The Evolution of Investment Liberalization under the recent Investment Treaties[*1]

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Abstract

Investment liberalization under investment treaties is defined in terms of the expansion of the definition of investment, expansion of the scope of matters subject to substantial provisions, and expansion of the scope of matters subject to dispute settlement (scope of potential investors and damage suffered in pre-establishment activities). In particular, investment treaties and investment chapters of free trade agreements (FTAs) and economic partnership agreements (EPAs) concluded in recent years have made progress in developing substantial rules intended to lower entry barriers that obstruct investment liberalization, such as restrictions on foreign investment.

However, in order to make investment liberalization more substantive, it is necessary to establish and improve institutional systems between Contracting Party States because there are limits to the pursuit of liability (damage claims) by investors using the investor-state dispute settlement (ISDS) provision, which has until now been used as a means to address the violation of investment treaties on established investment.

Keywords: investment treaties (investment agreements), free trade agreements (FTAs), economic partnership agreements (EPAs), investment liberalization, restrictions on foreign investment, performance requirements, ISDS provision, ICSID Convention

JEL Classification: F02, F21, F23

I. Introduction

Since the 1990s, the rules based on the treaties between related countries has been widely developed regarding foreign direct investment, which is an economic activity in a foreign country by a private person (natural or legal person) of another country. In this paper, these treaties are referred to as the “investment treaties”. Investment treaties have been concluded primarily as bilateral treaties (bilateral investment treaties, BITs) .

The BIT provides for the treatment of an investor (national) of a Contracting Party State who establishes an investment in the other Contracting Party State. Since each BIT is concluded through bilateral negotiations, the details of the provisions differ from treaty to treaty. However, many countries have developed model treaties, and refer it. Alternatively, some countries refer to a previous treaty. These provisions are common to a certain extent. And

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many BITs contain most-favored-nation provisions, therefore differences in provisions may be meaningless to a certain extent. BITs generally provide for definitions (scope of the treaty), most-favored-nation status, treatment of investors in the treaty partner country (national treatment, fair and equitable treatment and full protection), expropriation conditions, resolution of investor-State disputes, and resolution of State-to-State disputes.

Many traditional BITs aim to "promote and protect" mutual private investment. However, with respect to the treatment of investors, it is a "protective type" treaty which provides for the treatment of investors of a Contracting Party State after they have established investments in the territory of the other Contracting Party State. The conditions for accepting foreign investments are, in principle, left to decisions in accordance with the domestic laws of the host country. In recent years, "liberalized type" BITs have also been concluded. These treaties contain provisions to reduce barriers to entry for private investment from partner countries. These "liberalized type" investment treaties sometimes take the form of investment chapters in free trade agreements (FTAs) and economic partnership agreements (EPAs).

The provisions of the "liberalized type" investment treaty shall also apply to a "potential investor" prior to the establishment of an investment. In this situation, entry barriers that are inconsistent with the provisions agreed in the investment treaty are subject to violation of the treaty. However, there are some limitations for potential investors to recourse dispute settlement based on the investor-State dispute settlement (ISDS) provision. Because the ISDS provision is provided for the dispute between an investor of a Contracting Party State and a host country (another Contracting Party State) under the investment treaty. In the strict sense, a potential investor has not invested or established an investment, so they cannot be subject to the treaty. Such problems are addressed by the expansion of the investment definition. The definition deals with "Establishment, acquisition and expansion" of investments. However, even if investment treaty has such definition, i.e. potential investors also are treated as investors, sometimes they may not be subject to dispute resolution under the ISDS provision. ISDS procedures assume damages on investments. Therefore, potential investors who have not made an investment may not be able to use the procedures.

If, despite the conclusion of a liberalized investment treaty, there remain barriers to entry to investment from the other Contracting Party State, measures other than the ISDS provisions are necessary to realize investment liberalization. Such measures may include dispute settlement procedures between States Parties and consultations between States Parties.

This paper analyzes and summarizes the provisions on investment liberalization under the investment treaty, and then considers measures to ensure the implementation of liberalization.

II. Liberalization of investment under the investment treaty

II-1. Barriers to investment

The liberalization of investment under the investment treaty is to reduce barriers to foreign investment. Therefore, it is necessary to analyze specific barriers to foreign investment. Entry barriers to foreign investment take many forms. Discriminatory regulations, such as imposing heavier requirements on foreign investors than on domestic investors and imposing arbitrary and excessive administrative procedures, are typical. Restrictions may be imposed on both foreign and domestic investors, as well as on discriminatory barriers to entry targeting only foreign investors. There are also direct and indirect barriers.

