Current Issues in Investment Treaty Law

Volume IV

The Future of ICSID and the Place of Investment Treaties in International Law

British Institute of
International and
Comparative Law

Published and Distributed by
The British Institute of International and Comparative Law
Charles Clore House, 17 Russell Square, London WC1B 5JP

© BIICL 2013

British Library Cataloguing in Publication Data
A Catalogue record of this book is available from the British Library

ISBN 978–1–905221–50–9

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, or stored in any restricted system of any nature without the written permission of the copyright holder, application for which should be addressed to the distributor. Such written permission must also be obtained before any part of this publication is stored in a retrieval system of any nature.

Typeset by Cambrian Typesetters
Camberley, Surrey
Printed in Great Britain by MPG Books Group Ltd
Cover design by Nick Clarke

Contents

Preface and Acknowledgements vii
N. Jansen Calamita

Foreword ix
Judge Sir David Edward KCMG QC

***In Memoriam* Thomas Wälde** xv
The Late Thomas Wälde, *Inconsistencies in the ICSID Annulment Process: Would a Standing Annulment Committee Work Better?*

I. The Place of Investment Treaties in International Law

1. Ernst-Ulrich Petersmann (European University Institute) *Human Rights, Trade and Investment Law and Adjudication: The Judicial Task of Administering Justice* 3
2. Luis González García (Matrix Chambers) *The Role of Human Rights in International Investment Law* 29
3. Ursula Kriebaum (University of Vienna) *Foreign Investments and Human Rights: The Actors and Their Different Roles* 45
4. Andrea Shemberg (former Legal Adviser to John Ruggie) *From Stabilization Clauses and Human Rights to Principles for Responsible Contracts* 61
5. Jan Kleinheisterkamp (London School of Economics and Political Science) *International Investment Law and its Intersection with EU Law and Policy* 77
6. N. Jansen Calamita (ITF Forum Director, BIICL) *The Making of Europe's International Investment Policy—Uncertain First Steps* 97
7. Nikos Lavranos (Dutch Ministry of Economic Affairs) *Is an International Investor-State Arbitration System Possible under the Auspices of the ECJ?* 129
8. Markus Burgstaller (Hogan Lovells) *Investor-State Arbitration in EU International Investment Agreements with Third States* 149
9. Jürgen Kurtz (University of Melbourne) *The Intersections between International Trade and Investment Law: Mapping a Research Agenda* 165

10. Anna Viterbo (University of Turin) *Tensions Between International Investment Protection and Financial Stability* 185

II. The Future of ICSID

11. Christoph Schreuer (University of Vienna) *Why Still ICSID?* 203
12. John R. Crook (George Washington University) *ICSID's Rule 41(5) – Breakthrough or Backwater?* 211
13. Jonathan Jacob Gass (Freshfields) *ICSID Rule 41(5): A Counsel's-Eye View* 235
14. Alain Pellet (University Paris-Ouest, Nanterre-La Défense) *Annulment Faute de Mieux: Is There a Need for an Appeals Facility?* 255
15. Laurent Gouiffès (Hogan Lovells) *Annulment of ICSID Awards: Adjustment Variables and Flexibility of ad hoc Committees* 275
16. Anne van Aaken (University of St Gallen) *The Interaction of Remedies between National Judicial Systems and ICSID: An Optimization Problem* 291
17. Stephen Bouwhuis (Commonwealth Secretariat) *Investor-State Arbitration: Some Concerns* 325
18. Meg Kinnear (Secretary General, ICSID) *The Future of ICSID* 339

Biographies 357

Editors' Preface

The Investment Treaty Forum is a special project of the British Institute of International and Comparative Law (BIICL) begun in 2004. The Forum builds upon BIICL's expertise in public international law for the purpose of carrying out applied research and analysis in the increasingly complex field of international investment law. In addition, the Forum facilitates dialogue and serious debate among lawyers, senior business managers, policy advisers, academics, and government officials. Like the Institute itself, the Forum enjoys a reputation for independence, even-handedness and academic rigour.

In 2011, as part of its annual programme of public meetings, the Forum organized two very successful conferences in London to address topics of great moment for the investment treaty regime: the relationship between investment treaties and other areas of international law and the future of the system for the resolution of investment treaty disputes under the ICSID Convention. The contributions to this volume derive from those conferences and represent a wide range of perspectives from some of the most experienced and insightful participants in the field.

This book is the fourth volume in the Forum's series on Current Issues in Investment Treaty Law. It is the product of a great deal of hard work not only by the contributors, without whom it would not exist, but to a great many others as well. In particular, the editors wish to thank the Institute's Publications Editor Anna Riddell for her overall stewardship of the publications process, Mona Pinchis, Nick Barrow and Seetha Sriraman for their fine editorial assistance, and BIICL interns, Kshama Loya, Victoria Sementsova and Deborah Yang for their help with initial editing.

The Investment Treaty Forum will continue to explore the terrain of international investment treaty law through its events and research. We are grateful to the Forum's members for their support over the years and encourage new members, both corporate and individual, to join the Forum.

N. Jansen Calamita
London, 12 January 2013

investment disciplines that sits at the critical juncture of that deep level of politicization as States parties either transplant legal devices in response (such as WTO-based flexibilities) or the inherent features of a particular system are offered as mechanisms of developing greater legitimacy in the other (such as the value of centralized appellate review in the WTO, and its strong commitment to principled hermeneutics and *de facto stare decisis*).

