not agree and held that:

> it finds itself unable to accept that an important principle of customary international law should be held to have been tacitly dispensed with[38].

Nevertheless, after all, the Court admitted this case, as despite its findings, the burden of proof was still on Italy, which, in its turn, failed to show that there existed any non-exhausted local remedy. The rule had been established. Later, Draft Articles on Diplomatic Protection[39] followed the same principle, not allowing implied waivers of the local remedies exhaustion rule before the dispute in question arises. In contrast, modern International Investment Agreements allow a foreign investor to bypass the local courts and address arbitration courts directly regardless of any contract provisions to the contrary, as the right to require unobstructed arbitration is provided by Article 26 of the ICSID Convention[40].

Another precedent illustrating the operation of the diplomatic protection mechanism is the classic *Barcelona Traction* case[41]. In this case, Belgium, on behalf of its nationals, who invested in a Canadian company located on the territory of Spain, commenced litigation against Spain in the ICJ. The claim was about breach by Spain of international law provisions, in that Spain had put a restriction on foreigners doing business on its territory which in turn resulted in damage to a Canadian company and consequently to its Belgian shareholders. The Court rejected the claimants' arguments and decided in favour of Spain, explaining its holding by lack of legal interest from the Belgian side, and, accordingly, absence of the right of action

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[37] Elettronica Sicula S.p.A., United States v. Italy, ICJ Judgment, 20 July 1989.

[38] Dugan C., Wallace D., Rubins N. & Sabahi B. (2011). *Investor-State Arbitration.* Oxford University Press, at p. 32.

[39] United Nations. (2006). Draft articles on Diplomatic Protection. Available at http://www.refworld.org/docid/525417fc4.html. Accessed 8 April 2015.

[40] Convention on the Settlement of Investment Disputes between States and Nationals of other States. 14/10/1966. 17 UST 1270, TIAS 6090, 575 UNTS 159.

[41] Barcelona Traction, Light and Power Company, ICJ (Belgium v. Spain). ICJ 1970 ICJ 3. Judgment of 5 February 1970.

in court (*jus standi)*, as the company belonged to Canada and solely Canada could bring a suit against Spain. Judge Morelli in his separate opinion noted that:

> there is no rule which authorizes diplomatic protection of shareholders on account of measures taken in respect of the company ...[42].

The judgment was negatively reviewed and was even assessed as evidence of denial of the existence of international law provisions that make the basis for protection of a foreign investor's interests[43].

On the other hand, a successful example of DP scheme enforcement was the settlement of a dispute between Italy, acting on behalf of its national who had immovable property on the territory of Switzerland which had been confiscated under newly adopted legislation restricting the acquisition of real estate by non-nationals. In arbitration, Italy based its arguments on the Establishment and Consular Convention between Italy and Switzerland of 1868 that released Italian nationals from restrictions on acquisition of immovable property on Swiss territory. Under pressure from the Italian government and complaints from its own citizens that did not want Italy to apply reciprocal restrictions to Swiss nationals, Switzerland accepted an Italian proposal for settlement and paid compensation for the damage[44].

To sum up, although the FCN Treaties covered a wide range of aspects of investment protection, their main weakness was the absence of regulation of the mechanism for Investor-State dispute resolution. Furthermore, they became not suitable for arrangements between states with different levels of economic development, so that the need for them gradually fell away.[45] In respect of diplomatic protection, which was both financially and politically a costly procedure, the international community acknowledged the need to develop "more economical alternatives to the full intervention of governments"[46].

Accordingly, this necessity led to the approach of a second era, which began with expansion of the ISDS mechanism, the primal task of which has been to protect the rights of the investor and their investments rather than to defend states' interests. Thus, in contrast to the diplomatic protection scheme, the FDI protection system has now become less politicized. Under the ISDS procedure, if the host state acts contrary to the investment agreement and violates the investor's interests, the investor can bring claims against the foreign government on its own behalf[47]. The legal basis of protection has become the Bilateral and Regional Investment Agreement, as well as investment chapters of FTAs with an ISDS clause. The first

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[42] Barcelona Traction, Light and Power Company, ICJ (Belgium v. Spain). ICJ 1970 ICJ 3**.** Separate Opinion of Judge Morelli, Barcelona Traction case: 222-243, at p. 229.

[43] Lunc L. (2002). *The Course of International Private Law in three Books*. Moscow: Sparkb, at p. 391.

[44] Sagerdoti G. & Recanati M. (2015). State Dispute Settlement Systems: Diplomatic Protection and State to State Arbitration. *Bocconi Legal Studies Research Paper No. 2562782:* 17*,* at p.5.

[45] Campbell M., Shore L., and Weiniger M. (2007). *International Investment Arbitration: Substantive Principles*. Oxford International Arbitration Series. at p. 26.

[46] Bishop D., Crawford J. & Reisman W. (2005). *Foreign Investment Disputes: Cases, Materials, and Commentary*. Kluwer Law International. at p. 3.

[47] Akhtar S. & Jones V. (2014). *Proposed Transatlantic Trade and Investment Partnership (TTIP) Negotiations*. Washington, DC: Congressional Research Service: 13, at p.31.

state that started using ISDS clauses in its investment agreement was Germany, which signed its first BIT with Pakistan in 1959. Later, other EU MS and the United States followed its pattern. The main incentive to conclusion of modern-type bilateral investment treaties were two authoritative documents, adopted by the UN General Assembly. These were the General Assembly's Declarations on a New Economic Order[48] and the Charter of Economic Rights and Duties of States[49] that set the basis for future development of protection measures for foreign investors in host states. These acts provided for exclusive rights of states to revoke investment agreements and nationalize property belonging to third countries or their nationals entirely on the basis of national legislation (under the Calvo doctrine). Moreover, they exhorted parties to recede from an arbitration mechanism in favour of the national jurisdiction.[50]

Therefore, at this period, the international community, especially capital-exporting developed states, not satisfied with this state of affairs, attempted to create a multilateral legal instrument to deal with protection of foreign investments. These attempts resulted in creation of the Havana Charter in 1948, which sought to provide standards of fair and equitable treatment and prohibition of discrimination, but has never come into force[51]. Moreover, several scholars and institutions developed draft codes dealing with state responsibility issues in the context of investment protection, which have never become open for signature, but have significantly influenced the development of international investment law[52].

Finally, in 1965, under the patronage of the World Bank (International Bank for reconstruction and Development), was established the International Centre for Settlement of Investment Disputes (ICSID), which substantially advantaged development of investment arbitration. Nowadays the vast majority of International Investment Agreements provide for settlement of possible disputes under the rules of the ICSID Convention, currently ratified by 150 states[53]. To be able to address

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[48] UN General Assembly. (1974). Declaration on the Establishment of a New International Economic Order: resolution adopted by the General Assembly, 1 May 1974, A/RES/S-6/3201. Available at http://www.un-documents.net. Accessed 7 April 2015.

[49] UN General Assembly. (1984). Charter of Economic Rights and Duties of States: resolution adopted by the General Assembly., 17 December 1984, A/RES/39/163. Available at http://www.un-documents.net. Accessed 7 April 2015.

[50] Farhutdinov I. (2005). *International Investment Law: Theory and Application*. Wolters Kluwer Russia, at p. 373.

[51] Art. 12 (2)(a) of the Havana Charter for an International Trade Organization (Havana, 24 March 1948) stipulated that Member States are obliged:

(i) to provide … adequate security for existing and future investments, and
(ii) to give due regard to the desirability of avoiding discrimination as between foreign investments.

[52] Among those codes are:

- Draft convention on "responsibility of States for damage done in their territory to the person or property of foreigners", prepared by the Harvard Law School in 1929;
- Draft convention on the international responsibility of States for injuries to aliens, prepared by the Harvard Law School, 1961;
- OECD Draft Convention on the Protection of Foreign Property No.1563[6]7/December 1962.

[53] Convention on the Settlement of Investment Disputes between States and Nationals of Other States. 14/10/1966. 17 UST 1270, TIAS 6090, 575 UNTS 159.

ICSID with a claim and commence arbitration, first, the dispute must arise directly out of investment and second, both the respondent State and the State of the investor's nationality must be a party to the ICSID Convention. If one of the parties to a BIT did not ratify the ICSID Convention, states can still refer their investors to ICSID, but the proceedings will be governed by the ICSID Additional Facility Rules. Up to December 31, 2015, ICSID had registered 549 cases, with the biggest number of disputes recorded in 2015 (52 cases)[54].

In 1976, the United Nations Commission on International Trade Law (UNCITRAL) provided an alternative to ICSID arbitration. UNCITRAL presented Arbitration Rules[55] for resolution of a broad range of disputes, including non-institutional and institutional commercial disputes, investor-state disputes and state-to-state disputes. Thus, if states prefer to opt for non-institutional (ad hoc) arbitration, they can refer to the rules (last revised in 2010) in their investment agreements. Usually, the structure of an ad hoc arbitration tribunal operating under UNCITRAL Arbitration Rules is the following: the arbitration panel consists of three arbitrators, two of which are appointed by the parties, and one is selected by UNCITRAL. Apart from the differences in structure of the tribunal, UNCITRAL has recently changed its policy towards the openness of the arbitration process by creating new standards of transparency in ISDS procedure in April 2014. The example was taken from ICSID, which revised its rules in 2006, allowing for publication of information about investment disputes and free access to the hearings upon parties' consent. However, UNCITRAL went further, making proceedings and official arbitration documents available for the general public regardless of authorization for such access from the side of the parties. Although the legal force of transparency rules will expand only on arbitrations under agreements concluded after 1 April 2014, in order to provide the mechanism of its application to existing IIAs, the UN General Assembly adopted the Convention on Transparency in Treaty-based Investor–State Arbitration[56].

Finally, apart from the arbitration venues mentioned, contemporary IIAs can provide for such arbitration forums as the Arbitration Institute of the Stockholm Chamber of Commerce or the International Chamber of Commerce.[57]

It should be mentioned that after the investor-state dispute settlement mechanism occupied a prominent position in a majority of international treaties, state-to-state dispute settlement is being used only for resolution of conflicts regarding interpretation and application of inter-state investment agreements. Nevertheless, some scholars assert that we are on the edge of a third era of investment protection due to the emergence of an absolutely new SSDS system that is characterized by a more proportional approach to the balance of investors and

[54] ICSID. (2016). *Caseload Statistics* (Issue 2016-1), at p. 8. Available at https://icsid.worldbank.org. Accessed11 April 2015.
[55] UNCITRAL. (1976). Arbitration Rules, UN Doc. A/RES/31/98; 15 ILM 701.
[56] United Nations. (2014). Convention on Transparency in Treaty-based Investor-State Arbitration. Currently signed by 10 States, none of which have ratified it to date.
[57] Coleman M., Aldridge H. & Innes T. (2015). Choosing an Arbitral Forum for Investor-State Arbitration. January 27, 2015, para. 4. Available at http://www.steptoe.com/publications-10156.html. Accessed 11 April 2015.

states' rights, where neither of the parties have privileges.[58] However, as this work is focused on the investor-state type of dispute resolution, I will not discuss the state-to-state method in detail.

To sum up, countries interested in participating in the global inter-state investment circuit must ensure that their public and financial interests, as well the rights of their residents, are properly protected. Until the middle of the 20th century, investors could sue a host state that afforded inappropriate treatment but only through the help of their home government, which used diplomatic channels to require cessation of certain activity or compensation for damage. Such diplomatic protection scheme had numerous disadvantages, so that states had to search for new ways to regulate FDI matters and ensure better safeguarding of investors' property abroad. In order to obtain such assurance, states concluded International Investment Treaties either with one (BIT) or several (IIA or FTA) other states, in which they secured a list of protection guarantees (e.g. most-favoured-nation ad national treatment standards, ISDS clauses) ensuring that no party went beyond the limits of obligations set in the agreement. In case one of the actors violates the provisions, the investor has the right to address either an ad hoc or institutional arbitration tribunal under UNCITRAL, ICSID, SCC, ICC etc. rules depending on the relevant provisions of the IIA between home and host states. The system of direct appeal by the investor to the host government is called investor-state dispute settlement. ISDS was preceded by the diplomatic protection scheme and state-to-state dispute settlement, which strictly required involvement of the home state in resolution of a conflict, restraining investor's rights and making the administration of justice more complicated.

After familiarization with the general theoretical and historical background to the topic, it is necessary to address concrete examples of FDI protection policies. The next section will critically assess and compare the investment policies of "the world's most important investors and bankers" that "occupy a key place in the international political economy"[59]: the United States and the European Union.

[58] Roberts A. (2014). State-to-State Investment Treaty Arbitration: A Hybrid Theory of Interdependent Rights and Shared Interpretive Authority. *Harvard International Law Journal*, Volume 55, Number 1, Winter 2014, 1-70, at p. 5.

[59] McGuire S. & Smith M. (2008). *The European Union and the United States: Competition and Convergence in the Global Arena*. Palgrave Macmillan, at p. 12.

Section 2
Comparative Review of FDI Protection Policies

2.1 International Order of FDI Protection and Dispute Resolution: United States Experience

This chapter will introduce the reader to the US experience of investment policy regulation, present an analysis of the FDI safeguarding provisions of the North American Free Trade Agreement (NAFTA) and US Model Bilateral Investment Treaty (BIT) 2012 and illustrate modern trends of US FDI protection policy. The US and the EU are each other's major investors and have relatively open investment climates[60]. The EU share in total FDI inflows in the US amounts to 71%, while US investments constitute 56% of total FDI in the Union[61]. According to the UNCTAD report of June 2014[62] both the EU and the US are actively involved in investor-state arbitration. 75% of all ISDS investor claims are brought against EU Member States and the US, while global FDI inflows to the economy of these two regions amount only to 30% - equal to the percentage of FDI inflows to developing Asia, which now holds the leading position of the largest FDI recipient.[63]. Nevertheless, to date, only 16 investment claims have been brought against the US, none of them by investors from the EU, while the EU Member States have acted as respondent in 117 cases, 88 of which were internal disputes. EU MS won half the cases, and the US did not lose a single case[64]. Therefore, for reasons of:

1) close interconnection between American and EU markets;
2) US status as the main holder of inward FDI stocks in the EU;
3) US status as the major EU competitor regarding third-country investment inflows in the national economy;
4) longstanding US experience in the sphere of investment protection;
5) successful US defence practice in investment-state dispute resolution proceedings;
6) the upcoming conclusion of a comprehensive US-EU economic and trade agreement on investment protection (TTIP)

it is necessary to analyse the development, content and structure of United States policy in the sphere of investment protection and dispute settlement.

In the first place, it seems to be logical to give a brief historical overview. The modern history of investment protection in the US started with the conclusion of the

[60] Buonanno L., Cuglesan N. & Henderson K. (2015). *The New and Changing Transatlanticism: Politics and Policy Perspectives*. Routledge, at p. 279.
[61] Hamilton D. & Quinlan J. (2015). *The Transatlantic Economy 2014*. Center for Transatlantic Relations, at p. 6.
[62] UNCTAD. (2015). Investor-State Dispute Settlement: An Information Note on the United States and the European Union. UNCTAD, №2 June 2014. Available at http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d4_en.pdf. Accessed 8 April 2015.
[63] *Ibid*.
[64] *Supra* note 67.