As a discriminatory barrier to entry, there are restrictions on foreign investment. In principle, the States have the right to determine the conditions for the entry and establishment of foreign investments in its territory. The States can control and restrict the entry and establishment of foreign investments as foreign investment regulations, and also restrict foreign ownership and control of domestic businesses. The entry control over access to the host-country's economy includes quantitative restrictions, registration, screening and monitoring, and conditional entry, and the performance requirements for local procurement and domestic economic development include cost sharing, special taxation, special guarantees, and capital and exchange restrictions[1]. The rules regulating foreign ownership and control of local business include quantitative restrictions on foreign ownership, mandatory transfers to local entities, and mandatory joint ventures or partnerships. There are also controls based on the limitation of shareholders powers, such as restrictions on shareholders rights and restrictions on the right to transfer the shares[2]. The controls based on governmental intervention in the running of the investment are also imposed, for example, direct governmental intervention in the management and restrictions on the management[3].

The regulations designed to protect national interests, like environmental and tax regulations, may also have a restrictive effect on the establishment of investments by foreign investors. These regulations usually apply indiscriminately to domestic and foreign investors. However, for legitimate domestic policy objectives, such as security, natural resource management, critical infrastructure, public health, environment and development, excessive and disproportional requirements may be imposed only on foreign investors[4].

Agreements between investors and host countries, such as various contracts, are also problematic. In particular, in the case of investment in natural resource development, concession agreements are often concluded in which host countries allow foreign investors to use their territories and other necessary state assets. In the case of investment in energy in-

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[1] Meguro (2017), p. 22

[2] *Ibid.*

[3] *Ibid.*

[4] OECD (2007), "Part I Chapter 3 Freedom of Investment, National Security and "Strategic" Industries: An Interim Report", pp. 53-63, "Part I Chapter 5 Essential Security Interests under International Investment Law", pp. 93-134

frastructure projects with public-private partnerships, BOT (Build-Operate-Transfer) and BOOT (Build-Own-Operate-Transfer) schemes are generally used. Under these contracts or agreements, the host country and investor agree on financing, design, construction and equipment operations for the period until the ownership of the project is transferred to the host country entity. The host country will provide land and other facilities necessary for the project. In addition, the host country agrees to purchase business products to enable the investor to recover their initial investment costs.

The investor and the host country conclude the mutually related some agreements, i.e. concession agreement, purchase agreement, performance agreement, implementation agreement and so on, to determine the conditions for entry into the investment. While the provisions of performance agreement impose certain performance obligations on the investor, the provisions of purchase agreement such as political force majeure guarantees clause and refund clause limit the right of the host country. The effect of these agreements as barriers to entry should take into account the overall agreements on rights and obligations between the investor and the host country.

In addition to the discriminatory barriers to foreign investors mentioned above, there are *de facto* barriers to entry by host countries that adversely affect foreign investors to establish investments. For example, such barriers include arbitrary application of regulations, process delays, lack of transparency, inefficiency, and excessive management procedures. These barriers usually affect investors as a whole, including domestic investors in specific business areas. These barriers arise from a lack of respect for the rule of law and from poorly designed regulations and institutions. Unlike the discriminatory barriers discussed above, *de facto* barriers are not consistent with the policy objectives, like development, of the host countries. The international organizations such as the World Bank, OECD and UNCTAD emphasize the importance of transparency and predictability in the regulatory and the investment environment of host countries to promote trade and investment[5]. Administrative burdens caused by inconsistent or inaccurate policies in host countries, the number of steps involved in the administrative decision-making process, and lack of clarity in administrative policy prevent investment facilitation[6]. A report by the World Bank also points out the impact of administrative costs on investment[7]. In particular, the administrative burden in developing countries is large scale. According to the World Bank, there is an average of three times the difference between developing and developed countries in the procedures required to start an investment project[8]. The unpredictability of regulations in developing countries is also a concern for investors. According to a World Bank survey in 2004, 95% of enterprises report a gap between formal policies and their implementation, and investments in high-risk countries with regulatory unpredictability require returns at least 2 times greater than investments in low-risk countries[9]. The political and economic conditions of host countries also