Such a research model would also pay particular attention to cross judging and interpretation.[68] International courts and tribunals are capable of talking with each other and this is especially important in any research directed at the common terrain of trade and investment law. As we have already seen, there is strong evidence of citation of WTO law in investor–state arbitration with limited practice in the reverse direction. That might lead some to begin from the loose premise that the (usually) older WTO jurisprudence on common norms is necessarily better than select approaches on investment arbitration. Yet any such claim would need to be tested against the full suite of case law in both systems which, given the enormous growth of such jurisprudence, is no small task. It is, however, a critical inductive exercise insofar as state parties are unlikely to isolate with precision the sufficient components of breach in their drafting of treaty commitments. The deeply incomplete nature of trade and investment treaties inevitably requires adjudicators to supply those components. And in fact, at least when it comes to a critical common norm of national treatment, it is possible to argue that parts of investment arbitration jurisprudence are superior to their WTO counterparts and may offer a useful guide to the evolution of the latter. This is especially the case on whether and how to construct a test for identification of state purpose as a condition of breach of that legal obligation. This is not to say that the entirety of the national treatment arbitral case law is superior to its WTO counterparts. There are indeed flaws in select arbitral cases on national treatment that, as flagged earlier, have been caused by the mistaken perception of the breadth or narrowness of WTO law on questions such as the role of competition in a national treatment test. Indeed, investigation of those flaws again requires qualitative, fine-grained analysis in order to provide scholars, practitioners and adjudicators with a basis for distinguishing between strong and weakly reasoned awards, a task that is especially important in investment law given the absence of an appellate organ. One can see therefore that despite its apparent modesty, the third research model raises a set of highly complex and challenging issues.

[68] On the normative implications of cross-judging across international law, see R Teitel and R Howse, 'Cross-Judging: Tribunalization in a Fragmented but Interconnected Global Order' (2009) 41 *NYU Jnl Intl L and Pol* 959.

10

Tensions between International Investment Protection and Financial Stability

*Annamaria Viterbo**

I. INTRODUCTION

This study is a contribution to the debate on the consistency between the measures adopted by States in the aftermath of the global financial crisis and their international investment law obligations.

From 2008 onwards, States have adopted a vast array of policy tools to safeguard financial stability. These measures can be classified in three categories: crisis prevention, crisis management and crisis resolution measures. The main crisis prevention tools consist of new or revised financial regulations and prudential standards and—in certain cases—controls on capital inflows. Crisis management instruments, on the other hand, are those remedial measures deemed necessary to contain and mitigate the effects of a crisis, ultimately avoiding its worsening; they encompass financial stimulus packages and bailouts, as well as controls on capital outflows.[1] Finally, crisis resolution tools consist of mechanisms designed to avoid insolvencies and defaults, for example through the restructuring of sovereign debt securities.

* Assistant Professor of International Law Faculty of Law, University of Torino—Italy. Many of the themes in this paper were first explored by the author in her book *International Economic Law and Monetary Measures: Limitations to State's Sovereignty and Dispute Settlement* (Edward Elgar, 2012).

[1] The consistency of bank bailouts with the GATS and with the obligations arising from investment treaties was questioned. See B De Meester, 'The Global Financial Crisis and Government Support for Banks: What Role for the GATS?' (2010), 13(1), *Journal of International Economic Law* 27–63; M Parish, 'The Public International Law of Bank Bail-Outs' (2010), 7(1), *Transnational Dispute Management*. Besides, for bailing-out systemically important cross-border financial institutions recourse can be made to *ex-ante* established burden-sharing mechanisms. See C Goodhart and D Schoenmaker, 'Fiscal Burden Sharing in Cross-Border Banking Crises' (2009) 5(1) *International Journal of Central Banking* 141–165.

In the next paragraphs we will focus on financial standards, capital controls and sovereign debt restructurings, analysing their consistency with the international investment law obligations of the host State.

We will demonstrate that the interaction of trade and investment treaties greatly limits the number and scope of policy tools at States' disposal and that a better balance should be found between investment promotion and protection and the safeguard of global financial stability. To this end, carefully drafted safeguard clauses should be included in international investment agreements (IIAs) to leave governments adequate room for manoeuvre and prevent and manage financial crises.

A. Financial Standards and Investment Law

As a consequence of the global crisis, many governments are reforming their financial regulatory and supervisory framework. For instance, in the United States (US) the *Dodd–Frank Wall Street Reform and Consumer Protection Act* (Pub. L. 111–203, H.R. 4173) introduced a number of reforms of the financial sector intended to implement the lessons learned from the global crisis. The European Union (EU) is in the process of adopting a package of measures to tighten regulations for the banking sector, hedge funds, over-the-counter (OTC) derivatives and rating agencies.[2]

To mention just one of the international standard-setting bodies, the Basel Committee developed a comprehensive set of reform measures—the so-called Basel III—to strengthen the resilience of the global banking system.[3] This new international regulatory framework aims to raise the quality, quantity and consistency of bank capital and liquidity, improve risk management and governance and deepen cross-border supervisory cooperation. The leaders of the G20 endorsed the Basel III framework at the Seoul Summit of November 2010 and implementation is due to start on the 1st of January 2013.[4]

In 2009, the G20 took the lead in guiding the reform of the global financial system by also establishing the Financial Stability Board (FSB) as a successor of the Financial Stability Forum.[5] The FSB was mandated to promote the implementation of effective regulatory, supervisory and other financial sector policies and to coordinate national financial authorities and

[2] Up-to-date information on EU regulations and directives on financial services and capital markets is available online <http://ec.europa.eu/internal_market/top_layer/index_24_en.htm>.