FCN Treaties in the 20th century. In the 1970s, the US began to sign individual BITs, the first of which was with Panama in 1982, followed by later arrangements with Haiti, Senegal, Congo, Morocco and Turkey[65]. To date, the US has concluded 46 BITs, 40 of which are in force, including nine agreements with EU Member States (Bulgaria, Croatia, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania and Slovakia) and 14 Free Trade Agreements (FTA), that include investment chapters[66]. Still, the majority of EU States, as well as China, India and the Russian Federation, do not have investment agreements with the US. In contrast to the US, the EU, as a rule, did not include investment chapters with investor-state arbitration clauses in its FTAs.

The situation changed dramatically in 1989 with the conclusion of a FTA with Canada[67], which, at that time, was already a country with a strong and competitive economy. The partners created a rather comprehensive and detailed document and, on that basis, in 1992, the United States, Canada and Mexico signed the North American Free Trade Agreement (NAFTA) which has been used as a model act for many later trade and investment treaties. The population of the NAFTA Contracting States exceeds 375 million people; thus, the market created for goods, services and investment was extremely large[68]. This was the first US IIA where the accent was not only on protection of American investors abroad, but also on the obligations of the US as a country-recipient of FDI inflows. The deal has been beneficial for both parties: Canadian and Mexican exports formed the largest share of the US market for exported goods, and vice versa, the US mainly exported its products to Canada and Mexico[69]. After 1992, the majority of US FTAs have been drafted in accordance with North American FTA standards.

In 2012, the US created its Model Bilateral Investment Treaty, which replaced its predecessor, the Model BIT of 2004. The reason for adopting the latter document was popular discontent with the nature of US obligations under NAFTA, pursuant to which a foreign investor could challenge the actions of the US public authorities and sue the US government in arbitration. The drafters of the Model BIT attempted to accumulate all previous US experience in conclusion of BITs and FTAs in order to create an ideal document that will become a reflection of the US position in the course of negotiations of future BITs and other IIAs. The US Model BIT, as well as the majority of Model BITs of other countries, only sets an alternative pattern in case the parties do not come to agreement or when there is a need to interpret the terms of the final version of a Treaty[70]. Overall, the Model US BIT, in comparison with EU Member States' Model BITs, ensures higher predictability of possible arbitration

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[65] The list of US Bilateral Investment Treaties is available at http://www.state.gov/e/eb/ifd/bit/117402.htm. Accessed 31 March 2016.

[66] *Ibid*.

[67] Canada-United States: Free Trade Agreement, 2 January, 1988, 27 ILM 281 (1988).

[68] Kozak U. (2007). *International Organisations: Academic Textbook*. Kyiv: Center of Academic Literature, at p. 325.

[69] Wilson C. (2011). *Working Together: Economic Ties between the United States and Mexico*. Washington: Mexico Institute Woodrow Wilson International Center for Scholars, at p. 9. Available at http://www.wilsoncenter.org. Accessed 20 May 2015.

[70] Vyshnyakov O. (2007). *Legal Regulation of External Economic Activity: The Questions of Subject Attachment*. Odessa: Legal Literature, issue 34, at p. 115.

proceedings and protects the US as a host state from the risk of being held responsible for any inappropriate measure of treatment afforded to third-state investments and investors. The main standards of treatment provided by the US Model BIT and NAFTA are:

- National treatment standard, according to which the host State is obliged to treat foreign investors in the same manner as it treats its national investors. This principle is provided in Article 1102 of NAFTA and Article 3 of Model BIT 2012
- Most-Favoured-Nation treatment, which requires the state to give no less favourable treatment to the investors of the Contracting party than it gives to investors of other states. This principle is set in Article 1103 of NAFTA and Article 4 of the Model BIT
- Minimum standard of treatment, which includes the requirements of "fair and equitable treatment" (FET) and "full protection and security" (FPS)[71].

These principles stand as a guarantee of due process and, in contrast to MFN and national treatment clauses, have an absolute nature, meaning that they do not depend on the extent of protection afforded to nationals of other countries[72]. Under Article 1105 of NAFTA, the contracting states are required to provide such treatment to investments of the other party's investors that will be "in accordance with international law, including fair and equitable treatment and full protection and security."[73] In addition, the Minimum Standard of Treatment rule is expressly defined in Article 5 of the US Model BIT 2012, where FET is interpreted as an obligation not to deny justice and FPS means the requirement to provide police protection. In terms of discussion of non-denial of the justice principle set in NAFTA provisions, it would be not correct to overlook the judgment in the famous *Loewen case*[74]. Scholars describe this case as a "leading case of denial of justice"[75]. Briefly, the Canadian company, Loewen Group funeral homes, brought a claim against the US before the ICSID arbitration tribunal for alleged breach of Article 1105 of NAFTA. The company challenged the decision of the Mississippi state court, which rendered a $500 million award against Loewen and required it to post a $625 million bond in case it wanted to appeal. The sum of this bond exceeded the worth of the company and constituted a violation of the international minimum standard of justice. Nevertheless, the arbitration tribunal ruled against the claimant and held that there had been no denial of justice from the American side as the plaintiff failed to appeal the lower court's

[71] US Model BIT 2012. Available at http://www.state.gov/documents/organization/117601.pdf. Accessed 11 April 2015.
[72] Walker H. (1957). Modern treaties of Friendship, Commerce and Navigation. *42 Minnesota Legal Review:* 805-820, at p. 810.
[73] Been V. (2002). NAFTA's Investment Protection and the Division of Authority for Land Use and Environmental Controls. *Pace Environmental Law Review:* 19-61, at p. 24.
[74] Loewen Group Incorporated and Loewen (Raymond L.) v United States, Decision on Respondent's Request for a Supplementary Decision, ICSID Case No ARB(AF)/98/3, (2004).
[75] Weiler T. (2005). *International Investment Law and Arbitration: Leading cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law*. Cameron May, at p. 670.

decision[76]. In other words, the tribunal explained that the state does not have to bear responsibility under international law for the mistakes of an individual judge.

- Ban on illegal and uncompensated expropriation or nationalization of investments provided in Article 1110 of the NAFTA and Article 6 of the Model BIT. It is worth noting that expropriation can be both direct and indirect (partial or temporary), although in order to prove the existence of the latter, the arbitration tribunal should scrutinize all the facts of the case and contract clauses. For example, in *Myers v. Canada*, the tribunal underlined that

> An expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights although ... it would be appropriate to view a deprivation as amounting to an expropriation, even if it were partial or temporary.[77]

- Prohibition of enforcement of certain performance requirements, such as e.g. "to relate in any way the volume or value of imports to the volume or value of exports … " or "to act as the exclusive supplier of the goods … or services … to a specific region or world market" set in Article 1106 of the NAFTA and Article 8 of the Model US BIT 2012.

- Prohibition to demand appointment "to senior management positions individuals of any particular nationality" set in Article 1106 NAFTA and Article 9 of the Model US BIT 2012.

Additionally to the standards mentioned, NAFTA, in Article 1109, also provides freedom of currency transfers, stipulating that they should be "made freely and without delay".

With regard to the settlement of investment disputes, Article 1117 NAFTA lists possible alternatives for an investor who wishes to sue the host state for inappropriate treatment or loss resulting from states' conduct. Accordingly, claims can be brought under the rules of the ICSID Convention, the ICSID Additional Facility or UNCITRAL. Unlike the Energy Charter Treaty, pursuant to Article 1121 of NAFTA, once an investor commences the arbitration, the right to address local courts or any other dispute settlement body is considered to be waived. Therefore, it provides more safety for the host government, which is protected from abuse of process by the foreign investor. Moreover, NAFTA sets the statute of limitations of three years in Article 1116 and in Article 1118 requires the parties to "attempt to settle a claim through consultation or negotiation" prior to commencement of arbitration proceedings. These provisions coincide with ECT norms that will be discussed later, by providing for mandatory pre-arbitration and cooling-off periods thus reducing the number of costly and time-consuming arbitration proceedings and protecting the host government from tardy investor claims.

Addressing the question of future development of FDI protection in the US, it should be mentioned that recent trends in US investment policy concern the intention to establish an appellate mechanism for reviewing decisions of the tribunals

[76] Murphy S. (2006). *United States Practice in International Law: 2002-2004*. Cambridge University Press, at p. 92.

[77] S.D. Myers, Inc. v. Government of Canada, UNCITRAL, NAFTA. Final Award (concerning the apportionment of costs between the Disputing Parties), 30 December 2002, para. 283.

and the creation of a separate permanent investment arbitration court. The legal basis for implementation of the first project is already present. The Model US BIT 2012 in Article 28 (Conduct of arbitrations) provides that:

> In the event that an appellate mechanism for reviewing awards … is developed in the future … the Parties shall consider whether awards rendered under Article 34 should be subject to that appellate mechanism.

The possibility of establishing a bilateral appellate body for revision of awards was envisaged in Model BIT 2004, although this mechanism has never been enforced. Some contemporary US IIAs also mention the prospect of an appellate review, if the parties consent that there is a need for it[78]. However, opponents to introduction of an appellate mechanism in the practice of investor-state arbitration under US IIAs claim that as the US today has a "perfect record of defending itself against investors", it has no interest in enabling investors to appeal the final decision.[79] Formation of a standing tribunal for investor-state dispute settlement is a much more complicated task and currently finds its development only in theory.[80]

In addition, in 2012, the US together with the EU drafted an agreement on Shared Principles for International Investment, in which they affirmed their mutual commitment to seven principles of investment protection that are of crucial importance for "maintaining open and stable investment climates and policies". Among those principles are "strong protection for investors and their investments" maintained by ensuring non-discriminatory and fair treatment as well as a guarantee of "prompt, adequate, and effective compensation" and "fair and binding dispute settlement" providing for accessible and transparent conflict resolution procedures, including arbitration[81]. Overall, it can be concluded that today the US, as well as the majority of developed and developing countries, are striving for liberalization of their investment regimes by amending both national and international legislation so that it provides for facilitation of global capital transfer[82]. After outlining the US approach to the management of foreign direct investment protection, it is important to switch the attention to the EU and look at the:

- development of Union investment policy before the acquisition of exclusive competence over FDI under Lisbon Treaty;
- changes introduced by the Lisbon era;

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[78] Pursuant to annex 10-F of CAFTA (Central America–Dominican Republic Free Trade Agreement, 2004) "within three months of the date of entry into force of this Agreement, the Commission shall establish a Negotiating Group to develop an appellate body or similar mechanism to review awards rendered by tribunals under this Chapter".

[79] Walsh T. (2006). Substantive Review of ICSID Awards: Is the Desire for Accuracy Sufficient to Compromise Finality. *24 Berkeley Journal of International Law*, Volume 24: 444-462, at p. 461.

[80] Sampliner G. (2013). Arbitration Innovations in Recent US Investment Treaties. International Arbitration: Contemporary Issues and Innovations / ed. John Norton Moore. Nijhoff: 147-164, at p. 156.

[81] Statement of the European Union and the United States on Shared Principles for International Investment. (2012). Available at http://trade.ec.europa.eu/doclib/docs/2012/april/tradoc_149331.pdf. Accessed 20 April 2015.

[82] Rubalkin V. (2012). *International economic relations,* 9th edition. Moscow: Unity-Dana, at p. 213.

- relevant provisions of the Energy Charter Treaty, Model MSs BITs and CETA with Canada;
- history of adoption, aim, scope and nature of new Financial Responsibility Regulation.

2.2 Overview of EU Legal Background

a) The EU Investment Protection Scheme and Dispute Settlement Mechanism before the Treaty of Lisbon

This chapter will introduce the reader to the development of investment policy in the European Communities and the Member States before the Lisbon Treaty entered into force in 2009. The EC started shaping its FDI regulation mechanism with the conclusion of the Rome Treaty[83], which, besides establishing the EC itself, secured the concept of the common market, which supposes the economic integration of all Community Members. The process of creation included a wide range of activities, among which were establishment of a customs union, adoption of the four freedoms (freedom of goods, labour, services and capital movement), and development of positive integration through conducting a common financial, competition and investment policy by the Member States.[84]. Later, the European Single Act of 1986[85] promoted liberalization of capital transfer, although the removal of barriers took place only within the Union. With the entry into force of the Maastricht Treaty[86], all limitations concerning investment inflows and outflows from third states were abolished. However, the Union was far from reaching comprehensive control over the field of FDI.

Until 2009, trade liberalization in the EU had been promoted exclusively through the conclusion of FTAs and agreements with the WTO. At the same time, the investment protection sphere was shaped individually by each MS, which had complete freedom to conclude bilateral investment agreements both within the Communities and with third states, and to decide upon the means and rules of investment dispute resolution procedure without any interference from the side of the EC. Concluded BITs did not follow the NAFTA pattern, and set different standards of foreign investment protection, although some scholars contend that they were all "inspired" by the OECD Model BIT of 1962[87][88]. Thus, while the Common Commercial Policy was the domain of EU exclusive competence pursuant to Article 113 (modern Article 133) of the EEC Treaty and, according to established case law[89], its scope did

[83] Title 9 of the Treaty Establishing the European Community (Consolidated Version), European Union, Rome Treaty, 25 March 1957.
[84] Jakubovska N. (2005). Legal Regulation of Foreign Direct Investments of Transnational Corporations in European Union Countries. Odessa: Legal Literature: 157-162, at p. 157.
[85] European Union. (1986). Single European Act, 28 February 1986. OJ, 167, 29.06.1987.
[86] European Union. (1992). Treaty on European Union (Consolidated Version), Treaty of Maastricht, 7 February 1992. OJ C, 325, 24.12.2002.
[87] Organisation for Economic Co-operation and Development. (1962). Draft Convention on the Protection of Foreign Property, December 1962, OECD Pub. No. 15637.
[88] Fontanelli F. & Bianco G. (2014). Converging towards NAFTA: an Analysis of FTA Investment Chapters in the European Union and the United States. *Stanford Journal of International Law:* 211-245, at p. 221.
[89] Opinions 1/75 (1975) ECR 1355.

not extend to FDI matters. Later, Article 56(1) of the Maastricht Treaty provided for elimination of all restrictions on capital movement (with some exceptions, such as investment in real estate)[90], but regulation of FDI transfer remained within the competence of each MS[91].

The absence of a uniform policy towards foreign direct investments led to the situation when the Articles of BITs, in whole or in part, did not correspond or even contradicted the provisions of EU legal acts. After the big EU enlargement in 2004, when 10 Eastern and Central European countries joined the European Union and were obliged to accept and implement its *acquis communautaire*, the EU faced the problem of nonconformity with EU law of BITs signed with the US, Canada and other European countries by recent MS prior to their accession.[92] The scope of investment protection in BITs has been usually broader than under EU law. This led to conflicts of norms that concerned collision between:

- the possibility of unqualified capital transfer provided by a majority of BITs and the Council's authority to impose restrictions on capital transfer under Articles 64, 66. 75 TFEU;
- national and most-favoured-nation principles covered by BITs and EU performance requirements and quotas, and matters of public policy of EU Member States;
- the regimes of MS BITs and EU FTAs containing FDI provisions[93];
- EU law on State aid and Fair and Equitable Treatment Standards in MS BITs.[94]

As a large number of MS BITs were concluded with the US, in order to resolve these discordances, new Member States signed a Memorandum of Understanding with the United States[95]

> to seek compatibility between the Acceding and Candidate Countries' obligations that arise from membership in the EU, and thereafter under EU law, and their obligations arising from their BITs with the US[96].

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[90] European Union. (1992). Treaty on European Union (Consolidated Version), Treaty of Maastricht, 7 February 1992. OJ C, 325, 24.12.2002.