[5] *See*, World Bank (2004), Jacobs and Coolidge (2006), UNCTAD (2013), UNCTAD (2014), OECD (2015-1)
[6] OECD (2015-1), pp. 39-45
[7] World Bank (2015)
[8] *Id*, pp. 167-230

have a significant impact on foreign investment. Investors spend a lot of money to set up investments, but they don't make money quickly. Investors bear significant risks assuming that the relevant regulatory and contractual conditions do not change during the investment project. As a result, situations such as national default and currency devaluations during economic crises pose significant political risks to investors[10]. In order to promote investment liberalization and promote foreign investment, it is necessary to legally regulate such entry barriers by international rules such as investment treaties. In addition to the hard laws such as investment treaties, the soft laws such as guidelines by relevant international organizations are also important[11].

II-2. Protection of pre-investment activities

The "protective type" investment treaty covers investments that have already taken place, *i.e.,* post-establishment activities. To regulate on entry barriers is therefore difficult. On the other hand, the "liberalized type" investment treaty serves as a regulation against entry barriers to foreign investment by covering activities prior to the establishment of investment. Pre-investment activities mean activities related to entry and establishment of investments in the territory of the host country[12]. Investors often take various steps before setting up an investment. In other words, investors assess risks and returns, apply for licenses and permits, conclude some relevant contracts with host countries, and conduct feasibility studies to conduct investment-related activities before entering into final investment contracts with host countries or establishing investments in the form of actual business operations.

In order for these activities to be covered by the investment treaty, the definition of "investments" or "making of investment" in the investment treaty may include the establishment of new investments, the acquisition of all or part of existing investments, or the transition to investment activities in various fields. For example, Energy Charter Treaty (ECT) Article 1 (8) provides that,

> (8) "Make Investments" or "Making of Investments" means establishing new Investments, acquiring all or part of existing Investments or moving into different fields of Investment activity.

And the 2012 US Model BIT refers to pre-investment activities in Article 3 of the National Treatment,

> 1. Each Party shall accord to investors of the other Party treatment no less favorable

[9] World Bank (2004), pp. 23-24
[10] For example, foreign investor had been effected in Argentine economic crisis case, *See*, Daseking, Ghosh, Lane and Thomas (2004), Hornbeck and Marshall (2003)
[11] However, there are some critical views on whether the provisions of the investment treaty will lead to an increase in foreign direct investment. *See*, Berger, Busse, Nunnenkamp and Roy (2013), Busse, Königer and Nunnenkamp (2010).
[12] Dolzer and Schreuer (2008), pp. 79-81

> than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.

The “establishment, acquisition and expansion” of investment is pre-investment activity. The expression “expansion of investment” has the function of connecting pre-investment and post-investment activities. In recent negotiations on investment treaties, Canada, and Japan, as well as the United States, which established the model BITs mentioned above, often take the approach of promoting liberalized investment treaties, including provisions on activities prior to the establishment of investment. For instance, Canada-Cameroon FIPA article 1 defines a Contracting Party’s investor as a Contracting Party’s national or enterprise that seeks to make an investment and is making an investment in addition to the Contracting Party’s national or enterprise that has made an investment. Article 10.2 of the Japan-Mongolia EPA (entered into force in 2016) defines investment activities as including “establishment, acquisition and expansion” of investment.

The negotiated investment chapters within regional economic integration also have such provisions. For example, the Trans-Pacific Partnership (TPP) Agreement (2016)[13] includes “establishment, acquisition and expansion” of investments in “National Treatment (NT)” “Most Favored Nation (MFN) Treatment” and “Performance Requirements (PRs)”. A similar provision exists in Chapter 14 of the Agreement among the United States, Mexico, and Canada to Replace NAFTA agreed in November 2018, and came into effect in July 2020 (USMCA, NAFTA 2.0)[14]. Furthermore, the Central American Free Trade Agreement (CAFTA) and the Southern African Development Community also have similar provisions.

On the other hand, the EU and developing countries are taking the approach of promoting the conventional “protective type” investment treaty. These approaches do not address the establishment, acquisition or expansion of investments. However, even in these cases, there are examples of provisions regarding “right to establish” or mutual commitments to permit “admission” and expansion of non-discrimination, transparency, fair and equitable treatment and investment facilitation to foreign investment entry. Some recent FTAs concluded by the EU include protection in establishing investment in the chapter on establishing services or market access.