[3] In order to guarantee a smooth transition to the new standards regime, national implementation of the Basel III risk-based capital requirements will begin on 1 January 2013.

[4] G20 Leaders' Declaration, Seoul Summit, 11–12 November 2010, para 28 ff.

[5] See G20 Declaration on Strengthening the Financial System, London Summit, 2 April 2009.

international standard-setting bodies. One of the first initiatives by the FSB was to identify 12 Key Standards for Sound Financial Systems and to prioritize their implementation in member States.

In March 2010, the FSB launched a global initiative (not limited to its members) to promote adherence of all countries to internationally agreed information exchange and cooperation standards in the areas of banking supervision, insurance supervision and securities regulation.[6] As part of this initiative, the FSB identified a toolbox of positive and negative measures to foster the implementation of standards. Among the negative measures were, for instance, higher capital requirements as well as tighter regulatory and audit requirements for financial institutions operating in a non-cooperative jurisdiction (NCJs).[7] Being of a discriminatory and sanctioning nature, they are however at odds with the traditional soft-law approach of international financial standards.

In November 2011, the G20 Leaders urged again all jurisdictions to adhere to international standards in the areas of taxation, prudential supervision, anti-money laundering and combating the financing of terrorism. They also declared to be ready to use said 'countermeasures' to deal with jurisdictions that fail to meet the identified standards.[8]

The question is whether the implementation of new financial regulation and standards is consistent with the investment law obligations of host countries. In fact, not all the IIAs contain a prudential carve-out clause, which is an exception specifically designed to preserve the host State's right to regulate its financial sector for prudential reasons, adopting domestic laws or regulations that are aimed at financial stability without breaching its treaty obligations. On the contrary, many free trade agreements contain strong chapters on investment and financial services which facilitate the entry of foreign financial institutions by granting them market access and thus leading to the liberalisation of financial services.

When present, prudential carve-out provisions are often modelled on Article 2(a) of the General Agreement on Trade in Services (GATS) Annex on Financial Services. They enable the parties to an IIA to adopt measures relating to financial services for prudential reasons, including those conceived to protect investors, depositors and policy-holders or persons to whom a fiduciary duty is owed by a financial services supplier. They also allow the

[6] See FSB, Promoting Global Adherence to International Cooperation and Information Exchange Standards, 10 March 2010. The FSB's initiative complements similar initiatives by the Global Forum on Transparency and Exchange of Information for Tax Purposes and by the Financial Action Task Force to promote adherence to international standards in the tax area and for standards concerning anti-money laundering and combating the financing of terrorism.

[7] Ibid, Annex D: Toolbox of Possible Measures to Promote the Implementation of International Financial Standards.

[8] G20 Leaders' Final Declaration, Cannes 3–4 November 2011, para 35–6.

State to adopt measures aimed at the integrity and stability of the financial system. Sometimes it is clarified that the term 'prudential' covers also the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions.[9]

Prudential carve-out provisions have been inserted in bilateral investment treaties (BITs) and free trade agreements (FTAs) since the 1990s, especially by the European Union, Canada and Japan.[10]

As regards the US, this exception appears only in very few US BITs, even if it is present in both the 2004 and 2012 US Model BIT. However, a prudential carve-out was included in some US FTAs like the US–Chile, US–Singapore and Republic of Korea–US (KORUS) FTAs.[11]

1. The interpretation of prudential carve-out clauses raises the following issues

a) First, while the GATS prudential clause has never been brought before a World Trade Organization (WTO) Panel, two investment arbitration tribunals have already considered the issue. Consequently, a cross-fertilization of jurisprudence from investment arbitration to WTO dispute settlement might occur.

It is understood that *Fireman's Fund Insurance Company v Mexico* is the only case that directly concerned a prudential carve-out clause, ie Article 1410.1 of the North American Free Trade Agreement (NAFTA).[12] The *Saluka Investments BV v The Czech Republic* case, however, is also relevant: in the absence of a prudential exception, the arbitral tribunal was called to establish whether the capital requirements adopted by the host State breached the fair and equitable treatment clause of the Netherlands–Czech Republic BIT.[13]

[9] See United States (US) Model Bilateral Investment Treaty (BIT) (2004) art 20.

[10] See eg Canada–Peru Free Trade Agreement (FTA) (2008) art 1110; Annex on Financial Services, Association of South East Asian Nations (ASEAN)—Australia–New Zealand Free Trade Area (2008) arts 3, 4; Annex 6-C, Korea–India Comprehensive Economic Partnership Agreement (2009) art 2; Japan–Colombia BIT (2011) art 16; Japan–Mexico Agreement for the Strengthening of the Economic Partnership (2004) art 110; Singapore–Japan Agreement for a New-Age Economic Partnership (2002) art 85; European Union (EU)–Korea FTA (2010) art 7.38; EU–Chile FTA (2002) art 123(4). See also North American Free Trade Agreement (NAFTA) Chapter XIV on Financial Services art. 1410.1 and Energy Charter Treaty art 9:4.

[11] US Model BIT (2004) art 20.1; US–Rwanda BIT (2008) art 20; US–Uruguay BIT (2005) art 20; US–Chile FTA (2003) art 12.10, para 1; US–Singapore FTA (2003) art 10.10, para 1; Republic of Korea–US FTA (KORUS) (2007) art 13.10, para 1; US–Colombia FTA (2006) art 12.10.