[91] Kashkin S. (2011). *European Union Law*, 3rd edition. Moscow: Prospect, at p. 124.

[92] Radu A. (2008). Foreign Investors in the EU: Which Best Treatment? Interactions between Bilateral Investment Treaties and EU Law. *European Law Journal*, Vol. 14, Issue 2, March 2008: 237-260, at p. 240.

[93] For example under the EU FTA with Chile the Contracting Parties were allowed to put restriction on capital transfers in exceptional circumstances, while under MSs BITs with Chile free movement of capital without restrictions was guaranteed.

[94] Kleinheisterkamp J. (2011). *The Next 10 Year ECT Investment Arbitration: A Vision for the Future – From a European Law Perspective*. LSE Law, Society and Economy Working Papers 7/2011, at p. 5.

[95] Understanding Concerning Certain US Bilateral Investment Treaties, signed by the US, the European Commission, and acceding and candidate countries for accession to the European Union (22 September 2003). Available at http://www.state.gov/s/l/2003/44366.htm. Accessed 9 April 2015

[96] *Ibid*, Preamble of Understanding.

Consequently, the Memorandum helped to balance the interests of all parties and disengaged Member States from the obligation to renegotiate separately every concluded BIT to comply with the *acquis*[97].

Apart from the problem with the BITs of recently joined MS, it turned out that investment agreements of the old MSs also contained provisions conflicting with European legislation. The EU found the way out of this situation by obliging these States to renegotiate their BITs to bring them in correspondence with EU law. Nevertheless, the majority of the Member States did not wish to engage in a process of long and costly renegotiations of existing agreements and ignored this demand. Nevertheless, later, the states had to take the consequences of their omission, as in 2009 the EU initiated infringement procedures before the ECJ against Austria, Sweden and Finland for refusal to review their investment agreements and bring them in line with Union law. The ECJ supported the EU position and passed judgment against the MS, declaring that they had failed to take appropriate steps to eliminate incompatibilities of BIT provisions with paragraph 2 of Article 307 EC.[98]

A large step forward in shaping EU FDI and dispute resolution policy was the Energy Charter Treaty[99] (ECT) in 1995 (which entered into force in 1998). Among the Contracting States of ECT were the European Union, the EU Member States, former Soviet bloc countries, Japan and Australia. The US also took part in drafting the ECT, although, eventually, its representatives decided to abstain from signing it. The main aim of this document was to provide the basis for protection of investments in the energy resources of Eastern Europe[100]. The provisions of the ECT have covered a wide range of questions including matters of investment protection, trade, taxation, environment, competition and, more importantly, established the rules of dispute resolution proceedings. Maintenance of the investment protection mechanism has been carried out by ensuring:

- fair and equitable treatment according to Article 10 (1) ECT;
- observance of national treatment as well as the most-favoured treatment rule pursuant to Article 10 (7) ECT;
- protection from illegal expropriation set in Article 13 ECT;
- freedom of capital transfer provided by Article 14 ECT;
- the right of the investor to employ key personnel irrespective of their nationality according to the Article 11 ECT.

The ECT contains norms regulating both state-to-state and investor-state arbitration (Articles 27 and 26 accordingly). The former is conducted only under UNICTRAL Rules in ad hoc tribunals in case the subject of a dispute concerns competition or WTO issues. In contrast, pursuant to Article 26, Investor-State disputes can be settled by several means, namely:

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[97] Dimopoulos A. (2011). *EU Foreign Investment Law*. Oxford University Press. at p. 311.
[98] C-205/06 (Commission v Austria) [2009] ECR I-1301; C-249/06 (Commission v Sweden) [2009 ECR I-1335; C-118/07 (Commission v Finland) [2009] ECR I-1301, I-1335 and I-10889.
[99] Energy Charter Treaty, 2080 UNTS 95; 34 ILM 360 (1995). Available at http://www.encharter.org/fileadmin/user_upload/document/EN.pdf. Accessed 13 April 2015.
[100] Herman L. (1997). NAFTA and the ECT: Divergent Approaches with a Core of Harmony. *15 Journal of Energy & Natural Resources Law* 130: 129-154, at p. 130.

1) in local courts or administrative tribunals of a host state;
2) through a previously agreed dispute settlement mechanism;
3) in arbitration tribunals under the provisions of the ICSID Convention, ICSID Additional Facility Rules, in ad hoc tribunals according to the UNCITRAL rules or in the Arbitration Institute of the Stockholm Chamber of Commerce.

However, prior to addressing any strict dispute resolution methods, the ECT[101], similarly to NAFTA, provides that any dispute between Contracting States and investors shall, within the bounds of possibility, be resolved by means of negotiations, mediation or conciliation without involvement of courts or tribunals[102].

Paragraph 3(a) of Article 26 ECT sets the rule that each party "gives its unconditional consent to the submission of a dispute to international arbitration or conciliation"[103], meaning that arbitration is automatically binding on the parties to the Convention subject to several exclusions listed in the article (e.g. the "fork in the road" exception for states in Annex ID and the "umbrella clause" for states listed in annex IA[104]). Moreover, the ECT does not explicitly prohibit forum shopping, as it does not require waiver of other forums as a precondition of access to arbitration, in contrast to the norm of Article 1121 of NAFTA, thus tolerating the possibility of abuse of the investment protection mechanism by a foreign investor who can simultaneously or sequentially address the local courts and arbitration. Although, in the *Meffenzi case*[105] as well as in *Plama*[106]*,* tribunals ruled that forum shopping is unacceptable practice under the ECT, the absence of direct prohibition of forum shopping in the Treaty does not add more clarity and predictability to the process.

With regard to the involvement of the EC in arbitration, it is important to mention that Article 26 ECT allows the investor to bring a claim directly against the Communities. In its statement of 1994[107], the EC confirmed its role in investor-state arbitration as a respondent party by declaring that both MS and the EC are "internationally responsible for the fulfilment of the obligations … in accordance with their respective competences." However, in practice, there was no case where the European Communities would act as respondent in investor-state arbitration under the Energy Charter Treaty. The scope of legal remedies available for the investor in case the EC would not agree with the final award and refuse to compensate damages, has been rather limited. Therefore, it can be inferred that the ECT, in fact, indirectly narrowed down formally possible "investor-EU" arbitration to mediation, conciliation, or any other type of half-binding types of alternative dispute resolution, depriving it of its main advantage of the obligatory nature and enforceability of the

[101] In Art. 2 (a) Annex D (Interim Provisions for Trade Dispute Settlement (in Accordance with Article 29(7)) of the Energy Charter Treaty.
[102] Gushyn V. (2013). *Investment Law:* Textbook. Litres, at p. 346.
[103] Art. 26(3)(a) ECT.
[104] Ribeiro C. (2006). *Investment Arbitration and the Energy Charter Treaty.* JurisNet, LLC, at p. 27.
[105] Emilio Agustín Maffezini v. The Kingdom of Spain, ICSID Case No. ARB/97/7, 2000.
[106] Plama Consortium Limited v. Republic of Bulgaria ICSID Case No. ARB/03/24, 2005.
[107] Statement submitted by the European Communities to the Secretariat of the Energy Charter Treaty pursuant to Art. 26. (3) (b) (ii) Energy Charter Treaty. L 336, 23.12.1994: 3-23.

final award. That is why investors always opted for a more reliable and predictable way of obtaining compensation for damages by suing individual states that are bound by the New York or ICSID Conventions.

Finally, it worth mentioning that, although, prior to the Lisbon Treaty, no legal act explicitly authorized the Union to conclude international agreements covering FDI protection issues, the EU, apart from the ECT, has also concluded such FTAs as the Trade, Development and Cooperation Agreement with South Africa in 1999, the Economic Partnership Agreement with Mexico in 2000 and the Association Agreement with Chile in 2002. Such actions were justified by the effect of an implied powers doctrine[108], first established by case law (*Commission v. Council*)[109] and then included in Article 3 of TFEU.

To conclude, during the pre-Lisbon period, FDI policy matters were regulated individually by each Member State, while the EC organs almost did not take part in this process, except for adoption of the Energy Charter Treaty in 1995 and conclusion of several investment agreements in 1990th. Thus, at that time, the Communities did not have a unified investment policy and were not directly involved in the dispute resolution process. However, after the Lisbon Treaty entered into force, the situation changed radically, as the EU acquired exclusive competence over FDI matters and started actively developing its common investment strategy.

b) Analysis of Changes in EU Legal System Introduced by the Lisbon Treaty

A swift change in EU investment policy took place together with the entry into force of the Lisbon Treaty in 2009[110] introducing reforms to the Treaty of the European Union and the Treaty of the Functioning of the European Union (previously named the Treaty establishing the European Community). The common commercial policy, part of which is foreign direct investments (Article 207 (1) TFEU) has fallen under the exclusive competence of the EU under Article 3 TFEU[111]. The same article states the exclusive power of the Union to conclude and negotiate international agreements on behalf of the Member States and manage investment protection obligations. This newly acquired exclusive competence means that the European Union has now become a direct independent participant in investment dispute settlement proceedings. While the Union had consolidated its position as a legitimate international disputant by continuous participation in the WTO dispute settlement

[108] The doctrine of implied powers means that the Union has powers that are not expressly provided by law, but the use of which is deemed to be necessary for pursuing the purposes of the Treaties.

[109] Commission of the European Communities v Council of the European Communities. 31 March 1970, Case 22/70, AETS. It has been established that the power of the Commission to conclude international agreements "may equally flow from other provisions of the Treaty and from measures adopted, within the framework of these provisions, by the Community institutions."

[110] European Union. (2007). Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, 13 December 2007, 2007/C 306/01.

[111] Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, 2012/C 326/01.

system[112], this will be its first experience of being a defendant in litigation with a private party on an international level.

From now on, in the framework of centralized investment policy, under Article 2(1) TFEU[113], Member States are obliged to seek the approval of the Union prior to the conclusion of any BIT. It is pertinent to note that although the existing investment treaties signed by the EU Member States have not been terminated automatically[114], the EU took a course for a progressive replacement of existing BITs signed by the MS with new agreements concluded by the EU. One of the first steps towards realization of this policy is the proposed US – EU Transatlantic Trade and Investment Partnership, currently at the negotiation stage. Upon conclusion, this agreement will become the world's largest international investment agreement, covering around 30% of world trade.[115] Apart from the TTIP, the European Commission is negotiating a Free Trade agreement with Singapore, a major destination for European investment in Asia, as well as Asia's second largest investor in the EU (after Japan)[116]. Together with the already signed CETA with Canada, the TTIP and FTA with Singapore will regulate a substantial share of global international trade and investment[117].

However, realization of a common policy does not proceed without complications. One of the concerns raised by scholars is the existence of disagreement between two main EU organs – the EU Parliament and the Commission – regarding the strategy and course of development of investment protection policy. Briefly, the Parliament is inclined to protect the autonomy of the Member States by narrowing the scope of foreign investor's rights in EU MS (e.g. not to allow investors to challenge MS public policy), while the Commission is standing for a broad extent of protective measures for alien investors in the EU to ensure that EU investors will receive the same level of protection abroad.[118]

In the framework of the new investment regime, important changes have taken place with regard to the content of the notion of 'investment'. As emphasized

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[112] Under the WTO Understanding on Rules and Procedures Governing the Settlement of Disputes. 1869 UNTS 401; 33 ILM 1226 (1994).

[113] Art. 2(1) TFEU states that "when the Treaties confer on the Union exclusive competence in a specific area, only the Union may legislate and adopt legally binding acts, the Member States being able to do so themselves only if so empowered by the Union or for the implementation of Union acts."

[114] Weaver M. (2014). The Proposed Transatlantic Trade and Investment Partnership (TTIP): ISDS Provisions, Reconciliation, and Future Trade Implications. *Emory International Law Review:* 214-275, at p. 242.

[115] Palmer D. (2013). After Long Buildup, US-EU Free Trade Talks Finally Begin, Reuters. Available at http://uk.reuters.com/article/uk-usa-eu-trade-idUKBRE96704B20130708. Accessed 11 April 2015.

[116] Data of the European Commission on Trade statistics with Singapore. Available at http://ec.europa.eu/trade/policy/countries-and-regions/countries/singapore. Accessed 29 April 2015.

[117] Galagan D. (2015). Mechanisms of Investment Protection in Regional Trade Agreements. *Investment,* Мосты, Vol. 8, Number 1, 12 March 2015. Available at http://www.ictsd.org/bridges-news. Accessed 29 April 2015.

[118] Fontanelli F. & Bianco G. Converging towards NAFTA: an Analysis of FTA Investment Chapters in the European Union and the United States. *Stanford Journal of International Law:* 211-245, at p. 6.

in the first section, the concept of 'foreign investment' comprises two distinct parts, one of which is the aforementioned foreign direct investment, and the other is portfolio investments. Notably, the articles of the TFEU do not openly touch upon portfolio investments[119]. However, in its Communication 'Towards a comprehensive European international investment policy of 2010'[120], the Commission underlined that:

> ... chapter does not expressly provide for the possibility to conclude international agreements on investment, including portfolio investment ... to the extent that international agreements on investment affect the scope of the common rules set by the Treaty's Chapter on capitals and payments, the exclusive Union competence to conclude agreements in this area would be implied.

The Commission referred to Article 63 of the TFEU, providing for free movement of capital in EU territory, which is one of four Union internal market freedoms. It should be borne in mind that secondary legislation, such as recommendations, regulations and directives governing aspects of investment policy are applicable only to FDI and do not regulate portfolio investments. Therefore, despite existing concerns raised by some scholars that "all investment agreements which cover both aspects of investment need to be concluded as mixed agreements"[121], the Union has directly awarded itself the competence to conclude investment agreements on protection of both direct and portfolio investments.

After providing an insight into the general background of the new EU investment policy, I will highlight the changes in the investor-state dispute settlement mechanism. According to the Communication of 2010, all Institutions expressed their support for inclusion of an ISDS clause in all future EU-third State IIAs to increase the level of legal security for foreign investors in the EU.[122] Along with the Communication of 2010, the Commission presented a draft of the proposed Regulation establishing transitional arrangements for bilateral investment agreements between the Member States and third countries[123] (extra-EU BITs) that came into force by the end of 2012. Pursuant to this document, the Commission can scrutinize existing and new MS BITs to ensure their correspondence with EU law. Under its rules, pre-Lisbon BITs will remain in force upon their replacement by new EU agreements, while BITs concluded after 2009 must be amended after "authorization to open formal negotiations" is granted by the Commission pursuant

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[119] Judgment of 26 September 2008, Commission/Netherlands, Joined Cases C-282/4 and C-283/04, ECR at p. I-9141, para. 19. "Portfolio investment" is the "the acquisition of shares on the capital market solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking".

[120] Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions Towards a comprehensive European International Investment Policy. Brussels, 07/07/2010, COM(2010)343, at p. 8. Available at http://trade.ec.europa.eu/doclib/docs/2010/july/tradoc_146307.pdf. Accessed 9 April 2015.

[121] Biondi A., Eeckhout P. & Ripley S. (2012). *EU Law After Lisbon*. OUP Oxford, at p. 302.

[122] *Supra*, at p. 9.

