Global Counsel

Trade, regulation and TTIP's political troubles

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Summary

The issue of Investor State Dispute Settlement (ISDS) has surfaced in the EU as a focus of political opposition to a possible TTIP trade and investment deal with the United States. The ISDS issue has reinforced the fact that TTIP's key rationale - that the EU and US markets are now so integrated that common approaches to market rulemaking make sense - is also its key political vulnerability. Despite attempts by the European Commission to substantively rewrite ISDS rules, the concept may yet be removed altogether from TTIP, which may or not save the deal politically in the EU. But the wider reasons why a concept that has existed for decades has proved so controversial in the TTIP context are important.

A little over a year into the negotiation of the Trans-Atlantic Trade and Investment Partnership (TTIP) the issue of Investor State Dispute Settlement (ISDS) has surfaced in the EU as a focus of political opposition to a possible deal with the United States. For campaigners both in EU member states and in the European Parliament the prospect of litigative companies on both sides using dispute settlement clauses to constrain the regulatory freedom of politicians have cast TTIP as a Trojan horse for lowering regulatory standards.

Defenders of TTIP and ISDS have argued that investor-state arbitration against expropriation of assets or unfair treatment are an integral part of Bilateral Investment Treaties (BITs) and many domestic legal systems. This is right, but misses the political point. As the flow of trade and investment has evolved around these legal instruments over the last two decades, these protections have shifted politically in Europe from being a backstop against the nationalisation of European fixed assets abroad to being potential checks on the policy space to define and defend policy priorities at home.

The conclusion supporters of TTIP in business or government might draw from this debate is that TTIP's key rationale – that the EU and US markets are now so integrated that common approaches to market rulemaking make sense - is also its key political vulnerability. Political support for TTIP has always depended on the fragile political consensus that EU and US rules can be materially converged without being weakened, or political autonomy surrendered, and the ISDS debate has seriously upset that balance. Despite attempts by the European Commission to substantively rewrite ISDS rules to placate critics, the concept may yet be removed altogether from TTIP, which may or not save the deal

politically. But the wider reasons why it has proved so controversial in the TTIP context are worth understanding.

ISDS in theory

The apparently divergent political fortunes of ISDS inside and outside of TTIP are tell us something important. The Commission continues to argue for the need for ISDS, especially in jurisdictions where investment agreements are not directly enforceable by domestic courts. However it accepts the basic need to clarify and reassert the right to regulate for authorities in defined circumstances, updating the framework used in the hundreds of Bilateral Investment Treaties signed by EU member states over decades. As part of the process of migrating the negotiation of investment protection agreements to the European Commission under the terms of the 2009 Lisbon Treaty, the Commission proactively sought to update its negotiating template for ISDS and stamp its own worldview on the EU's approach to investor protection.

In November 2013 the European Commission proposed adaptations to the basic template for EU ISDS clauses in trade agreements and EU investment treaties (Fig 1). These reflect many of the basic criticisms of ISDS identified by UNCTAD and others, in particular the problems of inconsistent interpretation of law across states and cases, a lack of transparency and abuse of the system by aggressive multinationals. The Commission proposes to clarify the right to regulate and limit the scope of concepts of expropriation and to introduce a range of procedural safeguards and appeals mechanisms.

Assuming such innovations are accepted by EU trading partners – as they have been in the EU-Canada and EU-Vietnam agreements which road-tested them - this worldview moves a lot closer to that of many ISDS critics and substantively addresses key weaknesses of the ISDS concept. It has in fact alienated some business advocacy groups in its weakening of implied investor prerogatives. Certainly in the US-EU context they would add only marginally if at all to the protections provided by domestic law.

These revisions have been informally agreed with the European Council. They have also explicitly been agreed by European Parliamentarians who clearly saw them as a big step towards a more circumscribed and abuse-proof ISDS approach that protected the prerogatives of lawmakers. In April 2014, the European Parliament approved this template by a large majority of 535 votes to 119, including most of the Parliament's centre-left Socialists. And yet the Commission has clearly not neutralised the ISDS problem with the Parliament. Given that this is the basic template that the European Commission proposes to table in the TTIP negotiation, this would appear to suggest that the European Parliament supports ISDS in principle, but not in TTIP in practice. Why might this be?