[12] *Fireman's Fund Insurance Company v Mexico*, Award, 17 July 2006, ICSID Case No. ARB(AF)/02/01, 162–8.

[13] *Saluka Investments BV v. The Czech Republic*, UNCITRAL/PCA, Partial Award, 17 March 2006. See GS Georgiev, 'The Award in Saluka Investments v. Czech Republic', in G Aguilar

b) When interpreting the ordinary meaning of 'prudential', attention should be paid to economic and political developments.

In fact, as it has been demonstrated by recent events, the concept of prudential regulation and supervision is in constant evolution. For instance, it can be claimed that a consensus has emerged on a set of minimum standards (like FSB's *12 Key Standards for Sound Financial Systems*), which can serve as a benchmark to assess whether a country's prudential regulations comply with its IIAs obligations. This assumption, however, has been strongly criticised by countries not taking part in the standard-setting process: they argue that financial standards cannot be used as a benchmark for the interpretation of the clause as they are the outcome of a non-inclusive process and because they are of a soft-law nature and implemented only on a voluntary base.

c) It needs to be determined whether prudential carve-out provisions are self-judging.

It is interesting to note that some of the prudential carve-outs negotiated by the United States set forth a special consultation procedure envisioning the involvement of financial experts: arbitration may be initiated only if the financial authorities of the parties are unable to reach a joint determination on the issue being disputed.[14] This procedure was foreseen to address the regulators' concerns on the outcome of litigation in cases involving prudential measures.

In the *Fireman's Fund* case, the NAFTA Tribunal rejected the claim that the prudential clause of the NAFTA (Article 1410.1) was a self-judging provision.[15]

d) Often, carve-out clauses specify that prudential measures not conforming to the provisions of the treaty 'shall not be used as a means of avoiding the Party's commitments or obligations under the treaty'.[16]

This wording has raised many concerns and it has been read as 'self-cancelling': measures adopted for prudential reasons could in fact be challenged when they undermine the regulatory constraints otherwise established by the treaty.

Alvarez and WM Reisman (eds.), *The Reasons Requirement in International Investment Arbitration* (Martinus Nijhof 2008) 149–190.

[14] See US Model BIT (2004) art 20 and Uruguay BIT (2005) art 20.

[15] *Fireman's Fund* (n 12), 166.

[16] Compare US Model BIT (2004) art 20.1; KORUS FTA (2007) art 13.10; EU–Korea FTA (2010) art 7.38, para 2.

The wording of the above mentioned phrase may be likened to the *chapeau* of General Agreement on Tariffs and Trade (GATT) Article XX, the rationale being to ensure that prudential measures are introduced in good faith and not with protectionist intent or to discriminate foreign investors.

In 2009, during the review of the US Model BIT, the *Subcommittee on Investment of the Advisory Committee on International Economic Policy* recommended the clarification or deletion of the sentence.[17] However, Article 20 of the 2012 US Model BIT still contains this specification.

e) Usually, prudential carve-out provisions do not require prudential measures to be necessary, reasonable or justifiable (one notable exception being NAFTA Article 1410.1).

Recently, some European FTAs have introduced a 'necessity test': for example, Article 7.38 of the EU–Korea FTA establishes that prudential measures must not be more burdensome than necessary to achieve their aim.

This development is criticisable, as it adds complexity and risk 'at a time when governments need utmost flexibility to respond to systemic financial crisis'.[18] Additional requirements may in fact cause legal uncertainty and increase litigation.

f) Finally, it has to be verified whether prudential measures of a discriminatory nature (direct or indirect) are covered by carve-out exceptions.

Prudential measures are legitimately introduced when they aim at the general interest and are not conceived with a discriminatory intent.[19] For instance, banking support schemes *a priori* excluding foreign-owned banks are not genuinely prudential, but protectionist, as a foreign-owned bank poses the same threats as a domestic bank to the financial stability of a country.

This stance was adopted in the *Saluka* case. The arbitral tribunal ruled that, by denying support to foreign investors, the bail-out package amounted to a breach of the fair and equitable standard and impaired the plaintiff's investment.[20]

In the *Fireman's Fund* case, the arbitral tribunal concluded that the NAFTA carve-out exception covers reasonable prudential measures even when they have discriminatory effects, provided that they are not set out with a discriminatory intent.[21] The tribunal also rejected the contention that a measure discriminatory in effect is *eo ipso* unreasonable.

B. Capital Controls and International Investment Law

During the global financial crisis many influential voices began to advocate for the return of controls both on inflows and outflows of capital. Nevertheless, it has to be verified whether States still have policy space to deploy capital controls or if they are constrained by trade and investment agreements.

The so-called Stiglitz Report, presented as a background document at the 2009 UN Conference on the World Financial and Economic Crisis, affirmed that governments should retain the power to apply capital controls as part of their development and risk management policies.[22]

Along the same lines, the General Assembly of the United Nations reached the conclusion that 'developing countries facing an acute and severe shortage of foreign reserves because of the fallout of the crisis can use, as a measure of last resort, temporary capital account measures, ***in accordance with the relevant bilateral and multilateral agreements***, in order to help to mitigate the adverse impacts of the crisis'.[23]

[17] In June 2009, the United States Department of State and the Office of the United States Trade Representatives requested the Advisory Committee on International Economic Policy to establish a Subcommittee to review the US Model BIT of 2004. The Subcommittee submitted its Report in September 2009. See Subcommittee on Investment of the Advisory Committee on International Economic Policy (2009), 'Report Regarding the Model Bilateral Investment Treaty', 30 September, <http://www.state.gov/e/eeb/rls/othr/2009/131098.htm>.