[123] European Parliament and the Council. (2012). Regulation (EU) No 1219/2012 of 12 December 2012 establishing transitional arrangements for bilateral investment agreements between Member States and third countries. OJ 2012, L 351, p. 40.

to Article 8. Following completion of negotiations, the Commission must examine the final text of the agreement as to correspondence with the requirements of Articles 9(1) and (2) of the Regulation and if no breaches are found, give authorization "to sign and conclude a bilateral investment agreement" (Article 11 of the Regulation). The act leaves the question of compatibility of intra-EU BITs with EU law untouched, in spite of the fact that in 2014 intra-EU investor-state arbitrations reached the point of 99 cases, which corresponds to 16% of all known cases worldwide. The absence of such regulation can lead to significant imbalance of investors' rights among the MS, and different procedural issues, as the tribunal is not formally obliged to respect EU law, and, consequently cannot request a CJEU preliminary ruling under Article 267 TFEU[124].

In the light of the aim of this chapter, it is important to address contemporary investment protection standards maintained by the EU and its MSs in the post-Lisbon era and fixed in its international investment agreements. The first productive results of the Union's work towards development of a unified investment policy after acquisition of exclusive competence in 2009 have emerged as the pioneer investment agreement negotiated and soon to be concluded: the Comprehensive Economic and Trade Agreement between the EU and Canada (CETA). It seems probable that the content of the CETA investment chapter will shed light on the direction in which the Union is going to develop its investment policy. Potentially, this agreement could become a blueprint for the future EU Model BIT, which is expected to follow the pattern of US or Canada Model BITs and be drafted in more detail and depth in comparison to those BITs that were previously concluded by EU Member States.

Nevertheless, at the moment, the most reliable and updated source reflecting today's EU position regarding investment protection and the ISDS mechanism is the consultation documents on TTIP with the US. In "Public consultation on modalities for investment protection and ISDS in TTIP"[125] of 2014, the Commission included the following substantive standards, illustrating the modern EU approach to FDI protection:

1. The right of the state to regulate. This means that the state has exclusive power to regulate specific or sensitive areas, such as, inter alia, public health, national security, education, and cultural diversity. The state government is entitled to enforce measures to maintain legitimate public policy goals so that these will not discriminate against the rights of foreign investors. There is no doubt that this right is inherent in the sovereignty of states[126]. However, its protection should be in balance with protection of foreign investors' interests. This standard is included in numerous EU BITs (with Egypt, Morocco, Tunisia), a joint EU and US Statement on

[124] European Parliament. (2014). "Legal Instruments and Practice of Arbitration in the EU". *The Law and Practice of Arbitration in the EU,* at p. 17. Available at: http://www.europarl.europa.eu/studies. Accessed 25 May 2015.

[125] Public consultation on modalities for investment protection and ISDS in TTIP. March 27, 2014. Available at: http://trade.ec.europa.eu/doclib/docs/2014/march/tradoc_152280.pdf. Accessed 7 May 2015.

[126] Mann H. (2002). The Right of States to Regulate and International Investment Law. Geneva, 6–8 November 2002. Available at http://www.iisd.org/pdf/2003/investment_right_to_regulate.pdf. Accessed 21 April 2015.

Shared principles for International Investment, and, finally, it has been mentioned in various EU documents on TTIP negotiations.[127]

2. Fair and equitable treatment (FET) standard. This rule is enshrined in almost all international agreements regulating investment flows (with the exception of the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS))[128]. Moreover, claims alleging violation of the fair and equitable treatment standard are usually considered to be most likely to succeed in arbitration [129][130]. This standard can be interpreted as the requirement to maintain due process, due diligence, avoid arbitrariness, discrimination and duress, as well as an obligation to act in good faith that must be followed by all Partner States to the investment treaty.[131] Sometimes, fair and equitable treatment is limited to the minimum standard of protection (MSP) under customary international law[132] (e.g. as in NAFTA); however, the EU follows the opposite approach, preferring autonomous interpretation of FET[133]. A dispute on the relationship between FET and MSP may arise in the context of TTIP negotiations, although state practice shows that different approaches do not constrain interpretation of the FET principle by arbitration tribunals.[134]

3. Full protection and security (FPS). This standard provides for a guarantee of physical safeguarding of investors and their investments and obliges the Host State to take the appropriate measures against forcible interference by armed forces, police, demonstrators etc.[135]. One of the first documents referring to this principle was the Abs-Shawcross Draft Convention[136], which set the pattern for the majority of future European BITs. The first article of the act stated that the property of a foreign investor should be under "the most constant protection and

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[127] Titi C. (2014). *The Right to Regulate in International Investment Law.* Bloomsbury Publishing, at p. 58.

[128] Kläger R. (2011). *Fair and Equitable Treatment' in International Investment Law*. Cambridge University Press, at p. 10.

[129] Paparinskis M. (2013). *The International Minimum Standard and Fair and Equitable Treatment.* Oxford University Press, at p. 4.

[130] Examples of investor-EU MSs arbitrations ruled in favour of the foreign investor:
AES Summit Generation Limited and AES-Tisza Erömü Kft v. The Republic of Hungary, ICSID Case No. ARB/07/22;
Frontier Petroleum Services Ltd. v. The Czech Republic, UNCITRAL, 12 November 2010.

[131] OECD. (2004). Fair and Equitable Treatment Standard in International Investment Law. OECD Publishing, 2004/03, at p. 40. Available at http://dx.doi.org/10.1787/675702255435. Accessed 21 April 2015.

[132] For example, the FET constitutes the component of minimum standard of treatment in NAFTA. Also, this approach was maintained in the Continental Shelf case (Libyan Arab Jamahiriya v. Malta), Judgment, para. 27 (3 June 1985).

[133] See Mahnaz M. (2009). Fair and Equitable Treatment. *Best Practices Series Bulletin,* No. 3, September 2009. ("European countries have traditionally opted for the unqualified 'fair and equitable' treatment standard which is at the nub of the uncertainty."). Available at http://www.iisd.org/pdf/2009/best_practices_bulletin_3.pdf. Accessed 21 April 2015.

[134] Porterfield M. (2013). A Distinction without a Difference? The Interpretation of Fair and Equitable Treatment under Customary International Law by Investment Tribunals. *Investment Treaty News,* March 22, at p. 12. Available at https://www.iisd.org. Accessed 21 April 2015.

[135] Schreuer C. (2010). Full Protection and Security. *Journal of International Dispute Settlement:* 1–17, at p. 16.

[136] Draft Convention on Investments Abroad (Abs-Shawcross Draft Convention), 1960.

security within the territories". The Energy Charter Treaty uses the same language, providing for "constant protection and security" for foreign investment and a prohibition to "impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal.[137] In general, under the European approach, the FPS standard is restricted entirely to the physical security of an investment, i.e. protection from physical damage[138]. It should be noted that the state has the duty to protect foreign investments in accordance with international standards of treatment regardless of national rules (case *Saluka Investments v. Czech Republic*)[139]. Although, in the context of EU legal doctrine, legal, regulatory and commercial protection is not covered by FPS, it has been confirmed in recent judgments (*Azurix Corp. v. The Argentine Republic and others*)[140] that the FPS standard goes beyond a duty to maintain the physical integrity of investments.

4. Adoption and maintenance of prudential measures by the Host State. Such measures include *inter alia* action to prevent destabilization of finances and ensure the integrity and stability of the state financial system. By way of exception, these measures can be acceptable under such special circumstances as external financial difficulties, difficulties with money or exchange rate policy, a state of financial crisis, and so on.

5. Prohibition of picking favourable provisions from other agreements. This means that the effect of the Most-Favoured-Nation Clause in IIAs does not extend on the adoption of external rules in other agreements by investors or States who wish to use the most advantageous clauses for their own benefit. This rule is clearly illustrated in Article 8.7 of the recent CETA draft from 2016, which, besides determining the scope of Most-Favoured-Nation Treatment standard, cautions that the concept of "treatment" "does not include procedures for the resolution of investment disputes between investors and states provided for in other international investment treaties and other trade agreements". As a rule, EU Member States' BITs are concise and formulated in vague language. Moreover, in contrast to the US Model BIT 2012, Model BITs of the EU MSs are brief: e.g. the French Model BIT consists of only 11 pages and the German Model BIT is 13 pages long. Therefore, the arbitration tribunal can broadly interpret the provisions of IIAs based on MS Model BITs. Moreover, the majority of these BITs do not touch upon national treatment or MFN standards of investment protection[141] and do not explicitly prohibit clause shopping.

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[137] Art. 10 ECT.

[138] Saluka Investments B.V. v. the Czech Republic, UNCITRAL, 17 March 2006. Para. 284: "…the "full security and protection" clause is not meant to … protect more specifically the physical integrity of an investment against interference by use of force".

[139] Malik M. (2011). The Full Protection and Security Standard Comes of Age: Yet another challenge for states in investment treaty arbitration? The International Institute for Sustainable Development. Available at http://www.iisd.org/pdf/2011/full_protection.pdf. Accessed 21 April 2015.

[140] Azurix Corp. v. the Argentine Republic, ICSID Case No. ARB/01/12, 2006; Compañiá de Aguas del Aconquija S.A. and Vivendi Universal S.A. v. Argentine Republic, ICSID Case No. ARB/97/3, 2007; Biwater Gauff (Tanzania) Ltd. v. United Republic of Tanzania, ICSID Case No. ARB/05/22, 2008.

[141] Tzanakopoulos A. (2014). National Treatment and MFN in the (Invisible) EU Model BIT. *Journal of World Investment and Trade,* Vol. 15, 2014: 484-505, at p. 8.

6. In terms of the dispute resolution mechanism, for a long time the EU has argued for the inclusion of investor-state arbitration system in all its future IIAs. It stated that the ISDS system should function in such a way as to:

- prevent unfounded claims and avoid parallel claims to two different arbitration tribunals;
- preclude the possibility of "forum shopping", i.e. bringing the case to a tribunal that will likely render the most favourable decision for the investor; the investor should be obliged to choose a single place of arbitration;
- set an obligation for a losing party to handle the procedural expenses of both sides;
- provide for a more controlled process of appointment of arbitrators and conduct of arbitration proceeding;
- limit the amount of the final award to actual monetary damage to the investor;
- provide public access to the materials in the case and make the proceedings open to the public, i.e. ensure greater transparency;
- include the possibility to use amicus curiae briefs (submission of the relevant information for resolution of the dispute by third parties); such possibility is provided in rule 37(2) of the ICSID Arbitration Rules, as well as in a number of BITs[142] [143]; moreover, in reverse, the tribunal can ask the Commission to intervene and provide relevant information, as happened in *Eureko v. Slovak Republic*[144];
- lay down the opportunity for the parties to appeal.

Nevertheless, despite proclamation of these treatment standards, recent EU MS FTAs with Chile, Peru and Columbia, as well as in association agreements with Ukraine and Moldova do not refer to a mechanism of investment protection or guarantees of fair and equitable treatment and protection from illegal expropriation. For example in the agreements with Peru and Columbia, the footnote to Article 111 (Scope of application) directly provides that agreement "... does not cover provisions on investment protection, such as provisions specifically relating to expropriation and fair and equitable treatment ..."[145]. The existence of such loopholes can be explained by the fact that the Union just started developing its investment policy strategy and in future it will retrieve those drawbacks so as not to expose itself to the unnecessary risk of being held responsible in arbitration.

Recently, the EU changed its position towards dispute resolution, as on September 16, 2015, the European Commission published its proposal on Investment Protection and Resolution of Investment Disputes and Investment Court System in

[142] *E.g.* Art.e 28(3) Model US BIT 2012.

[143] Schliemann C. (2013). Requirements for Amicus Curiae Participation in International Investment Arbitration. *The Law and Practice of International Courts and Tribunals.* Martinus Nijhoff Publishers: 365-390, at p. 366.

[144] Achmea B.V. v. The Slovak Republic, UNCITRAL, PCA Case No. 2008-13 (formerly Eureko B.V. v. The Slovak Republic), Award of 26 October 2010.

[145] Trade Agreement between the European Union and Colombia and Peru, signed in 2012.

TTIP[146], which stands for replacement of the ISDS mechanism in all ongoing and future EU investment negotiations by the Investment Court System. The aim is to protect the EU and MS right to regulate (under a non-stabilisation clause) while ensuring that both European Companies and foreign investors are duly protected against any kind of inappropriate treatment. The Court is supposed to consist of 15 judges, nationals of the EU, US and third countries, and will hear exclusively on the provisions of the TTIP. The Commission argues that the new system will be more accessible, transparent, certain, speedy and less costly than traditional ISDS. Furthermore, the document provides for the opportunity of mediation prior to the formal dispute settlement procedure, and the possibility to appeal the decision of the court in a special Appeal Tribunal that will be similar to the WTO Appellate Body[147]. However, this organ is considered as a temporary solution: the Commission stated that its final goal is to establish a permanent International Investment Court, which will be able to replace all current investment dispute resolution mechanisms in EU Agreements. The plan is to make it either a self-standing international body or make it a part of an existing multilateral organization[148].

Apart from the TTIP, similar investment protection and dispute resolution provisions have been included in Chapter 8 of the recent CETA draft of 2016 (EU-Canada Agreement)[149]. The parties agreed to move towards establishing a permanent investment court that will replace the current ISDS system and create an Appellate Tribunal to review the awards of the court. Other improvements concern modified rules on the appointment of the tribunal members, who will be selected by the Parties to the Agreement rather than by the investor and the state involved in a dispute, and higher ethical standards for the Court members. Moreover, revised CETA provisions now ensure full protection of the right to regulate for public policies and ban the Court from interpreting EU or MS law in a manner binding on EU courts or EU governments. In their Joint Statement of 29 February 2016, the EU Commissioner for Trade and the Minister of International Trade of Canada assured that CETA will be signed in 2016 and enter into force in 2017[150].

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[146] European Commission. (2015). Proposal on Investment Protection and Resolution of Investment Disputes and Investment Court System in TTIP. 16 September 2015. Available at http://trade.ec.europa.eu/doclib/docs/2015/september/tradoc_153807.pdf. Last accessed on 4 April 2016.

[147] European Commission. (2015). Press Release: "Commission proposes new Investment Court System for TTIP and other EU trade and investment negotiations". Brussels, 16 September 2015. Available at http://europa.eu/rapid/press-release_IP-15-5651_en.htm. Last accessed on 1 April 2016.

[148] European Commission. (2015). Concept paper: "Investment in TTIP and beyond – the path for reform. Enhancing the right to regulate and moving from current ad hoc arbitration towards an Investment Court". Brussels, 5 May 2015. Available at http://trade.ec.europa.eu/doclib/docs/2015/may/tradoc_153408.PDF. Last accessed on 1 April 2016.

[149] Comprehensive Economic and Trade Agreement (CETA) between Canada, of the One Part, and the European Union and Its Member States. (2016). Available at http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154329.pdf. Last accessed on 10 April 2016.