As stated above, where pre-investment activities are included in the scope of the investment treaty, each Contracting Party State is obligated to accord certain conditions of treatment to pre-investment activities by potential investors of the other Contracting Party State, such as national treatment at the stage of entry, most-favored-nation treatment and restrictions on performance compensation.

[13] TPP Full Text available on the United States Trade Representative Website at https://ustr.gov/trade-agreements/free-trade-agreements/trans-pacific-partnership/tpp-full-text

[14] Agreement between the United States of America, the United Mexican States, and Canada 05/30/19 Text, Chapter 14 Investment, Article 14.4 National Treatment, Article 14.5 Most-Favored-Nation Treatment, Article 14.10 Performance Requirements, available at https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/14_Investment.pdf

II-3. Disciplines on Entry Barriers

As noted in an earlier section, States have the sovereignty to control and regulate the entry and establishment of foreign investors in their territory, the acquisition of new shares in domestic businesses, and the expansion of existing businesses. States should also balance investment conditions and development policies so that foreign investment is integrated into their local economies and contributes to national security and sustainable development. For this purpose, the State will consider reducing or eliminating discriminatory barriers to foreign investment, including quantitative restrictions on investment, economic demand testing, foreign ownership restrictions, joint venture requirements, and direct exclusion from certain economic activities. In order to reduce or eliminate de facto barriers to foreign investment, the State will also consider introducing international standards based on the rule of law[15].

The relevant provisions of the investment treaty on the reduction and elimination of these barriers to investment entry include national treatment (NT), most-favored-nation (MFN), no-performance requirements (no-PRs), market access and establishment rights, fair and equitable treatment (FET) and umbrella (compliance with obligations) clauses. Among these clauses, NT, MFN, no-PRs and right to market access and establishment clauses are related to the reduction or elimination of discriminatory barriers against foreign investors. And FET and umbrella clauses are related to *de facto* barriers.

The principle of non-discrimination under national treatment and most-favored-nation clauses is a principle used in various areas of international economic law[16]. The principle of non-discrimination has traditionally been used to remove trade barriers and promote trade liberalization. The most-favored-nation clause aims to harmonize conditions of international competition in trade, and the national treatment clause aims to remove trade barriers for foreigners. The principle of non-discrimination is also stipulated in the investment treaty as a standard of treatment for foreign investment, and investment by investors in the other country is guaranteed to be treated no less favorable than domestic investment or investment in a third country.

The NT and MFN clauses in investment treaties, which include liberalization, require that domestic regulations on the investment of the investors of other Contracting Party State at the stage of entry shall not be less favorable than those on the investment of domestic investors or third country investors, and that pre-establishment activities by potential investors of partner countries shall be treated no less favorable than pre-establishment activities by domestic potential investors or third country potential investors. For example, Article 1102 of NAFTA[17] provides as follows as NT clause:

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[15] *See*, Franck (2007)
[16] *See*, Diebold (2011)
[17] As noted above, NAFTA has been replaced by the USMCA on July 1, 2020, but Chapter 11 of NAFTA has a significant impact as a model for other investment treaties. Therefore, NAFTA is taken as a representative example.

1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

2. Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

Article 1103 of NAFTA also provides as follows as a MFN clause:

1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to investors of any other Party or of a non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

2. Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of investors of any other Party or of a non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

Some recent BITs and EPAs in Japan contain similar provisions[18]. When the definition of "Investments" or "making an investment" includes the "establishment, acquisition and expansion" of investment, even if the NT and MFN clause does not list specific activities related to investment, such activities prior to the establishment of the investment are also covered. The EU approach to FTAs and EPAs is slightly different, and the establishment of investment or market access is treated as a trade in services issue similar to the third mode of GATS. Therefore, investment liberalization is not addressed in "investment treaty" but in FTAs and EPAs that provide for liberalization of trade in services.

Performance requirements of investments require investors to meet specific targets for their operations in the host country[19]. A local content requirement is a typical type of performance requirement. The prohibition of performance requirements is also discussed in the WTO and is stipulated in the Trade Related Investment Measures (TRIMs) Agreement. Performance requirements related to technology transfer are, in principle, permitted, but local procurement requirements and import/export restrictions are in violation of the WTO agree-

[18] Since the late 2000s, many of the liberalized BITs and investment chapters in the EPA signed by Japan are this type investment treaty. METI Website (in Japanese), Trade Policy, EPA/FTA/Investment Agreement "Comparative Table of Agreement Elements" available at https://www.meti.go.jp/policy/trade_policy/epa/file/element.xls

[19] *See,* Nikièma (2014), Genest (2019)

ments, i.e. Article 3.4 of the GATT and Article 2.1 of the TRIMs Agreement.