[18] J Kelsey, 'The Danger of a Necessity Test in the Prudential Exception for Financial Services in EU FTAs' (2010), paper presented at the BIICL Annual Conference on WTO Law, London, May 2010.

[19] On banking support schemes, see B De Meester, 'The Global Financial Crisis and Government Support for Banks: What Role for the GATS?' (2010) 13(1) *Journal of International Economic Law* 62–63. See also B De Meester, 'Testing European Prudential Conditions' (2008) 11(3) *Journal of International Economic Law* 609–647. For what concerns the relationship between subsidies violating the national treatment obligation in the financial sector and the GATS prudential carve-out clause see: P Poretti, *The Regulation of Subsidies within the General Agreement on Trade in Services—Problems and Perspectives* (Kluwer Law International 2009).

[20] *Saluka Investments BV* (n 13), 497–505.

[21] *Fireman's Fund Insurance* (n 12), 162. The Tribunal interpreted NAFTA Article 1410.1 in the context of the NAFTA and concluded that 'a judgment as to whether the exception applies is called for only after an initial, at least tentative, conclusion that NAFTA Article 1110 or another applicable provision of the NAFTA may have been violated', 160. Therefore, considering in the first place that the challenged measures did not amount to an illegitimate expropriation under the NAFTA, the Tribunal did not rule on the issue whether they were reasonable or arbitrary.

[22] Stiglitz Report, background document of the UN Conference on the World Financial and Economic Crisis and Its Impact on Development, 21 September 2009, para 204.

[23] UN General Assembly Resolution, 'International Financial System and Development', 21 December 2009, A/RES/64/190, 12, emphasis added.

Even the International Monetary Fund (IMF) reversed its long-held policy on capital account liberalization[24] and provided its financial support to Iceland, welcoming the country's introduction of capital controls.[25]

In recent years, other countries like Brazil, Colombia, Indonesia, South Korea and Thailand have resorted to controls to limit the inflow of speculative capital.

However, trade and investment treaties, which lead to the liberalization of capital movements, limits the capacity of States to introduce capital controls and safeguard financial stability, as the priority is given to the protection of trade and investors.

In particular, investors may claim that capital controls amount to a breach of the free transfer of funds provision, of the fair and equitable standard or even to an indirect expropriation of the investment.

Also in this case, reference has to be made to the relevant IIA safeguard clauses. The following aspects have to be taken into account.

a) First, it has to be established whether capital controls are covered by the prudential carve-out provision of IIAs together with prudential measures.

The two sets of policies have been often employed jointly to counter the risks associated with a surge of capital inflows, complicating the differentiation among prudential measures and, in particular, controls on capital inflows.[26] Precise classification is therefore not easy to draw, as capital flow management measures and macro-prudential policies overlap in some areas.[27]

In general, while capital controls discriminate by residency of the flows and foreign exchange regulations discriminate by currency, prudential regulations usually do not discriminate either by residency or currency.

In the absence of case law on the subject, it should be noted that the US administration repeatedly stated that capital controls are not covered by the prudential carve-outs of US FTAs. This position reflects the US's long-

24 See JD Ostry et al 'Capital Inflows: The Role of Controls', (2010) *International Monetary Fund Staff Position Note*, SPN/10/04. See also, more recently, International Monetary Fund, 'Recent Experiences in Managing Capital Inflows: Cross-Cutting Themes and Possible Policy Framework', 14 February 2011; JD Ostry at al, 'Managing Capital Inflows: What Tools to Use?', (2011) *International Monetary Fund Staff Discussion Note*, SDN/11/06.

25 See A Viterbo, 'Iceland's Capital Controls and the Constraints Imposed by the EEA Agreement' (2011) 6(2) *Capital Markets Law Journal* 214–237.

26 See K Habermeier, A Kokenyne and C Baba 'The Effectiveness of Capital Controls and Prudential Policies in Managing Large Inflows' (2011) *IMF Staff Discussion Note*, 5 SDN/11/14, 15.

27 See G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experience, endorsed by the G20 Leaders at the Summit of Cannes, 3 November 2011.

standing policy in favour of unimpeded capital movements through their IIAs.[28]

When the relevant treaty contains a prudential carve-out clause as well as a balance of payments exception, the two provisions should be read together.[29] In fact, as balance of payments exceptions specifically permit a country to introduce temporary measures limiting investment related transfers, it can be argued that capital controls are not also covered by the prudential carve-out provision.

b) It can be observed, however, that the vast majority of BITs does not include a balance of payments (BoP) clause, which is instead quite common in multilateral trade treaties containing an investment chapter.[17]

Even if BoP clauses typically allow States to introduce temporary derogations to the transfer of funds (capital controls or restrictions on cross-border payments), a survey on IIAs shows that German BITs never include BoP clauses, the 2005 UK Model BIT does not envision a BoP provision (despite the fact that earlier UK treaties contained it),[31] nor do the approximately 50 BITs and FTAs concluded by the United States.[32]

In contrast, BoP clauses are set forth in the 2006 French Model BIT and in many of the treaties concluded by Japan and other East Asian countries (especially those hit by the 1997–1998 Asian Tigers crisis).[33]

The absence of a BoP provision in IIAs concluded by the US, together with pressure by the US administration on capital account liberalization, was harshly criticised for contributing to global instability.