[150] European Commission. (2016). Joint statement Canada-EU Comprehensive Economic and Trade Agreement (CETA). 29 February 2016. Available at

Summarizing all of the above, since the Lisbon Treaty has entered into force, the EU started developing its unitary investment regime by adopting numerous policy papers, initiating negotiations on new EU-third state IIAs, replacing old EU MS BITs and scheming a system of FDI protection standards, form and status of dispute resolution mechanisms and EU involvement in proceedings. The latter issue turned out be one of the most problematic, as the EU had almost no experience of participation in investor-state arbitration, and it was unclear how to allocate responsibility between the Union and the MSs in the case of a claim against one of the entities. To shed light on this issue, the EU adopted the Financial Responsibility Regulation, in which it attempted to create a system of allocation of responsibility between the Commission and the MSs in ISDS proceedings.

c) Implications of the New Financial Responsibility Regulation and its Role in EU Investment Policy

Before the Lisbon Treaty came into force, the only legal tool that allowed investors to sue the EU through an international arbitration body for breach of its obligations had been the Energy Charter Treaty, as already mentioned. Under Article 26(1) ECT, an investor is entitled to initiate arbitration proceedings against Contracting States, i.e. either against the EU or/and its Member States, depending on their corresponding competences. Nevertheless, foreign investors have preferred to bring their claims only against individual EU Member States, so that the EU itself has never become a respondent in any investment tribunal in proceedings conducted under the ECT. Such practice can be explained by the vague and uncertain role of the European Union in investor-state arbitration at that time, especially regarding the enforceability of awards. Although the European Union is not a party to either the New York Convention or the ICSID Convention, [151]in several cases[152] when the matter touched upon first-rate interests of the Union, the European Commission assisted its Member States by filing written submissions with the Tribunal as a non-disputing party to the dispute[153].

Upon the acquisition of exclusive competence to manage policy in the field of foreign direct investment, the scope of EU powers in investment dispute resolution was significantly enlarged. However, it was still unclear what would be the mechanism of involvement and participation of the EU and its organs in investor-state arbitration proceedings in different situations and what effective remedies would an investor have with regard to enforcement of the final award, as the EU has not yet signed either the ICSID or the New York Convention. It became evident that investment policy should be conducted under a consistent and flexible strategy[154] with proper and detailed regulation to:

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http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154330.pdf. Last accessed on 1 April 2016.

[151] Mazzini G. (2013). The European Union and Investor-State Arbitration: a Work in Progress. *24 American Review of International Arbitration:* 611-649, at p. 612.

[152] Electrabel v. Hungary ICSID Case No. ARB 07/19, Micula v. Romania ICSID Case No. ARB 05/20.

[153] The possibility to file submissions by a non-disputing party is provided by Rule 37(2) of the Rules of Procedure for Arbitration Proceedings (ICSID Arbitration Rules of 2006).

[154] Duhaev A. (2005). *The Management of Investment Processes*. Moscow: Science, at p. 43.

1) increase the attractiveness of the EU as an investment destination by providing clear and structured rules on protection of foreign investors' rights;
2) secure the interests of EU investors abroad as, maintaining the principle of reciprocity, a majority of investment agreements provide for the same scope of protection for a Partner State's nationals as it provides for its own residents.

To alleviate the drawback regarding EU involvement in ISDS under new EU-third state investment agreements, on June 21, 2012, the Commission proposed the Regulation for managing allocation of financial responsibility between the EU and its Member States in cases of investor-state arbitration[155]. Initially, the need for such a legal document was expressed in a European Parliament Resolution of 2011 on future EU International Investment Policy.[156] After moving several amendments to the original text, the Parliament adopted a final version of the Regulation on 16 April 2014, followed by the Council, which approved the document in less than three months. After publication of the final text of the act in the Official Journal, the Regulation entered into force on 17 September 2014. The EU Trade Commissioner, Karel De Gucht, described the new Regulation as:

> another building block in our efforts to develop a transparent, accountable and balanced investor-to state dispute settlement mechanism as part of EU trade and investment policy.[157]

The Regulation manages the system of cooperation between the Commission, representing the EU's interests, and the Member State concerned, in case the investor addresses the arbitration tribunal to challenge the actions of the EU and/or a Member State. The Regulation applies to disputes brought under IIAs, to which the European Union itself (pure EU agreements) or together with its MS (mixed agreements) is the party, and which contain an ISDS clause.[158] Article 24 establishes the time limit of FRR legal force, allowing its application only to those disputes that:

- arise out of claims submitted after 17 September 2014, and
- concern treatment afforded after 17 September 2014.

In an explanatory Memorandum to the Proposed Regulation, the Commission emphasized that the goal of this legal act is to establish the framework for managing

[155] The European Parliament and the Council. (2014). Reg. 912/2014 establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is party. OJ 2014, L 257, p. 121.
[156] European Parliament. (2011). Resolution A7-0070/2011 adopted on 22 April 2011, para. 35.
[157] European Commission. (2014). Press release: "EU agrees rules to manage investor-state disputes". Brussels, 28 August 2014. Available at http://europa.eu/rapid/press-release_IP-14-951_en.htm?locale=en. Accessed 14 April 2015
[158] Recent Developments in EU Investment Agreements. July 14, 2014. Available at http://blogs.law.nyu.edu/transnational/2014/07/recent-developments-in-eu-investment-agreements. Accessed 14 April 2015.

the financial consequences of disputes that may arise out of EU "agreements currently under negotiation or to be negotiated in the future".[159]

The Regulation contains three underlying principles in light of which all other provisions should be interpreted and implemented. The first principle is the rule of budget neutrality, which is set in recital 5 of the Regulation, stating that awards and the costs of arbitration should not be paid from the Union budget where the treatment was afforded by a MS and not required by Union law. The second fundamental is the priority of an investor's financial interests, which means that any disagreement between EU institutions and MS regarding allocation of financial responsibility or any other issue will not affect the foreign investor's right to obtain an award rendered by the arbitration tribunal. This principal is embodied in recital 19, under which an award rendered against the Union in arbitration will be paid to the investor without any suspension. Moreover, recital 21 elaborates by proclaiming that in case a MS bears financial responsibility, the Union should either promptly accumulate that MS's contributions before payment of the final award or compensate first and then claim reimbursement from the Member State. Therefore, any internal allocations should by no means restrict fulfilment of financial obligations to the foreign investor, even if the Union and MS cannot reach agreement, or the responsible MS is not able or not willing to pay. An MS that fails to reimburse money paid by the Union in arbitration will receive a "reasoned opinion on the matter" delivered by the Commission under part 1 of Article 258 TFEU. If the State concerned ignores the opinion and does not undertake any action to comply with its requirements in due time, the Commission or another Member State (under Article 259 TFEU) "may bring the matter before the Court of Justice of the European Union" which will have to resolve the conflict. Finally, the last principle (to be discussed in detail later) concerns the duty of sincere cooperation between the Union and the Member States throughout all stages of dispute settlement.

With regard to the structure of the Regulation, it contains six chapters, two of which concern general and final provisions, while four others describe the criteria for division of financial responsibility, the process of conducting arbitration proceedings, rules of settlement procedure and payment of the final award. Responsibility under FRR is divided into:

- external (or international) and
- financial.

External liability concerns attribution of the conduct challenged to either the EU or a Member State based on their competences. Allocation of financial liability depends on which entity is responsible for inappropriate treatment to the investor. Under Article 3 (1) FRR, the EU should be financially responsible for treatment afforded by its institutions, organs or agencies; otherwise, the costs should be borne by the Member State that provided the treatment, except for the case when such MS acted "in a

[159] Proposal for a Regulation of the European Parliament and of the Council establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is party. COM/2012/0335 final - 2012/0163 (COD).

manner required by Union law"[160]. The latter exception derives from the principle of conferral, set in Articles 4 and 5 of the Treaty of European Union[161]. According to this principle, the European Union has only those competences that were voluntarily and explicitly conferred or, in other words, delegated by unanimous consent of all its Member States[162]. All other competences that were "not conferred upon the Union in the Treaties", i.e., fixed in sources of primary EU legislation, "remain with the Member States"[163]. Finally, in a situation where a MS acted in accordance with EU law to bring its prior act into line with the requirements of European legislation, the State must still bear financial responsibility unless Union law required adoption of such act.

Switching to procedural issues regulated by the FRR, it is necessary to mention that, as a rule, the outcome of apportionment of financial responsibility has a direct influence on attribution of the respondent's status in arbitration. Under Article 9 FRR, when a Member State holds financial responsibility it must also act as respondent in arbitration, unless there exist one of three exceptional circumstances listed in the same article, allowing MS to avoid participation in proceedings, remaining financially liable for the treatment afforded:

- first, in case financial liability is shared by the Union and MS, the former is entitled to represent both defendants in ISDS (Article 9(2)(a));
- second, when a Member State submits written notice of refusal to act as the respondent in arbitration, even if it is financially responsible for violation of investor's rights (Article 9(1)(a));
- finally, the Union will act as respondent when similar conduct is challenged in claims against the EU in the WTO (Article 9(3)).

According to Article 5 FRR the EU and MS should defend the Union and national interests with respect to the principle of sincere cooperation referred to in Article 4(3) of the Treaty on European Union (TEU) and further elaborated in case law. For example, in *Commission v. Sweden*[164], the CJEU ruled that the cooperation principle applies to any external action of the Union without regard to the nature of the competences concerned. It provides for full mutual respect and cooperation in solution of common tasks set in fundamental EU Treaties[165]. Some of the means of mutual effort are listed in recital 15 FRR, among which are prompt notification of any significant procedural steps, provision of relevant documents, frequent consultations, and so on. Moreover, the Regulation governs the procedure for settlement (chapter 4) and payment of the final award (chapter 5).

It is pertinent to note that the Regulation is a source of internal EU law, which means that it has no legal force under international law to govern EU relations with

[160] Recital 7 FRR.
[161] Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union. 2012/C 326/01. OJ C 326, 26.10.2012.
[162] Kashkin U. (2014). *The Basics of Integration Law*. Moscow: Prospect, at p. 205.
[163] Arts 4 and 5 TEU.
[164] European Commission v Kingdom of Sweden, Case C-246/07, Judgment of the Court (Grand Chamber) of 20 April 2010.
[165] Marchenko M. (2014). *European Union and its system of justice.* Moscow: Prospect, at p. 189.

third states. Under Article 3 of the Articles of Responsibility of 2001[166] a state cannot rely on the provisions of its domestic law to characterize its conduct as lawful when such conduct is regarded as wrongful under international law. Thus, the only way to enable this act to regulate external relations of the Union and impact investor-state arbitration is to incorporate or at least refer to the Regulation in the arbitration clause of future EU investment treaties. In such a case, the FRR will have legal effect on the international level and become a binding source of law for foreign states, investors from those states and arbitral tribunals.[167]

To sum up, the new Financial Responsibility Regulation aims to regulate the financial consequences of investment disputes arising out of current and new EU-third state IIAs, by managing the apportionment of external and monetary responsibility within the Union in investor-state arbitration. The allocation process is conducted according to the principles of budget neutrality, the priority of the investor's interests and sincere cooperation between MS and EU entities. The act governs the issues of division of financial liability, conduct of arbitration proceedings, settlement procedure and payment of the final award. In order to apply the FRR rules, the European Union has to include or refer to the text of the Regulation in all its future investment treaties, as this document is not automatically binding on another state as a source of internal EU law. Despite the profound work done towards creation of the FRR, scholars still raise concerns about its future realization. Within the next section, I will discuss questionable aspects of the Financial Responsibility Regulation, analyse the possible negative consequences of its implementation, provide potential solutions to existing problems and consider the manner of dealing with financial responsibility issues in the United States.

[166] International Law Commission. (2001). Draft Articles on Responsibility of States for Internationally Wrongful Acts, Supplement No. 10 (A/56/10), chp. IV.E.1. Available at http://legal.un.org/ilc/texts/instruments/english/draft%20articles/9_6_2001.pdf. Accessed 14 April 2015.

[167] Baetens F., Kreijen G. and Varga A. (2014). Determining International Responsibility under the New Extra-EU Investment Agreements: What Foreign Investors in the EU Should Know. *47 Vanderbilt Journal of Transnational Law:* 1203-1260, at p. 1220.

Section 3.
Disputable Aspects of Financial Responsibility Regulation 2014

3.1 Conflict of Competences: Division between the EU and MS

a) The Issue of Conferral of Respondent Status in ISDS Arbitration under FRR

The upcoming conclusion of global Investment Treaties with Canada, the United States and Singapore has hastened the Union's efforts towards contouring its emerging common investment policy. Such urgency led to expeditious adoption of the Financial Responsibility Regulation, which, although profoundly scrutinized and amended by EU institutions, remaining in close cooperation with national authorities, still leaves room for further improvements.

The first matter that causes concern is the wide discretion left to the Commission in deciding whether it wishes to act as a respondent in arbitration proceedings, even in those cases where the burden of representation is on the Member State. Such interplay of powers can be explained by the necessity to abide by the principle of unity of external representation, established in Articles 15, 17 and 27 of the Treaty on European Union and specified in Community case law.[168]

According to the previous, non-amended version of the Regulation (Article 8(2)), MS that wished to act as a respondent in ISDS had to submit written confirmation of such intention. This would mean that the Commission remains the respondent party by default unless the MS claims self-representation in arbitration proceedings. In turn, this would give the Commission a wide discretion to proclaim itself a respondent in arbitration without the express consent of the MS concerned. Due to the evident lack of balance in such approach, it was agreed to reformulate the norm. Under Article 9 of the final version of FRR, the Commission can replace a MS as a respondent in arbitration only if the latter refuses to participate in the proceedings within 45 days from receipt of arbitration notice. Apart from this, the Commission has the right to suspend MS from participation in arbitration if:

1) the whole or even a part of financial responsibility lies on the Union or
2) the dispute concerns treatment by institutions and/or other EU organs.

Consequently, if one of the situations described occurs, the Commission has the power to retain full control over development of the MS defence strategy in the course of arbitration proceedings. This can undermine both Member State freedom of defence and the right to a fair trial. If dissatisfied with the actions of its representative in arbitration proceedings, the MS has almost no influence on its own case except for rendering its opinions in consultations with the Commission (pursuant to Article 6 of the Regulation), also referred as the advisory procedure

[168] European Court of Justice. (1993). Opinion No 2/91 of 19 March 1993, ECR I-01061.

under Article 4 of Regulation 182/2011[169]. Taking into account the substantial sum of the average award in investor-state arbitration, the Member State would likely feel more safe using its own established defence tactics in the arbitration tribunal, rather than transferring all the power to the Commission.

The Regulation provides that both actors should maintain effective cooperation with regard to the defence, and "shall share with each other information where relevant to the conduct of disputes" taking into account the deadlines fixed in the Regulation's provisions and Agreement clauses. However, under the FRR, the Commission holds the right to oblige MS to uphold a certain legal position, accepted by the Union, in order to maintain "unity of external representation" based on the principle of loyal or sincere cooperation enshrined in Article 4 (3) TEU and the principle of consistency set in Article 13 (1) TEU and Article 7 TFEU. As a last resort, a Member State which considers the Commission defence strategy to be inappropriate or inadequate has the right to challenge its actions in the Court of Justice of the European Union.

To sum up, enforcing the Regulation's provisions regarding allocation of the respondent party in investor-state arbitration could cripple the autonomy of the Member State concerned and undermine its right of self-representation. Therefore, a modest limitation of Commission powers in this course may ensure a more stable balance between EU and Member State interests.

b) Questions on FRR Compliance with Primary Union Legislation

Before moving to discussion of FRR "alignment" with primary legislation and allocation of external responsibility, I need to refer to the *lex specialis* principle, set in Article 64 of the Draft articles on the responsibility of international organizations, which is relevant for the discussion in this chapter. According to this, internal rules of an international organization that are applicable to its relations with its member states override the provisions of Draft articles in relation to the "international responsibility of an international organization, or of a State in connection with the conduct of an international organization"[170]. Therefore, pursuant to this provision, the European Union, as an international organization, can rely on its domestic rules on division of respective competences inside the Union, in order to decide on the matters of its external responsibility.