Indirect expropriation	In future the Commission proposes to build into ISDS clauses a detailed set of provisions giving guidance to arbitrators on how to decide whether or not a government measure constitutes indirect expropriation. In particular, the Commission has implied that its view is that measures taken for public welfare objectives such as health, consumer protection or the protection of environment cannot be considered indirect expropriation. Similar concepts exist in WTO jurisprudence, provided the basic test of non-discrimination between foreign and domestic businesses in the application of new laws is met.
Fair and equitable treatment	The Commission is proposing greater precision on the definition of unfairness – chiefly manifest arbitrariness, coercion, duress or harassment, or failure to respect the fundamental principles of due process. The basic 'fairness' of the right to legislate would be explicitly clarified in the Commission's approach.
Conflicts of interests and consistency of arbitral awards.	The EU would introduce a binding code of conduct for arbitrators and an appellate mechanism to ensure consistency across awards over time.
Multiple claims	Proposed EU clauses would prohibit two claims on the same issue being brought at the same time before different tribunals.
Long shots	The Commission will propose that tribunals should be able to dismiss 'frivolous' or 'long shot' cases quickly, with all litigation costs borne by the losing party.
Treaty shopping	Tactically restructured investments involving shell companies would also not be covered by ISDS protections under the Commission approaches which would limit the scope for treaty shopping by disputants.
Transparency	Future EU ISDS clauses would also allow interested parties such as NGOs to attend hearings and would make certain case documents available to the public.

Fig 1. Proposed Commission tightening of ISDS rules in EU agreements 2014
Source: *European Commission*

ISDS in practice

The answer is more than just parliamentary advocacy under NGO pressure and is a reflection

of what makes TTIP itself unusual in trade policy terms. TTIP's problem in this respect is the way in which negotiating vis a vis the US has turned investor protection from an insurance policy for European assets or interests abroad to a material threat the autonomy of European lawmakers in exercising legitimate regulatory preferences at home. This question was rarely asked of bilateral investment treaties signed with dozens of less developed markets over the last five decades. In these cases the prerogatives of inward fixed capital flows or services trade *into* the EU were something of an academic question.

The US, in 2014, with $1.5trn in FDI stocks in the EU and $150bn in services exports to the EU annually, is clearly a different proposition. The EU and the US between them account for three times more ISDS challenges than the rest of the world put together and EU states have been challenged in 117 cases although almost 90 of these were intra-EU disputes according to UNICEF, and almost a quarter of them have been targeted at the Czech Republic alone. EU states have won half of the resolved cases brought against them; the US has lost none. US investors have launched 9 cases in the EU, all against post-Soviet Member States, typically over license revocations or expropriations.

The problem for TTIP is not so much this (relative) evidence of a willingness to litigate – although EU states are statistically much more likely to be sued by companies from other EU states than US ones – but some very sensitive political prerogatives. In particular, the worry that trade competition might undercut universal service provision, or import aggressive commercial practices into markets for public services. The fear that companies might hold lawmakers hostage in a way that prevents them setting – for example – ambitious environmental standards, has also been a staple of advocacy.

This is in itself an interesting reflection of the commercial and trade policy reality behind the launch of TTIP in the first place. The Transatlantic market is characterised by low levels of tariff protection, high levels of investment penetration and very high levels of service trade. Inevitably this highly integrated market has begun to push up against sensitive areas of public procurement, healthcare and education. These are areas where the barriers to trade competition are rules rather than tariffs, and especially in the EU case, often contiguous with the boundaries of the social welfare state and sensitive markets for public services. Hence the ease with which fears can be stoked about the possible impact of ISDS in TTIP on the UK public health service or state education, for example.

Again TTIP's express rationale fuels the problem. The negotiation's focus on regulatory convergence has made it easy to raise concerns about the challenge to statutory or normative frameworks. Alert to this, negotiators on both sides have protested that laws already on the books – from the EU's precautionary principle in consumer protection and GMO rules to the US Dodd Frank financial markets regulatory package – are not up for negotiation. Nevertheless, practical-minded businesses on both sides have understandably assumed – and said - that this is precisely what regulatory convergence should mean, and have been frustrated accordingly.