28 Compare the Testimony of the United States Under Secretary of Treasury for International Affairs, JB Taylor, before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology Committee on Financial Services of the US House of Representatives, 1 April 2003, titled 'Financial Services and Capital Transfer Provisions in Recent Free Trade Agreements' <http://archives.financialservices.house.gov/archive/hearings199.shtml>.

29 See for instance NAFTA art 1410.1, that sets forth a prudential carve-out clause and NAFTA art 2104, that establishes a balance of payments exception.

30 One explanation might be that in their investment treaties, host countries prefer to limit *ab initio* the admission of short-term capital flows in order to avoid their potentially destabilizing effects.

31 See for instance United Kingdom (UK)–Bolivia BIT 1993 art 6:1.

32 The US–Panama FTA (signed 2007) contains a balance of payments clause allowing only the introduction of trade measures adopted in accordance with the Balance of payments (BoP) provisions of the GATT 1994.

33 See for instance Korea–Japan BIT (2002) art 17; Japan–Colombia BIT (2011) art 16; Japan–Mexico Economic Partnership Agreement (2005) art 72; Japan–Vietnam BIT (2003) art 16; Agreement between the Government of Japan and the Government of Malaysia for an Economic Partnership (2005) art 108; Japan–Peru BIT (2008) art 20.

In 2009, during the revision of the US Model BIT, the dedicated Subcommittee discussed the introduction of a BoP provision on the model of those contained in GATS (Article XII) and in the OECD Draft of the Multilateral Agreement on Investments (MAI) (see the draft article on Temporary Safeguard).[34] The Subcommittee also considered proposals to make the measures adopted for BoP reasons not subject to investor–State dispute settlement.[35]

Many members of the Subcommittee expressed the view that future US investment treaties should include exceptions to the free transfer of funds. This would be an important change of policy as it would provide governments with greater flexibility in countering massive capital inflows and outflows connected to a financial crisis.

However, no formal decision was taken and in 2010 the issue was raised again by a group of 250 eminent economists. They urged the Obama administration to revise US trade and investment treaties to permit 'governments to deploy capital controls without being subject to investor claims, as part of a broader menu of policy options to prevent and mitigate financial crises'.[36] This can be achieved not only with the introduction of BoP exceptions, but also through controlled entry clauses granting a country the right to maintain or adopt controls on capital inflows in accordance with its domestic legislation.

In April 2011, the US Secretary of the Treasury replied to the economists' statement. He emphasized that the framework used by the US administration to negotiate FTAs and BITs is designed to establish predictable rules to govern trade and foreign investment, while providing the necessary flexibility to allow governments to mitigate the risks connected to large swings in capital flows. He also affirmed that surges in capital inflows are best managed through a mix of prudential, fiscal and monetary policy measures than through capital controls, in the belief that the current framework strikes the right balance among the different interests at stake.[37]

34 See OECD (1998), 'Multilateral Agreement on Investment: Draft Consolidated Text—Temporary Safeguard', DAFFE/MAI (98)7/REV1.

35 See US Model BIT (2004) art 20.1; KORUS FTA (2007) art 13.10; EU–Korea FTA (2010) art 7.38, para 2. For instance Annex 10-E of the US–Colombia FTA (signed 2006) stipulates that investors have to wait a year before filing a claim on the introduction of capital controls by Colombia. This cooling-off period is however inadequate to limit litigation on measures introduced to prevent or mitigate financial crises, which should be left to State-to-State dispute settlement. The US–Colombia FTA features an essential security clause and a prudential carve-out clause, but not a balance of payments safeguard provision.

36 The Group was constituted within the Global Development and Environment Institute of the Tufts University and the Institute for Policy Studies of Washington, DC. The Statement is available at <http://www.ase.tufts.edu/gdae/policy_research/CapCtrlsLetter.html>.

37 The letter of the US Secretary of the Treasury, TF Geithner, <http://www.ase.tufts.edu/gdae/policy_research/Geithner_response_to_capital_controls_letter.pdf>.

c) It should be considered that, in the absence of a BoP clause, a host State introducing capital controls to prevent or mitigate financial crises may still rely on three other lines of defence: the essential security clause, which is virtually present in all US and Canada BITs and in most FTAs; the customary law principle of 'state of necessity'; and the exercise of monetary sovereignty.

The numerous International Centre for Settlement of Investment Disputes (ICSID) cases arising from the 2001–2002 Argentinian crisis showed, however, the uncertainties connected with these legal arguments.[38]

In those cases, arbitral tribunals were called to establish whether the essential security clause of the applicable BIT could be interpreted as covering economic and financial crises in its scope of application.

They were also called to judge whether the customary law principle of 'state of necessity' (as codified by Article 25 of the *International Law Commission's Draft Articles on the Responsibility of States for Internationally Wrongful Act*) could be used to interpret the BIT essential security clause.