In the Regulation, following the competence-based approach mentioned [171], the Commission set that the conduct in question should be attributed not to the

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[169] European Parliament and the Council. (2011). Regulation (EU) No 182/2011 of 16 February 2011 laying down the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers. 2010/0051/COD. Available at http://eur-lex.europa.eu/legalcontent/EN/ALL/?uri=CELEX:32011R0182. Accessed 20 April 2015.

[170] International Law Commission. (2011). Articles on the Responsibility of International Organizations. Available at http://legal.un.org/ilc/texts/instruments/english/draft%20articles/9_11_2011.pdf. Accessed 20 April 2015.

[171] Baetens F., Kreijen G. & Varga A. (2014). Determining International Responsibility Under the New Extra-EU Investment Agreements: What Foreign Investors in the EU Should Know. *47 Vanderbilt Journal of Transnational Law:* 1203-1260. *Supra* note 140, at p. 1241.

entity that afforded the treatment challenged, but to those MS or EU organs, institutions or other body that have competence with regard to the question/s raised in the dispute. Recital 3 of FRR states that:

> International responsibility for treatment subject to dispute settlement follows the division of competences between the Union and the Member States ... Union will in principle be responsible for defending any claims alleging a violation of rules ... which fall within the Union's exclusive competence, irrespective of whether the treatment at issue is afforded by the Union itself or by a Member State.

Such complete dependency on the origin of the competence for determination of the responsible party may lead to a negative consequence arising out of Article 3 (1)(c) setting the criteria for distribution of responsibilities between the Commission and MS. This article obliges the Union to "bear the financial responsibility arising from treatment afforded by a Member State where such treatment was required by Union law". Considering the international responsibility of the EU, difficulties may occur with regard to directives that, according to Article 288 of TFEU, may be transposed into national legislation by any method chosen by the State. Such freedom of choice may result in distinct content of national legal acts in different Member States that implement the same Directive. The domestic rules of one MS, formally required by Union law, can harm the interests of a foreign investor, while another MS's legislation, drafted or amended to comply with the requirements of the same EU Directive, will not lead to mistreatment due to the different method of Directive implementation used by the latter MS. Such a situation can arise when the Member State is "gold-plating" by going beyond the minimum requirements of the Directive and over-implementing it[172]. As a consequence of such discretionary implementation of EU legislation in MS domestic law, the Commission will not only be held responsible under international public law, but will also have to bear the costs of arbitration and pay the final award.

To conclude, the manner of implementing secondary EU legislation could result in additional challenges for the Commission, which may have to answer for the actions of EU MS before an arbitration tribunal. To overcome these difficulties, it may be possible to switch to a conduct-based approach under which responsibility lies on the entity which afforded challenged treatment, disregarding where such treatment originated initially, and whether the MS acted pursuant to a measure prescribed by the Union. However, from the other side, such changes can result in even higher disproportionality; thus the method of competence-based allocation of responsibility seems to be the lesser of two evils.

Another issue with regard to the correspondence of FRR with fundamental EU Treaties arises out of Article 1 of the Regulation, under which its adoption and application "shall not affect the delimitation of competences … in relation to the treatment afforded by the MSs or the Union". This provision has been included in the

[172] Transposition Guidance: How to implement European Directives effectively. (2013). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/229763/bis-13-775-transposition-guidance-how-to-implement-european-directives-effectively-revised.pdf. Accessed 15 April 2015.

FRR in accordance with the requirements of primary legislation, namely Article 207(6) TFEU stating that:

> The exercise of the competences … in the field of the common commercial policy shall not affect the delimitation of competences between the Union and the Member States, and shall not lead to harmonization of legislative or regulatory provisions of the Member States in so far as the Treaties exclude such harmonization.

Nevertheless, taking into account the extremely broad scope of issues regulated by an average international investment agreement, it is arguable whether the international responsibility of the Union will (not) affect aspects of MS domestic law that cannot be harmonized. Investor-state arbitration, in contrast to dispute settlement in the WTO, can influence the EU legal order, as private investors have the right to challenge its policy before the arbitration tribunal. Therefore, if the arbitral tribunal holds the EU responsible for breach of its obligations under its investment agreement, while such breach directly or indirectly concerns a national legal act regulating the issue/s within exclusive or shared competence of the MS, the EU will have to require harmonization of that domestic law due to the obliging nature of the final award. Arguably, such harmonization would violate Member States' rights set in Article 207(6) of TFEU.

Therefore, fulfilment of the provisions of the fundamental Treaties in the process of FRR implementation can lead to violation of MS independence in deciding on matters within its exclusive or shared competence. This problem can be overcome by including a special clause in all investment agreements concluded by the EU alone or together with its MS, limiting the list of available remedies to monetary compensation. The problem of remedies will be discussed in more detail in the fourth section of this article.

c) Settlement Procedure Complications

The Regulations do not leave out of account the procedure for drafting and enforcing the settlement agreement. Settlement in arbitration and for the purposes of the FRR should be understood as an amicable agreement between the parties to the dispute who reach a compromise position and decide to settle their interests before the arbitration tribunal presents its decision on their case. According to UNCTAD statistics for 2015, out of 356 concluded cases, approximately 28% (101) were settled by the parties. Generally, the disputants decide to opt for an amicable resolution of the conflict in order to:

1) maintain business relations and continue investments in future
2) avoid time-consuming, costly and complicated arbitration proceedings
3) bypass unnecessary and formal proceedings (in particular, when the State in breach acknowledges that its defence strategy is prospectless) to obtain a speedy and mutually-beneficial monetary settlement
4) bypass the procedure for recognition and enforcement of a final award, especially under NY Convention rules[173].

[173] Panov A. & Petit S. (2015). Amicable Settlement in International Arbitration. *The European, Middle Eastern and African Arbitration Review*. Available at:

All these motives are applicable not only to the realities of investor-state arbitration, but also to any other commercial dispute resolution proceedings. The specificity of the ISDS mechanism is that states can be willing to settle the conflict prior to its official resolution by the tribunal, both to preserve commercial contacts with the foreign investor and to ensure that its nationals will be treated reciprocally, i.e., in the same manner, in the investor's home country.

Chapter 4 of the Regulation describes different rules of settlement that should be applied to four specific situations, where:

1) the treatment has been afforded by the EU;
2) the treatment has been fully or in part afforded by a MS where the Union wishes to settle;
3) the treatment has been afforded wholly by a MS where such MS wishes to settle;
4) the treatment has been partially afforded by a MS where such MS wishes to settle.

In the context of the first scenario, the Commission can independently decide whether there is a need for a settlement, taking into account the interests of the Union, and, if the arrangement is necessary, it may adopt an implementing act "in accordance with the examination procedure"[174]. A problem can arise with non-pecuniary remedies, referred to in the second paragraph of the article and further discussed in the last part of the paper. Non-monetary remedies, such as an obligation to carry out specific performance, can require the active involvement of the Member State and, consequently, affect its interests. However, the article does not provide any mechanism for influence on a Commission decision by the MS concerned other than through vetoing the proposed act by an examination committee consisting of representatives of all MS[175]. Bearing in mind that the committee delivers its opinion by majority, the past considerations of the Member State concerned will be almost of no weight for the outcome of the examination procedure. Thus, the Commission, which may wish to settle the dispute by any means for maintenance of the Union's interests, can easily neglect MS disagreement on the terms of the settlement agreement even if it affects the states' interests.

When the Member State afforded the treatment in full or in part, and the Commission wishes to settle in order to safeguard the financial interests of the Union, it must first consult with the Member State concerned and carry its consent for the settlement. Afterwards, if the parties reach an agreement, the MS must "enter into an arrangement with the Commission setting out the necessary elements for the negotiation and implementation of the settlement", meaning that further initiative should come from the state even if initially the idea of settlement belonged to the Commission. Paragraphs 3, 5 and 6 of Article 14 clearly establish that solely

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http://globalarbitrationreview.com/reviews/67/sections/232/chapters/2680/amicable-settlement-international-arbitration/. Last visited 26 April 2015.

[174] European Parliament and the Council. (2011). Art. 5 of Reg. (EU) No 182/2011 of 16 February 2011.

[175] *Ibid*, Art. 3.

the entity which incurs full financial responsibility may decide to settle the dispute[176]. A complication arises with regard to the rule set in paragraph 4, pursuant to which, in case the Commission acts as a respondent due to a MS's refusal to participate in arbitration proceedings (Article 9 (1)(b)), the former can "decide to settle the dispute where the settlement is in the financial interests of the Union". Therefore, if the Member State concerned expresses a negative attitude to the settlement itself or any conditions of an agreement in course of consultations, the Commission does not have to follow its opinion, even if the biggest part of the financial burden will be on the state. From the other side, the proviso in paragraph 7 forbids the inclusion of terms that will oblige MS to perform any actions other than pay financial compensation to the foreign investor in the settlement agreement, thus providing a mechanism for the protection of states' public policy immunity.

Finally, in both cases where the MS wishes to settle, it must first seek Commission approval of the settlement agreement, and, when the treatment has been provided exclusively by the MS, the Commission can refuse to accept the draft only based on a limited number of grounds[177]. In contrast, when part of the responsibility for treatment lies on the Union, the Commission can refuse to give consent "based on a full and balanced factual analysis and legal reasoning provided to Member States". Taking into account that in such case the part of compensation for damages should be repaid from the Union budget, these restrictions on a state's discretion to decide on settlement terms seem to be necessary in order to protect the financial interests of the EU, and accordingly, the interest of all EU Member States.

To conclude, the Commission, similarly to the issue of respondent status attribution, has allocated to itself an overly broad circle of powers in prejudice of the interests of MS, which may be financially dependent on the Commission's considerations even if the rules entitle them to influence the outcome of the settlement.

At this point, I will move to procedural aspects governed by the Regulation, and, in particular, examine the rules on recognition and enforcement of final awards. In this paper, I will consider only the ICSID Convention and the availability of ICSID arbitration for the resolution of disputes under future EU-third states IIAs, although it

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[176] 3. Where the Union is the respondent in a dispute pursuant to which a Member State would incur financial responsibility and where no Union financial responsibility is involved, only the Member State concerned may settle the dispute, ...
5. Where the Union is the respondent in a dispute pursuant to Article 9(2) which solely involves the financial responsibility of the Union and where no Member State financial responsibility is involved, the Commission may decide to settle the dispute.
6. Where the Union is the respondent in a dispute pursuant to Article 9(2) which involves the financial responsibility of the Union and of a Member State, … the Commission may nonetheless decide to settle provided that such settlement does not have any financial or budgetary implications for the Member State concerned..

[177] (a) the Member State concerned accepts any potential financial responsibility arising from the settlement;
(b) any settlement arrangement is enforceable only against the Member State concerned; and
(c) the terms of the settlement are compatible with Union law.

needs to be acknowledged that similar regulations are included in the New York Convention, the UNCITRAL Rules and several other treaties.

3.2 Concerns about Availability of the ICSID Arbitration Option in Light of the New Regulation

The emergence of BITs in the middle of the last century entailed the necessity to establish a mechanism able to enforce the list of guarantees set in such agreements. This necessity led to the creation of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention[178]) in 1966, negotiated and substantially drafted by the World Bank[179]. This Treaty provided a legal basis for foundation of the International Centre for Settlement of Investment Disputes, the aim of which was determined as to "provide facilities for conciliation and arbitration of investment disputes"[180] between Member States and private investors under the rules set in the Convention. The possibility to sue the host government directly has been the major innovation introduced by this new system, which remained autonomous and independent from external interference by national governments. As of June 30, 2015, the ICSID Convention had 159 signatory States, 151 of which have ratified it.[181] The Centre, established under the Convention, is not an arbitration forum, but rather an organization that provides facilities for resolution of investment conflicts and assists in, e.g.:

- adopting arbitration rules for proceedings;
- appointing arbitrators and monitoring the conduct of proceedings;
- arranging a Panel of Arbitrators, consisting of qualified professionals;
- creating model provisions for investment agreements.

The main advantage of arbitration under the ICSID Convention is the binding nature of its enforcement provisions. This means that an award rendered by the arbitration tribunal should be enforced without additional difficulties. Article 53 states that

> The award shall be binding on the parties and shall not be subject to any appeal or to any other remedy except those provided for in this Convention.

Furthermore, pursuant to Article 54, Contracting States are obliged to recognize such award as binding and enforce the financial obligations on its territory as "if it were a final judgment of a court in that State". Furthermore, an arbitral award under the Convention has a "self-executory nature" [182] and its enforcement does not need

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[178] Convention on the Settlement of Investment Disputes between States and Nationals of Other States. Washington, 18 March 1965. (1966). *American Journal of International Law,* 60, at p. 892.

[179] Mortenson J. (2010). The Meaning of "Investment": ICSID's Travaux and the Domain of International Investment Law. *Harvard International Law Journal,* Volume 51, No 1: 257-318, at p. 263.

[180] Art. 1(2) of ICSID Convention.

[181] World Bank. (2015). ICSID Fact Sheet. Available at https://icsid.worldbank.org. Accessed 4 April 2016.

[182] Banifatemi Y. (2009). *Defending Investment Treaty Awards: Is There an ICSID Advantage?* ICCA Congress Series No. 14, Dublin 2009. Kluwer Law International: 318-324, at p. 318.

application of the New York Convention of 1958[183], which may impose additional restrictions on the process of recognition and enforcement of a final award. Finally, according to established practice (e.g. *Mobil Oil v. New Zealand*[184]), ICSID has the right to establish its own jurisdiction in a case, irrespective of actions undertaken by governmental authorities that do not wish to cooperate or comply with the arbitration rules. Therefore, the system functions properly even when one party evades performance of its obligations or tries to address another means of dispute resolution. Under the ICSID Convention, national courts and other state organs can neither interfere in the ICSID system of arbitration nor challenge its decisions in other instances. The Centre itself (in particularly, the Secretary-General) can review or annul an award upon the request of one of the parties, based on the list of circumstances set in Articles 51 and 52, including *inter alia* discovery of a new fact, failure by the arbitration panel to deliver a reasoned opinion, violation of procedural rules, and so on. The last advantage of the system is the fact of unified control over the process of dispute resolution that ensures absolute conformity of ICSID arbitration practice[185].

Taking into account all the strengths of the ICSID system for resolution of investor-state disputes, it comes as no surprise that nowadays the overwhelming majority of investors prefer to file their claim under ICSID rules. Accordingly, the majority of countries involved in FDI transfer, and, subsequently in the mechanism of investor-state dispute resolution, select the rules of the Centre to govern arbitration proceedings in their IIAs.

The European Union, not being an exception to the general rule, cannot join the ICSID Convention, as according to Article 67, only states can sign it. Nevertheless, in its investment policy communication of 2010[186], the Commission stated that the Union is willing to accede to the ICSID Convention, underlining that it has already had successful experience of accession to various international organizations (for example, the World Customs Organization). Moreover, the Parliament, in its Resolution on investment policy of 2011, accented the need to reform the Union system in order to ensure the EU's accession to the ICSID Convention[187] in the nearest future.

However, the current inaccessibility of the ICSID option for the European Union, *qua* supranational body, can create a number of obstacles for realization of its external investment policy. For example, a previous version of CETA (IIA with Canada) from 2014 contained Article X22 (Submission of a Claim to Arbitration),

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[183] Rhone Mediterranee Compagnia Francese di Assicurazioni e Riassicurazoni [sic] v. Lauro. 712 F.2d 50. US Court of Appeals, 3d Cir., July 6, 1983. (1984). *American Journal of International Law,* 78(1), at p. 217.