The investment treaties also have the provisions related performance compensation. The reasons for imposing performance requirements on foreign investors include overcoming information asymmetries in the market, distributing economic benefits to the nationals of host countries, and correcting distortions and other market failures through government intervention. In developing countries in particular, local economies can be revitalized by requiring foreign investors to procure locally as part of a long-term development strategy.

However, the effectiveness of PRs for sustainable development is controversial. According to UNCTAD, some studies have found that local procurement requirements are costly and inefficient in terms of resource allocation and growth, while others have found that local procurement requirements are being used as an effective tool to correct information asymmetry and improve regional capacity[20]. Performance requirements aim to distribute the benefits of foreign investment more widely, including local services, labor and product suppliers, but may actually create rent-seeking to benefit small and organized interest groups rather than a broad public distribution. According to an OECD study, local procurement requirements for renewable energy, such as solar and wind power, may hinder international investment flows from a global value chain (GVC) perspective[21]. It is believed that local procurement requirements not only undermine the investment environment by reducing competition and causing efficiency losses, but also distort trade and adversely affect global competition.

Although performance requirements have an aspect that contributes to the economy of developing countries, it is regulated by various international economic conventions because it is recognized as having an adverse effect on the international economy, and it is explicitly prohibited by investment treaties including investment liberalization. For example, Article 1106 of NAFTA provides as follows;

> 1. No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory.

And that list the prohibited performance resources. Similarly, the BITs and investment chapter of the EPA in Japan include provisions regarding the prohibition of performance requirements. For example, Article 5 of the Japan-Colombia BIT signed in September 2011 and entered into force in September 2015 restricts performance requirements.

The "Promotion and Protection" and umbrella clauses of the investment treaties govern the de facto barriers to regulation by the host country, such as its application in an arbitrary manner, complexity, inconsistency and excess relative to regulatory objectives. The former re-

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[20] UNCTAD (2003), p.8

[21] *See,* OECD (2015-2)

quires that appropriate permits be granted to host countries for the realization of investments by investors of the other Contracting Party State after they have been approved. The latter may extend to pre-investment activities related to the performance of investment contracts.

There is room for debate as to whether the scope of the fair and equitable treatment clause extends to pre-investment activities, but the lack of protection and transparency from the arbitrary treatment of investors may constitute a breach of fair and equitable treatment[22]. However, under Japan's BITs and EPAs, pre-investment activities are explicitly excluded from the scope of the fair and equitable treatment clause.

II-4. Exceptions Clause

In order to ensure both legal stability against foreign investment and national interests such as sustainable development and security, some investment treaties provides for an exception to the aforementioned provisions on investor and investment treatment in other countries. The purpose of the exceptions clause in the investment treaties is to harmonize national development policies with the treaty obligations to reduce and eliminate barriers to foreign investment. The exceptions clause in the investment treaty include exceptions to the scope of investment protection, reservations to non-conforming measures, reservations to the ISDS provision, and security exceptions.

Exceptions to the scope of investment protection of an investment treaty limit the scope of the investment treaty by the positive list method, which lists the sectors to be liberalized, or the negative list method, which excludes specific sectors from liberalization[23]. The positive list approach is similar to that used in the market access provisions of Article 20 of the General Agreement on Trade in Services (GATS) of the WTO. GATS obligations do not apply unless the department is scheduled. An example of a negative list approach, on the other hand, is Article 7 (10) of the EU-Korea FTA. It provides as follows;

> With a view to improving the investment environment, and in particular the conditions of establishment between the Parties, this Section applies to measures by the Parties affecting establishment in all economic activities with the exception of:

and then specifies the economic activities to be excluded as follows;

> mining, manufacturing and processing of nuclear materials;
> - production of, or trade in, arms, munitions and war material;
> - audio-visual services;
> - national maritime cabotage; and
> - domestic and international air transport services, whether scheduled or non-sched-

[22] *Waste Management v. Mexico (II)*, Award on 30 April 2004, para. 98, *Glamis v. United States*, Award on 8 June 2009, para. 605.
[23] Mann (2007), pp. 3-5

uled, and services directly related to the exercise of traffic rights, other than:
(i) aircraft repair and maintenance services;
(ii) the selling and marketing of air transport services;
(iii) CRS services; and
(iv) other services auxiliary to air transport services, such as ground handling services, rental service of aircraft with crew and airport management services.