In the minds of TTIP critics, ISDS is another front in the same potential encroachment on EU public policy space, but more worrying in its apparent ability to challenge domestic policy through the mechanism of tribunals. They point to pending cases of ISDS clauses in the Energy Charter Treaty, NAFTA and BITs to claim compensation for changes to energy and tobacco policy in Germany and Australia and contest fracking bans in Canada – although in none of these cases were changes to the law sought or offered, and in none of them no compensation was yet been awarded. But the prospect of additional disincentives for challenging commercial interests in environmental frameworks in particular is clearly an area where TTIP critics will need reassurance.

The new European Trade Commissioner Cecilia Malmström has refused unilaterally to withdraw investor protection clauses from TTIP under European Parliament pressure. Malmström knows that if she caves in to demands to remove ISDS in this case not only will the US extract a negotiating price from the EU, but she will struggle to return it to the table in subsequent negotiations with China and others. She also knows that carving ISDS out of TTIP could simply provoke the European Parliament – whose support is required to ratify such deals, and whose left and centre-left majority could in principle stall a deal - to demand the same from the yet-to be ratified EU-Canada CETA, the EU-Singapore FTA or the close-to-finalised EU-Vietnam FTA.

She faces a tough battle to convince the European Parliament (and her European Commission colleagues, especially Vice President Frans Timmermans, who has been given the task of overseeing the issue, but who his broadly

sympathetic to the concept) that sufficient protections are in place in ISDS clauses to preserve European regulatory autonomy, especially in sensitive markets for public services. She is also walking a fine line politically in Member States, where the perception that the European Commission is inserting itself into sensitive areas of domestic policy such as healthcare and education via an ambiguous EU trade policy mandate could not be worse timed, especially in the UK.

Interests and incentives

The ISDS debate reflects a wider reality of EU and US commercial interests in trade policy. EU and US trade flows are now heavily characterised by exported fixed capital and the kinds of trade in services that are constrained not by tariffs but by rules and regulatory practice. This means EU and US trade policymakers are now consistently finding themselves seeking from trading partners sophisticated commitments on market frameworks, rules of establishment and operation and regulatory practice that trading partners are often unwilling – or feel no imperative given their existing access to EU and US markets for their key interests in goods exports - to concede.

As capital outflows and services exports from the emerging world rise, the willingness to deal on these issues to secure protections or access for their own interests may rise, but for now interests are often mismatched. These 'modern trade policy' questions have limited traction at the WTO level, which is in large part why Washington in particular has opted for alternatives like the Trans-Pacific Partnership (TPP) where it can set the thematic scope and the ambition.

Part of the rationale for TTIP was that at least in the case of the Trans-Atlantic market the commercial incentives to write sophisticated protections for investment and embed high levels of regulatory convergence for services trade are well matched. Watchers of TTIP have often assumed that biggest challenges to the deal would be practical obstacles related to getting parochial regulators on both sides to engage. The ISDS debate suggests another set of more explicitly political problems. Without politically nimble handling the same incentives to deepen and merge the regulatory 'zone' of the North Atlantic though negotiation can and will work against the same deal by appearing to critics to sideline voters and lawmakers.

If and how Commissioner Malmström and her allies are able to defuse this debate will depend on a number of things. The Commission will need to convince campaigners (as it has had to do in previous debates over the GATS) that WTO and EU rules carve out public service provision such as public healthcare from trade disciplines and leave states with wide regulatory prerogatives, typically provided foreign and domestic companies are subject to identical treatment. They will also need to insist that the EU's revised approach does much to close the scope for abuse of the ISDS concept.

Creative and motivated lawyers will inevitably be able to present claims, and in the EU and US context have recourse to domestic law for breach of contract issues in any event. Nevertheless, the Commission's revised template is a genuine attempt to tighten the legal framework, remove the scope for tenuous claims of injury and make ISDS more transparent. Malmström's challenge will be driving these points home in an environment of unprecedented political scepticism of the conduct of multinationals. Her handling of the current public consultation on ISDS in TTIP which concludes in November will be important to watch.

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