While the issue on the applicability of the essential security clause to economic crises cannot be considered definitely settled by recent case law,[39]

38 On the Argentine cases, essential security clauses and the customary law principle of 'state of necessity' in international investment law see, among many, AK Bjorklund, 'Emergency Exceptions: State of Necessity and Force Majeure', in P Muchlinski, F Ortino and C Schreuer (eds.) *The Oxford Handbook of International Investment Law* (Oxford University Press 2008), 459–523; WW Burke-White and A von Staden, 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties'(2008) 48(2) *Virginia Journal of International Law* 307–410; A Kolo and T Wälde, 'Economic Crises, Capital Transfer Restrictions and Investor Protection Under Modern Investment Treaties' (2008) 3(2) *Capital Markets Law Journal* 154–185; J Kurtz, 'Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis' (2010) 59(2) *International and Comparative Law Quarterly* 325–371; L Mola, *Sicurezza Nazionale e Trattamento Degli Investimenti Stranieri Nel Diritto Internazionale* (Giappichelli 2010); SW Schill, 'International Investment Law and the Host State's Power to Handle Economic Crises' (2007) 24(3) *Journal of International Arbitration* 256–286. On the last two mentioned lines of defence, see in particular *Continental Casualty Company v Argentine Republic*, Award of 6 September 2008, ICSID Case n. ARB/03/9, 238.

39 To mention just two among the many ICSID awards, the Tribunal in *CMS Gas Transmission Co. v Argentine Republic* established that even if the essential security clause of the Argentina–US BIT only referred to internal security, it could not be interpreted as excluding major economic crises from its scope *CMS Gas Transmission Co. v Argentine Republic*, Award of 12 May 2005, ICSID Case n. ARB/01/8, 359 ff.; compare Decision of the *ad hoc* Committee on the Application for Annulment of the Argentine Republic of 25 September 2007. On the contrary, the Tribunal in *Enron Corp. Ponderosa Asset, L.P. v Argentine Republic* considered that the same clause did not apply to an economic emergency situation; therefore, in order to fill the gap, resort has to be made to the customary law rules on necessity *Enron Corp. Ponderosa Asset, L.P. v Argentine Republic*, Award of 22 May 2007, ICSID Case n. ARB/01/3, 334; compare Decision on Annulment of 30 July 2010. The Tribunal in *Sempra Energy International v Argentine Republic*

it can be said that, after initial uncertainty, the relationship between treaty-based safeguard clauses and the customary law rule on 'state of necessity' was thoroughly clarified by the *CMS Annulment Committee* and in the *Continental Casualty v Argentina* award.[40]

The two defences are in fact legally distinct and serve different purposes: the protection provided by the principle of 'state of necessity' can only be sought after a breach of a secondary rule of international law has been found, and thus after a breach of the BIT (like the introduction of emergency measures not justified by a safeguard clause). The customary principle of 'state of necessity', therefore, becomes relevant only in a further stage of the legal analysis.[41] Moreover, due to their different scope of application, the customary law standards for the operation of 'state of necessity' cannot be applied to interpret the BIT safeguard clause.

However, while the BIT safeguard clause exonerates the host State from all responsibilities, when a 'state of necessity' defence applies, the host State still has to pay compensation.

Finally, it should be noted that a defence based on monetary sovereignty is a very slippery one. The developments of treaty law (especially in trade and investment) seem in fact to corroborate the emergence of an international customary norm which makes it illegal to impose exchange restrictions and capital controls, at least—in the words of F. A. Mann—'in those cases in which capital has been introduced into a State's economy with its approval and on terms providing for the retransfer of the capital, profits and the compensation if any'.[42]

C. *Sovereign Debt Restructuring and International Investment Law*

When the default of a State is imminent, the restructuring of public debt via an exchange offer is usually the only viable solution.

However, as demonstrated by the fiercely criticised decision over jurisdiction in the case *Abaclat et al. v Argentina*,[43] investor–State arbitration can be

followed the same reasoning. *Sempra Energy International v Argentine Republic*, Award of 28 September 2007, ICSID Case n. ARB/02/16, 378; compare Decision on Annulment of 29 June 2010.

[40] For the most convincing analysis see *CMS Gas Transmission Co. v Argentine Republic*, Decision of the *ad hoc* Committee on the Application for Annulment of the Argentine Republic of 25 September 2007, ICSID Case n. ARB/01/8, 129–135 and *Continental Casualty* (n 38), 166.

[41] See also J Kurtz, 'The Paradoxical Treatment of the ILC Articles on State Responsibility in Investor–State Arbitration' (2010) 25(1) *ICSID Review: Foreign Investment Law Journal* 200–217.

[42] See FA Mann, *The Legal Aspect of Money, with Special Reference to Comparative, Private and Public International Law* (Clarendon Press 1992) 468.

[43] *Abaclat and others v Argentine Republic (case formerly known as Giovanna A. Beccara and others v Argentina)*, Decision on Jurisdiction and Admissibility of 4 August 2011 ICSID Case No. ARB/07/5; see also the Dissenting Opinion of the Arbitrator Georges Abi-Saab, 28 October 2011.

used to challenge arrangements with stakeholders on the grounds of breach of the fair and equitable standard, of the national treatment and most favoured nation principles, or claiming that they amount to expropriation. This may have the effect of complicating a State's effort to restructure its sovereign debt.

The plaintiffs in the *Abaclat* case claimed that Argentina's sovereign debt restructuring of 2005 (which followed the suspension of payments on bonds in 2001), breached their investors' rights under the Italy–Argentina BIT. The ICSID tribunal—in a majority award, with judge Abi-Saab dissenting—upheld jurisdiction to hear the claims of over 60,000 bondholders on the alleged breach of the BIT.

The *Abaclat* case raises the question as to whether the purchase of sovereign bonds *per se* amounts to an 'investment'. *Abaclat* is one of the few cases related to 'pure portfolio investments'—i.e. purchases of financial instruments not made in connection with a direct investment in the territory of the host State.