[184] Mobil Oil v. New Zealand, Findings on Liability, Interpretation and Allied Issues, 4 May 1989, 4 ICSID Reports 140, 164.

[185] Boguslavskyi M. (2005). *International Private Law*, 5th edition. Moscow: Yurist, at p. 290.

[186] Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions Towards a Comprehensive European International Investment Policy. (2010). Brussels, 07/07/2010, COM(2010)343, at p. 10. Available at http://trade.ec.europa.eu/doclib/docs/2010/july/tradoc_146307.pdf. Accessed 9 April 2015.

[187] *Ibid*, para. 33.

providing for an option to submit future disputes to ICSID arbitration, although EU participation in ICSID is excluded. As this could have undermined the balance of EU and Canadian investors' rights, this provision has been modified in the current draft of 2016 to restrict submission of the claim under the ICSID Convention by the requirements of Article 25(1) of the ICSID Convention.

Furthermore, the Financial Responsibility Regulation contains a legal loophole that can be exploited by Member States that for some reason do not wish to take part in ICSID arbitration. Under Article 9 FRR, the MS concerned can file a written submission to the Commission indicating that it "does not intend to act as the respondent", and in that way shift the responsibility on to the Union, which, in its turn, cannot be involved in arbitration under ICSID rules. Accordingly, a foreign investor can face a dead-end situation when the ICSID option, although provided by the IIA, is simply unavailable, even if the claim has been initially brought against the MS. Therefore, the EU and/or the MSs has the opportunity to block the availability of ICSID arbitration for foreign investors by its/their unilateral decision.

Thus, the EU needs to introduce some changes to the existing system so as not to risk its future inter-state investment relations. The option to join the ICSID Convention can be excluded straight away, as accession will become possible only if the provision limiting the possibility for non-state actors to sign the Convention is altered. According to Article 66, any amendments to the Convention must be "ratified, accepted or approved" by all Contracting States. Taking into consideration the number of such States (currently amounting to 150), this task seems to be extremely challenging.

Therefore, the Union should keep searching for other ways to deal with this difficulty. For instance, there is a possibility to supplement the Financial Responsibility Regulation with a provision allowing joint representation of the EU and the MS in arbitration proceedings. Therefore, even in a situation where the Union itself has to bear financial responsibility and act as a respondent in arbitration, the MS will be able to act as a defendant jointly or instead of the Commission so as not to restrict the claimant's rights to commence arbitration under ICSID rules. The other alternative could be to authorize a foreign investor to choose against whom he would like to bring the claim irrespective of the outcome of internal division of responsibilities. Thus, an investor who suffered damages resulting from the conduct of the host state, will not depend on any external decisions, and can defend his rights in whatever instance he chooses. Finally, some scholars assume that the ICSID venue could become available through EU accession to the ICSID Additional Facility Rules (AFR) [188]. The rules precluding the Union from participating in the settlement of investment disputes submitted under AFR, can be amended by a majority vote of the ICSID Administrative Council. Therefore, accession of the EU to the AFR requires the votes of only half of the Contracting States, which thus provides for a "more realistic chance for the EU to finally be considered a party to international investor-state arbitration within the ICSID system"[189].

[188] Vives F. (2014). Shaping the EU Investment Regime. *Cuadernos de Derecho Transnacional,* March 2014, Vol. 6, No 1: 269-293, at p. 275.
[189] *Ibid*.

After analysis of the new Union approach to allocation of financial responsibility in investor-state arbitration, it is important to consider relevant experience of other states in this sphere. Thus, in the next chapter I will review financial responsibility regulation in the United States.

3.3 Ways of Dealing with Financial Responsibility Issues in the US

In order to explore the possible drawbacks and strengths of financial responsibility allocation under the new Regulation, it is necessary to look outside of the box and carry out comparative analysis based on the experience of other states in this sphere. The European Union is a unique and unprecedented supranational political authority, sometimes even described as a "new form of state"[190] that is distinguished by organizational complexity and a multilevel structure. Thus, it is a rather difficult task to compare its activity with the policy of any other political entity. However, keeping in mind the fact that since the moment of its establishment, the EU is gradually moving towards federalization, i.e. creation of a state in the traditional meaning, it seems to be appropriate to draw a comparison with a federal state, the experience of which can become of value for the European Union.[191] The most successful example of a federal state with meaningful experience in concluding investment treaties, developing its investment protection policy and involvement in investor-state arbitration could be the United States of America.

The method of allocating financial liability within the United States is based on the principle of exclusive responsibility of the state for any actions of its federal subdivisions. This concept finds its roots in the norms of public international law. For example, the Vienna Convention[192], setting the territorial scope of treaty application, specifies that international agreements are "binding upon each party in respect of its entire territory"[193]. Thus, irrespective of which subdivision of the state is liable for financial damages to the investor, full responsibility will rest on the whole state. Moreover, the articles on state Responsibility[194] in Article 4, set that the conduct of any organ of a state or its territorial subdivisions should be attributed to the state regardless of whether such organ has factual or legal autonomy under local or state law, or whether it exceeded its authority or contravened instructions given [195].

The legal foundation of the US approach to the division of competence between the federal and state governments lies in its Constitutional provisions. Article 6 section 2 of the US Constitution provides that

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[190] Fabbrini S. (2005). *Democracy and Federalism in the European Union and the United States: Exploring Post-National Governance*. Routledge, at p. 6.

[191] Laursen F. (2013). *The EU and Federalism: Polities and Policies Compared*. Ashgate Publishing, at p. 17.

[192] United Nations. (1969). Vienna Convention on the Law of Treaties, 23 May 1969, United Nations, Treaty Series, vol. 1155, at p. 331. Available at https://treaties.un.org. Accessed 16 April 2015.

[193] Art. 29 Vienna Convention.

[194] International Law Commission. (2001). Draft Articles on Responsibility of States for Internationally Wrongful Acts, November 2001, Supplement No. 10 (A/56/10), chp. IV.E.1. Available at http://legal.un.org. Accessed 14 April 2015.

[195] Although sometimes the actions of a person in an official capacity, such as the ruling by a local judge in the *Loewen case* discussed in Section 2 of this article, will not be attributed to the state if such actions do not touch upon state policy.

> This Constitution, and the Laws ... and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land.[196]

This means that federal laws overbear any non-corresponding state rules. The Constitution also includes a provision authorizing the federal government, represented by Congress, to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes"[197]. Moreover, apart from the statutory law, the Supreme Court of the US in *Missouri v. Holland*[198] affirmed the power of the federal government to conclude international agreements, even if its provisions infringe states' rights under the Tenth Amendment[199]. Thus, competence in the sphere of foreign affairs, including foreign commerce, belongs to Congress, the President and the Senate, i.e. the federal government. In addition, Article 1 of section 10 of the Constitution directly precludes states from independent and unauthorized entering "into any treaty, alliance, or confederation". Thus, the states are not allowed to negotiate and conclude any international investment agreements, and consequently cannot be sued for monetary compensation in an arbitration tribunal. In contrast, EU investment agreements with third states can be concluded not only by the Commission itself, but also together with the MS (mixed IIAs). In the latter case, the competences, and consequently, responsibilities will be shared between the EU and the MS involved.

To understand the manner of the power division within the US, we can take the example of NAFTA. Despite the fact that under both the American and Canadian Constitutions international agreements can be concluded only on the federal level, during the negotiations on NAFTA the territorial subdivisions of both countries entered into close cooperation with their central government to lobby their local interests. In America, the states were represented by the Intergovernmental Policy Advisory Committee to the Office of the US Trade Representative, while in Canada such power was delegated to the Committee for the North American Trade Agreement.[200] The latter institution, lobbying the interests of the provinces (territorial subdivisions in Canada), was involved in such an active and efficient cooperation with the central government, and had so much weight in the negotiation process, that no clause got through before prior approval by the Committee. Such close collaboration is explained by the role which state or provincial governments were going to play in the process of Treaty implementation, and by NAFTA's impact on state (provincial) law and policy. Article 105 of NAFTA set the obligation for the parties to undertake necessary measures in order "to give effect to the provisions of this Agreement, including their observance ... by state and provincial governments". The federal governments were not only obliged, but also interested in bringing the

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[196] US Constitution, Art. 6 section 2.

[197] Art. I, Section 8, Clause 3, US Constitution.

[198] Missouri v. Holland, 252 US 416 (1920). Available at Findlaw http://supreme.justia.com/us/252/416/case.html. Accessed 17April 2015.

[199] The tenth Amendment to the US Constitution states that: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people."

[200] Tarr A. (2007). NAFTA and Federalism: Are They Compatible? *North American Studies Centers,* Year 2, number 2, July-December 2007: 133-160, at p. 148.

laws of their subdivisions into correspondence with NAFTA, as in case the obligations were breached, financial responsibility would anyway be imposed on the federal rather than local governments, irrespective of whether local or state laws were involved. Article 23 of the Energy Charter Treaty (Observance by Sub-National Authorities) contains quite a similar provision stipulating that the Parties must take all reasonable measures in order to ensure that their regional and local governments and authorities will observe the Treaty provisions.

Therefore, the United States (as well as the EU under the ECT) can compel state governments to alter or abolish any laws that do not comply with NAFTA provisions.[201] Such authority enables the US to protect its budget from the consequences of disputes arising out of claims under state (municipal) legal acts that, for example, contain discriminatory provisions or in some other manner violate investors' rights. Therefore, US financial interests as an outcome of investor-state arbitrations are safeguarded, as the federal government exercises almost full control over the actions of local authorities and is not restricted by the law of its states. The EU follows the same model of general legal and financial responsibility for external actions. The Financial Responsibility Regulation in recital 3 provides that the Union bears all responsibility for the alleged violation of any obligation arising out of an international investment treaty regardless of "whether the treatment at issue is afforded by the Union itself or by a Member State".

However, despite the fact that, as a rule, US BITs as well as investment treaties of any other federal state do not contain provisions directly dealing with the role of its administrative subdivisions, the US-Polish BIT provides that "This Treaty shall apply to the political subdivisions of the Parties".[202][203] As, up to date, no dispute has been submitted to arbitration under this particular BIT, it is hard to evaluate the full significance of this provision and the course of its practical implementation.

Coming back to the question of the division of competences, in contrast to the same method of external liability apportionment, the situation with internal allocation of responsibilities in the US and EU is different. According to established case law (*Pennhurst State School & Hospital v. Halderman*[204]), the federal government cannot request repayment of a monetary award from a state which is responsible for harm, *post factum*, i.e. after an arbitration tribunal rendered an award and damages were compensated from the federal budget[205]. However, due to the fact that up to date no successful claim has been brought against the US government in investor-state arbitration, we can only assume how this difficulty would come into play in a real situation. In contrast, Canada has experience of signing a costly settlement

[201] Under para. 3312(b)(2) of 19 United States Code "No State law … may be declared invalid … except in an action brought by the United States for the purpose of declaring such law or application invalid."

[202] Article XIII (Application to Political Subdivisions) of the Treaty between the United States of America and the Republic of Poland Concerning Business and Economic Relations**.** Signed 21 March 1990; entered into force 6 August 1994.

[203] Ribeiro C. (2006). *Investment Arbitration and the Energy Charter Treaty*. JurisNet, LLC, at p. 288.

[204] Pennhurst State School & Hospital v. Halderman, 465 US 89, 104 S. Ct. 900, 79 L. Ed. 2d 67 [1984].

[205] For such repayment the separate federal legal act is required.

agreement with foreign investors due to the fault of its provinces[206]. In *Abitibi Bowater Inc. v. The Government of Canada*[207], the federal government had to settle the claim and compensate the claimant $130 million CND for the expropriation of its investments in the province. Following the proceedings, Canadian Prime Minister Stephen Harper in a public speech emphasized that

> in future, should provincial actions cause significant legal obligations for the government of Canada, the government of Canada will create a mechanism so that it can reclaim monies lost through international trade processes."[208]

This example illustrates how federal states such as Canada and potentially the United States can be held financially liable for the actions of their subdivisions, even if they were not directly involved and could not prevent a breach of its obligations. The EU approach, *a contrario*, provides for a fair and merited distribution of responsibilities between the Union and its Member States, depending on the criteria set in FRR provisions. In the light of the concluded CETA agreement, and negotiated TTIP, both the US and Canada should thoroughly examine all *pros and contras* of existing system of division of responsibilities, and, if necessary, reform it, so that in future they will not find themselves on the hook for multi-million awards for the actions of their subdivisions.

At this point, I will get back to the discussion on the development and implementation of the Union's investment protection policy and call the reader's attention to the role of the Court of Justice of the European Union in this process. The next section will address different problematic aspects arising out of interaction between the jurisdictional competences of the CJEU and the new EU investment strategy, an opportunity to challenge the defence strategy of the Commission before the CJEU and the possibilities of external interference in the EU legal order.

[206] Currently Canada has 10 provinces and 3 territories. The Constitution Act, 1982, Schedule B to the Canada Act 1982 (UK), 1982, c 11.

[207] AbitibiBowater Inc., v. Government of Canada. ICSID. NAFTA. 15 December 2010. Available at http://www.international.gc.ca/trade-agreements-accords-commerciaux/assets/pdfs/disp-diff/abitibi-03.pdf. Accessed 23 April 2015.

[208] Leon B., McDougall A. & Siwiec J. (2011). Canada and Investment Treaty Arbitration: Three Prominent Issues – ICSID Ratification, Constituent Subdivisions, and Health and Environmental Regulation. *South Carolina Journal of International Law and Business,* Volume 8, Issue 1, Fall, Article 3: 63-86, at p. 77.

Section 4.
Role of the CJEU in the Context of Investor-State Arbitration and in the Light of New FRR

4. 1 Threats to the Court's Exclusive Jurisdiction Posed by Enforcement of Certain Remedies in the Course of Arbitration

In this chapter, I will consider some problematic aspects arising out of the enforcement of non-pecuniary remedies in investor-state arbitration in conjunction with the exclusive jurisdiction of the Court of Justice of the European Union (CJEU) on the example of the Energy Charter Treaty. As a preliminary remark, the Court in its Opinion 1/91 established that the Union, Member States and CJEU must be bound by the decisions of arbitration tribunals[209]. Nevertheless, in some cases[210], awards can contradict the provisions of the fundamental EU Treaties or/and undermine the exclusive jurisdiction of the Court.

According to Article 344 TFEU "the Member States undertake not to submit a dispute concerning the interpretation or application of the Treaties to any method of settlement other than those provided for therein." The aim of this provision is to prevent the authorities, other than the CJEU, from interpreting EU law both directly and indirectly. In addition, Article 344 protects the Court from the parallel jurisdiction of other judicial bodies, including international arbitration tribunals. It is important to note that, in the course of time, the risk of concurrent judgments becomes more and more tangible due to the constant expansion of the Union's competence. Moreover, Article 263 TFEU provides the Court with authority to review the legality of any legal act adopted within the Union. In the context of investor-state arbitration, difficulties may arise with regard to the enforcement of non-monetary or "judicial review" remedies, which are permitted under the ECT.