The TPP agreement (and also TPPCP agreement) stipulates, in principle, "liberalization" and the negative list approach is adopted. Annex I of the TPP Agreement contains a list of reservations with a ratchet obligation (standstill obligation), which allows deregulation in the direction of promoting liberalization in the future but does not allow stricter regulation, and Annex II contains a list of reservations without a ratchet obligation (comprehensive reservation).

A reservation clause for non-conforming measures in investment treaties enables a Contracting Party State to make a reservation for an entire sector that may be inconsistent with its obligations under the investment treaty or to exclude existing laws and measures. Some investment treaties allow these only if they exist prior to the conclusion of the treaty.

There are also investment treaties that explicitly exclude pre-investment activities from the ISDS provisions. For example, the issue of whether the ISDS provision should cover disputes involving pre-establishment rights was also a point of contention in the 1998 OECD Multilateral Investment Agreement (MAI)[24]. In many cases, "protective type" investment treaties do not cover pre-investment activities as a whole. Even in investment treaties that expand the scope of disciplines prior to the establishment of an investment, such as the "liberalized type," there are cases where the application of dispute resolution procedures is limited to post-investment activities. For example, while the Japan-Brunei EPA expands the protection of the investment treaty prior to the establishment of an investment, the ISDS provision (Article 67 (6)) provides "A disputing investor may not submit to conciliation or arbitration referred to in paragraph 4 an investment dispute with respect to the establishment, acquisition or expansion of its investments" and excludes pre-investment activities from conciliation and arbitration based on the ISDS provision.

Security exceptions in investment treaties aim to harmonize national interests with investment protection[25]. The security exception is also stipulated in Article 21 of the GATT in the WTO. As an interpretation of Article 21 of the GATT, the applicability of the requirements has been considered in principle to be a self-judging of a State which is invoking such exception, but in recent cases, the WTO dispute settlement panel has been found that it is subject to panel review[26]. There is a possibility that investment treaty arbitration will review

[24] *See*, Multilateral Agreement on Investment documents on the OECD Website, at https://www.oecd.org/investment/internationalinvestmentagreements/multilateralagreementoninvestment.htm
[25] Henckels (2019), pp. 319-340. *See also,* OECD (2018)
[26] *Russia Measures Concerning Traffic in Transit*, WT/DS512/

to cases where any measure regarding investment is claimed as a security exception. Whether a measure taken by a Contracting Party State that is a host country meets the requirements for being recognized as an exception may also be determined in the dispute settlement procedures under the ISDS provisions of the investment treaty.

III. Ensuring the implementation of liberalization under the investment treaties

III-1. Investment treaty arbitration and its limitations

As a means of ensuring the implementation of the provisions of an investment treaty by a Contracting Party State, first of all, there is the procedures of the ISDS provisions of the investment treaty by the investor of another Contracting Party State. Any failure, non-compliance or breach of duty by a host Contracting Party State to the provisions of the investment treaty shall be brought to account by the procedure of the ISDS provisions of that investment treaty for the investor who has suffered as a result of such failure.

However, disputes concerning pre-investment activities related to investment liberalization raise issues of jurisdiction. In principle, the scope of jurisdiction *ratione materiae* (subject-matter jurisdiction) shall be determined by the intent of the Contracting Party appearing in the definition of "investment" in the applicable investment treaty.

In addition, if the International Centre for Settlement of Investment Disputes (ICSID) is to be used as an arbitration procedure, it must meet the "legal dispute" and "investment" requirements of Article 25 of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention)[27]. And where ICSID arbitration is used, it is necessary to determine whether pre-investment activities are within the scope of the jurisdiction, even if the applicable investment treaty explicitly includes pre-investment activities. Disputes over activities at a stage prior to the establishment of legal relationships, such as investment contracts, between investors and host countries may not be subject to ICSID arbitration "legal dispute"[28].

Also, with regard to the "investment" requirement, the wording of Article 25 of the ICSID Convention itself does not define investment, and the discussion on the scope of "investment" has not been settled. Pre-investment activities were not discussed during the drafting stage of the ICSID Convention[29]. In past cases where ICSID arbitration has been used, it is evaluated that it has been established as a "judicial precedent" in which activities prior to the establishment of an investment alone do not constitute an "investment" as a requirement of jurisdiction[30].