It is worth mentioning that also the *Continental Casualty* award concerned the restructuring of Argentina's debt in the framework of its economic crisis. In that case, the tribunal considered the Argentinian Treasury Bills (the so-called LETEs) to be part of the investment that Continental Casualty made in CNA, an Argentinian insurance company. CNA's portfolio consisted of low-risk securities, like treasury bills and government bonds, made to protect the company's liquid assets from inflation and earn a profit. The value of these assets plummeted when in 2001 Argentina converted US dollar denominated securities into the peso and restricted capital outflows. Moreover, in 2004, CNA did not accept a swap offer envisioning the waiver of 75 per cent of principal, together with interest accrued until then. On the point, the Tribunal rejected Argentina's defence that the restructuring of the LETEs was covered by the BIT essential security clause[44] and ruled that it breached the fair and equitable standard of protection.[45]

Coming back to the aforementioned *Abaclat* case, the tribunal held that the government bonds under litigation were protected investments as they were instruments of a purely financial nature that ultimately benefitted the issuing State despite being purchased by the investor on the secondary market.

We consider this finding to be based on flawed legal reasoning. The majority award relied in fact only on the definition of investment provided by the

[44] *Continental Casualty* (n 38) 220–1.

[45] *Continental Casualty* (n 38) 265.

Italy–Argentina BIT, which explicitly lists among the protected investments '*debentures, public or private securities or any other right to the performance of services amounting to an economic value, capital revenues included*'.[46] Moreover, it failed to consider the importance of the requirement of a territorial link between the investment and the host State, or to take into account the core interpretative criteria of Article 25 of the ICSID Convention.

Besides, it should be recalled that not all BITs explicitly cover financial instruments and portfolio investments.

Some treaties, for example, set forth an open-ended list of covered investments, which includes debentures in a company, but leaves it to the interpreter to determine whether they also cover government bonds.

On the contrary, some of the BITs and FTAs signed by Canada or Japan clearly exclude from the scope of their application 'public debt operations of a Party or a State enterprise'.[47]

Recent US FTAs contain special provisions on public debt and sovereign debt restructuring.[48] These provisions limit the investors' capacity to bring forward an investor–State claim with respect to the default, restructuring or rescheduling of sovereign debt instruments. In principle, investors must wait a given period of time (270 days) before commencing a lawsuit. However, for negotiated restructurings, no claim may be submitted to arbitration, except for alleged breaches of the national treatment and most favoured nation standards. The restructuring is negotiated when a qualified majority of the outstanding debt holders (usually no less than 75 per cent) has accepted a debt exchange offer or a fundamental modification of the payment terms. This limits the possibility for the so-called 'holdouts'—bondholders who do not accept exchange offers, thus retaining their right to seek the full repayment of original bonds—to disrupt the restructuring process.

The rationale behind these two types of provisions is to avoid *ab initio* any interference between a sovereign debt restructuring process and the legal framework for the protection of foreign investments.[49]

[46] Italy–Argentina BIT (1990) art 1. Similarly, other investment treaties include 'government-issued securities' in Korea–Jamaica BIT (2003) art 1, or 'bonds, debentures and other debt instruments' in US–Uruguay BIT (2005) art 1.

[47] See Canada–Colombia FTA (2008) art 838, note 11; Canada–Chile FTA (1997) art G-40; Japan–Peru BIT (2008) art 1; Japan–Colombia BIT (2011) art 1.

[48] See US–Peru FTA (2006) annex 10-F and US–Uruguay BIT (2006) annex G. According to Annex 10-B, US–Chile FTA (2003), in rescheduling its debts, Chile is only subject to respect the most favoured nation and national treatment obligations.

[49] See United Nations Conference on Trade and Development (UNCTAD), 'Scope and Definition', UNCTAD Series on Issues in International Investment Agreements vol II (Geneva 2011) 32–33; UNCTAD, 'Sovereign Debt Restructuring and IIAs' (July 2011) IIA Issues Note n 2.

Rather than through investor–State arbitration, claims related to sovereign debt restructuring should be settled resorting to an *ad hoc* international dispute settlement mechanism, which can better balance the public interest and investors' private concerns.

D. Conclusions

In conclusion, a better balance should be found between investment protection and financial stability. States should be granted the flexibility to safeguard financial stability by strengthening their financial systems through sound regulation and supervision and even introducing capital controls in time of distress.

Financial stability is in fact a global public good of paramount importance and its protection may justify setting aside or suspending an international obligation related to individual investors' concerns. Governments should be allowed to deploy all available crisis prevention, crisis management and crisis resolution tools.

To this end, new investment treaties should envision a prudential carve-out clause, applicable to prudential measures and free from any necessity test, together with a BoP safeguard clause permitting the adoption of controls both on capital inflows and outflows.

Moreover, new IIAs should contain a definition of investment that excludes sovereign debt instruments from the scope of application of the treaty, or at least an annex limiting the right to resort to investor–State arbitration.

It is interesting to note that the Japan–Colombia BIT, signed in September 2011, clearly establishes that bonds, debentures and loans issued by a contracting party or a State enterprise do not amount to an investment (Article 1). It also envisions both a BoP clause (Article 16) and a prudential carve-out clause (Article 17). The BoP clause allows temporary derogations to the free transfer provision and to national treatment in relation to cross-border capital transactions.