The Energy Charter Treaty contains a *lex specialis* provision in Article 26(8), providing that an award concerning the measure of an authority of a disputing Contracting Party "shall provide that the Contracting Party may pay monetary damages in lieu of any other remedy granted." Thus, the ECT directly allows a foreign investor to challenge before the arbitration tribunal a measure, decision or action undertaken by an MS which hosted investments. The remedies available for a foreign investor under ECT include:

- injunctions;
- declaration of the rights and obligations of the parties;
- requirement to acknowledge the illegality of a measure or decision;
- prohibition or requirement of certain action of the government (specific performance);

[209] Opinion of the Court of 14 December 1991 (on the second subpara. of Article 228 (1) of the Treaty). Opinion 1/91. European Court Reports, 1991 I-06079.
[210] *E.g.* MOX Plant Case, Ireland v United Kingdom, Order, Request for Provisional Measures, ITLOS Case No 10, ICGJ 343 (ITLOS 2001), 3 December 2001, International Tribunal for the Law of the Sea [ITLOS].

- annulment of a certain measure or decision of the Host government.[211]

Thus, if a third-country investor challenges measures adopted by the EU and the arbitration award rendered annuls or invalidates such measures, the exclusive jurisdiction of the CJEU set in Article 263 TFEU will be overruled. To avoid this situation, the Union can include specific provision in all its future EU IIAs, limiting the list of available remedies to those of a pecuniary nature. This approach was taken by Canada during negotiations on the dispute resolution clauses of the CETA with the EU. Initially, the Union offered to allow an arbitration tribunal to repeal governmental measures challenged by an investor; however, early on, Canada rejected this proposal. The final version of the CETA in Article 8.39 prevents a tribunal from awarding any remedy except for "monetary damages and any applicable interest" or/and "restitution of property". The latter remedy comprises "monetary damages representing the fair market value of the property at the time immediately before the expropriation ... ". Moreover, the same provision strictly forbids the tribunal to award punitive damages. This prohibition corresponds to the standard set in Article 36 of Articles on State Responsibility (Compensation)[212]. In a commentary to the Articles, the authors point out that "the award of punitive damages is not recognized in international law even in relation to serious breaches of obligations under peremptory norms"[213].

Therefore, the EU should take into consideration possible threats to the autonomy of its legal order and exclusive jurisdiction of the Court of Justice posed by enforcement of non-monetary awards on its territory, and limit the list of available remedies in all its future IIAs.

After scrutinizing the complications that may be caused by implementation of non-pecuniary remedies, we need to consider the role of the CJEU under the new Financial Responsibility Regulation. Within the next chapter, I will analyse the possibility for Member States to challenge the Commission's actions in arbitration before the Court of Justice and assess the possible outcome of such claims.

4.2 Analysis of Potential to Challenge the Defence Strategy of the Commission by the MS before the CJEU

According to Article 19 of the Treaty on the European Union, the primary function of the CJEU is to ensure proper interpretation and implementation of Union law according to the constituent Treaties. The Financial Responsibility Regulation is part

[211] OECD (2012). Investor-State Dispute Settlement Public Consultation: 16 May – 9 July 2012, at p. 24. Available at http://www.oecd.org/daf/inv/investment-policy/ISDSconsultationcomments_web.pdf. Accessed 23 April 2015.

[212] International Law Commission. (2001). Draft Articles on Responsibility of States for Internationally Wrongful Acts, November 2001, Supplement No. 10 (A/56/10), chp. IV.E.1. Article 36:

1. The State responsible for an internationally wrongful act is under an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution.

2. The compensation shall cover any financially assessable damage including loss of profits insofar as it is established.

[213] Crawford J. (2002). *The International Law Commission's Articles on State Responsibility: Introduction, Text and Commentaries*. Cambridge University Press, at p. 243.

of the body of secondary EU law, thus its application by EU entities and Member States can be the subject of the Court's judicial revision. Consequently, both Commission and MS have an opportunity to challenge each other's measures and decisions adopted within the framework of the FRR. Taking into account the predominant role of the Commission in the process of competence distribution under FRR, it can be assumed that its actions are more likely to be contested before the CJEU. The possibility to challenge the actions of EU authorities is provided by Article 263 TFEU, which expands the Court's jurisdiction on

> actions brought by a Member State, the European Parliament, the Council or the Commission on grounds of ... infringement of the Treaties or of any rule of law relating to their application, or misuse of powers.

Therefore, the misapplication of such "rule of law", which is, in our case, directions on the allocation of financial responsibility, settlement procedure, attribution of the respondent's status together with certain procedural requirements (e.g. mandatory consultations prior to the certain actions), set in the Regulation, will lead to the opening of Court proceedings for failure to act.

Apart from the breaches mentioned, a Member State can question the sufficiency and advisability of the Commission's defence strategy in ISDS proceedings. For example, the MS can try to prove in Court that if the Commission would not turn down the MS's participation in investor-state arbitration, the outcome of the dispute could be more advantageous for the Union. The MS can present the arguments which it planned to use in arbitration for the protection of its individual or joint EU-MS interests if it would be allowed to participate in the procedure, and which, in its opinion, seem to be more convincing and forceful than those presented by the Commission. Alternatively, if the MS demonstrates that the Commission did not take an offer for settlement made by the counterparty in the dispute when such a deal would be less harmful for the Union or MS budget than the final award, it might request reimbursement of the monetary loss it suffered as a result of the Commission's losing strategy in arbitration.

It is worth noting that Member States are financially affected by the final award regardless of whether they act or should act as a respondent, or whether the Commission represented their or the Union's interests in arbitration. According to Article 311 paragraph 2 TFEU, the Union budget is financed entirely from its own resources, which comprise the gross national income, customs duties on imports from outside the EU and sugar levies, value added tax and other sources of revenue[214]. Implementation of the budget should be conducted in accordance with several fundamental principles set in the provisions of the TFEU and acts of secondary legislation regulating the financial sphere of Union activity. One of those fundamentals is the principle of sound financial management, which embodies economy, efficiency and effectiveness of EU financial policy, as well as its "ex ante and ex post evaluation" by the EU and MS authorities[215]. Therefore, if the European

[214] EU Council. (2007). Decision of 7 June 2007 on the system of the European Communities' own resources. 2007/436/EC, Euratom. OJ 2007, L 163, p. 17.
[215] EU Council. (2002). Recital 11 of the Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities. OJ L 248, 16 September 2002, p. 1-48.

Union pays an award or compensation in a settlement from budgetary money, it indirectly touches the financial interests of all Member States, as the subsequent budgetary shortage will be covered by taxes collected from each EU Member State.

Accordingly, when the Union fails to manage its finances properly and loses an arbitration or signs an unbeneficial settlement arrangement when it was possible to avoid such an outcome, any Member State has the right to claim reimbursement of litigation costs in the CJEU.

4.3 The Possibility of External Interference in the EU Legal Order

In the final chapter I will examine and assess the risks of external interference in the EU legal order from the side of foreign investors. Part 4 of Article 263 TFEU authorizes a third-state investor to address the Court and challenge EU measures subject to the concurrent fulfilment of two conditions. The first requirement for *locus standi*, i.e. the capacity (legal standing) to bring an action in court or other judicial organ, of a non-privileged applicant (who is the foreign investor in our case) will be the existence of a public decision, which should be in form of a "genuine Regulation" rather than merely a "disguised Decision".[216] After the legal nature of the act is established, it is necessary to examine whether this act has directly and individually concerned the applicant. As it has been established in *Plaumann v Commission*

> ... the second paragraph of Article 173 of the EEC Treaty requires that it should be of 'direct and individual' concern to the applicant ...[217]

The requirement of "direct and individual concern" of EU legal acts to the individual was also confirmed in *UNICME v Council*[218] and *Piraiki–Patraiki v Commission* [219]. In the context of the FRR, the foreign investor can be directly concerned by the outcome of determination of the respondent party in arbitration proceedings by the Commission, as this party, chosen without his or his home state's prior consent, will be his opponent in arbitration. Therefore, the investor is authorized to challenge Commission decisions in front of CJEU and thus undermine the EU legal order.

Summing up all items mentioned in paragraphs 4.2 and 4.3, irrespective of who will challenge Commission actions under the Financial Responsibility Regulation, several possible negative scenarios could come into play:

1) foreign investors may abuse their rights by challenging the Commission's measures before the Court, pursuing their own purposes or following directions given by their home state;
2) when the Court's decision (on invalidity of any of the Commission's or MS's decisions, measures, actions or defence strategies) is rendered after the closure of arbitration proceedings, it can affect the validity of the award or the conditions of the settlement;
3) if the Court's judgment is passed before the arbitration tribunal resolves the case, it can influence the jurisdiction of the arbitration tribunal.

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[216] Berry E. & Hargreaves S. (2007). *European Union Law*. Oxford University Press, at p. 100.
[217] Plaumann & Co. v Commission of the European Economic Community. Case 25/62. Judgment of the Court of 15 July 1963.
[218] UNICME v Council, Case 123/77 [1978] ECR 845.
[219] Piraiki–Patraiki v Commission, Case 11/82 [1985] ECR 207.

One of the most effective ways to avoid all these difficulties will be, as in case of remedies, to add a reservation to all future EU Investment Treaties precluding foreign investors from lodging a complaint with the CJEU under FRR provisions. Moreover, the Union can indicate that any *ex post* CJEU rulings will not affect the validity of a final award. These measures will increase the security and predictability of the functioning of the ISDS mechanism and ensure its independence from any constraints arising out of internal EU law.

Conclusion

In the contemporary globalized world, investments have become an extremely important economic factor, which promote the industrial and financial development of the capital-importing state, contribute to the growth of competitiveness of national products and services, facilitate integration into the world economic system and help forward activation of foreign trade. Overall, investments are a powerful engine for maintenance and growth of a state's economic sovereignty.

Today, the European Union has one of the most dynamic and competitive economies in the world. This result has been achieved through effective and consistent policy in the spheres of the internal market, competition, state aid, financial services, foreign trade and capital transfer. In order to secure and maintain its status, the Union, as a multinational entity with a complicated organizational structure and mechanism for division of competences, should be flexible and promptly react to changes in the political, economic, legal, and social spheres. With the acquisition of long-awaited exclusive competence over foreign direct investments after the Lisbon amendments came into force, the Union faced several challenges, including:

- the absence of a model EU investment treaty that could serve as a starting point for future EU negotiations on International Investment Agreements (IIAs);
- diversity of Member States' approaches to the mode of investment protection and dispute resolution;
- lack of experience in designation of an adequate defence strategy in investor-state arbitration;
- absence of clear rules on the manner of EU involvement in investor-state dispute settlement (ISDS) proceedings.

To overcome the majority of these difficulties, the Commission hastily designed a number of legal acts regulating different aspects of the foreign direct investment (FDI) domain. Among these acts was the Financial Responsibility Regulation (FRR) that attempted to clarify the issue of competence allocation between the Union and Member States in case a foreign investor sues the EU or MS before an arbitration tribunal. The first draft of the Regulation has been severely criticized by the Parliament, Council and Member States for insufficient balance between Commission and MS rights and powers to decide on matters of division of competences and apportionment of financial responsibility. Finally, in the final version of the FRR that came into force in August 2014, the scope of the Commission's authorities was narrowed to give more powers to the Member States. Nevertheless, although the main purpose of the Regulation has been set so as to make the Union a more attractive place for foreign direct investment flows by providing more transparency, predictability and reliability to the investor-state dispute settlement mechanism, scholars raise the concern that its rules can rather deter investors from investing their capital in the economy of EU Member States. In Section 3 of this paper, I critically assessed the FRR provisions and identified the following problematic aspects that can raise such doubts:

- the overbalance of the Commission's authority to decide on determination of the respondent in arbitration proceedings and unilaterally conclude/preclude conclusion of a settlement agreements;
- existence of the risk of violating fundamental EU Treaty provisions in the process of FRR implementation;
- existence of a threat to the exclusive jurisdiction of the Court of Justice of the European Union (CJEU) to decide on the legality of measures adopted by Union entities or/and MS and its possible influence on the jurisdiction of an arbitration tribunal and enforcement of awards;
- existence of a legal loophole that may allow MS to avoid predictable and reliable arbitration under the International Centre for Settlement of Investment Disputes (ICSID) rules, regardless of whether the foreign investor has the right to choose this option or not.

The Union can bypass the majority of difficulties mentioned by inclusion of specific provisos in all its future investment treaties. However, this solution can be only temporary, as ultimately, the EU will have to review and scrutinize once again all these unsettled issues in order to secure the consistency and reliability of its investment protection system. In any case, a complete and comprehensive understanding of the real nature and effect of FRR provisions will become possible only after its repeated practical application.

The course of realization of the Financial Responsibility Regulation will have a significant impact on the level of EU attractiveness as an investment destination. It is a known fact that, in the majority of cases, investor-state arbitration has substantial financial consequences for the defeated party, regardless of whether it is the absence of compensation for harm to the investor's assets, or a multi-million award against the host state. Consequently, foreign investors, as well as future IIA partners of the Union, will not be willing to assume any risk for their investments if the mechanism for investment protection is uncertain and insecure.

Nowadays, for those who are seeking a place to invest their capital, there exist plenty of alternatives to the EU, such as, for example, the United States with clear protection standards, set in revised Model BIT 2012, low statistics of investor-state arbitrations, and, finally, long and successful experience in managing international investment policy. Comparing US and EU approaches to the nature and scope of investment treatment standards, dispute resolution system and organization of responsibilities division, the following key differences have been explored:

1. An autonomous fair and equitable treatment guarantee present in the Energy Charter Treaty (ECT) and the majority of EU MS bilateral investment treaties (BITs) and minimum standard of treatment limited to customary international law under the NAFTA and US Model BIT 2012. The latter is considered to be more advantageous for the host government, as it is harder to invoke, and an investor who claims breach of this obligation has less chance of succeeding in the arbitration.

2. The obligation to waive all other dispute resolution forums prior to commencement of the arbitration, provided by NAFTA and other US investment treaties, but absent in European IIAs. This rather significant legal loophole should be eliminated in all future EU-third state investment Treaties.

3. A detailed description of what constitutes indirect expropriation in US IIAs and vague language on this issue in European BITs. This is another case when United States experience can be of value for the European Union.

4. With regard to allocation of financial responsibility between local/regional and central authorities (either the federal government in the US or the Commission in the EU), the EU's approach seems to be much more balanced and cautious. Despite the different administrative structure of the United States and the European Union, the former should take a good look at the new EU system created by FRR and review its own mechanism for division of liabilities in order to indemnify central government against mistakes by its states that might eventually result in an obligation to pay a multi-million award from the central budget.

Therefore, in such competitive conditions, the Union should strive hard to retain its rather high rating among capital-importing states and keep improving its positions.

To conclude, the Regulation on managing questions of allocation of financial responsibility in the course of investor-state dispute settlement represents a compromise of interests, which could not be achieved without facing the need to break numerous barriers. These barriers included a complicated and diverse network of BITs concluded by Member States prior to the Lisbon Treaty, a complex Union legal framework and mechanism of power organization and, finally, a number of constraints imposed by primary EU legislation and the exclusive jurisdiction of the CJEU. Nevertheless, answering the research question, I must admit that despite all obstacles, as well as existing drawbacks and weaknesses of the FRR and other legal acts adopted in the framework of an emerging, but highly ambitious EU investment policy, today the Union is following the right path. This is evidenced by the approaching conclusion of negotiations with several powerful state partners, such as Canada, the United States and Singapore. It only remains to be desired that the Union will promptly correct its mistakes so that neither the EU itself nor foreign investors will sustain damage from realization of the new European investment policy.