However, there are also arbitration cases suggesting that pre-investment activities may meet the "investment" requirements, unless explicitly excluded by the applicable investment

[27] *See*, Schreuer (2009), pp. 14-210
[28] Id., pp. 41-82
[29] Id., pp. 134-136
[30] McLachlan, Shore and Weiniger (2007), p. 178

treaty. In the case of *Mihaly v. Sri Lanka*, which is considered to be the leading case in this issue, the tribunal concluded that the expenses associated with activities prior to the establishment of an investment do not constitute "investment" but it does not generalize this conclusion and states that "in other circumstances, similar expenditures may be considered investments"[31]. In many cases of arbitration, the conclusion of an investment agreement is regarded as a *prima facie* criterion of "investment establishment" and the pre-contract documents (e.g. Letter of Intent, LOI[32]) are judged to satisfy the "investment" requirement based on the consent of the disputing parties[33], whether or not they are legally binding[34], and whether or not they have any monetary value[35].

Thus, if a dispute arises after the establishment of an investment, the activities before the establishment of the investment can be covered by arbitration under the ISDS provision. On the other hand, if a dispute arises before the establishment of an investment, if ICSID arbitration is used in the ISDS provision, it is highly likely that it will be out of jurisdiction. However, it is difficult to clearly distinguish between pre-investment and post-investment activities. The establishment of investment in business activities is seen as a series of processes from the preparatory stage to the actual implementation of the project. In such business activities, uncertainty as to whether or not pre-investment activities are subject to the protection of investment treaties increases investment risk and can be an entry barrier to investment liberalization.

When a procedure other than ICSID arbitration, such as an arbitration procedure in accordance with the arbitration rules of the United Nations Commission on International Trade (UNCITRAL), is used, the case will be judged only by the provisions of applicable investment treaties. Where the provisions of an investment treaty include "establishment, acquisition and expansion" of investment, the pre-investment activities are also within the scope of the jurisdiction *ratione materiae*.

In addition, the expenses associated with pre-investment activities in calculating damages are also a problem. Whether compensation can be awarded for expenses associated with pre-investment activities depends on the specific circumstances of each case[36]. Where applicable investment treaties contain provisions that include loss or damage prior to the establishment of an investment, the calculation shall be made accordingly to such provisions[37]. In addition, if an investment agreement is subsequently concluded and there is a provision in that agreement that covers "all losses and damages", the expenses associated with activities prior to the establishment of the investment will also be subject to compensation for damages. In the absence of such provisions, the calculation of damages will be based on whether there is

[31] *Mihaly v. Sri Lanka*, Award on 15 March 2002, para. 49
[32] Prior to the conclusion of the final investment agreement, documents called Letter of Agreement (LOA), Letter of Extension (LOE) and Protocol of Intent (POI) are exchanged.
[33] *Mihaly v. Sri Lanka*, *Zhinvali v Georgia*
[34] *Generation Ukraine v. Ukraine*, *Petrobart v. Kyrgyz*
[35] *Nagel v. Czech*
[36] *See*, Ripinsky and Williams (2008)
[37] *Autopista v, Venezuela*, Decision on Jurisdiction 27 September 2001, para. 263

a causal relationship between damage and specific (illegality) acts by the host country.

Thus, in cases where disputes have arisen after the establishment of an investment, there is not necessarily a distinction between activities before the establishment of the investment (potential investment) and activities after the establishment of the investment (investment). However, even if the applicable investment treaties do not explicitly provide for obligations for pre-investment activities, there are also arbitration cases in which investors are found to be harmed by pre-investment expenditures[38].

As described above, it is not impossible for potential investors at the pre-establishment stage to use investment treaty arbitration in connection with pre-establishment activities and expenditures, but there are very high hurdles at the jurisdiction stage. In addition, if one of the Contracting Party States imposes restrictions on entry into investment despite the fact that a liberalization-based investment treaty has been concluded, it would be difficult for nationals (potential investors) of the other Contracting Party State to carry out activities prior to the establishment of investment, and it would be difficult to ensure liberalization through procedures under the ISDS.

III-2. State-State (inter-States) dispute settlement procedure in investment treaties

For investment treaties that provide for liberalization, it is likely that the procedures under the ISDS provisions will not be available even if the treaty is breached due to barriers at the entry stage. As a way to correct the violation of the provisions of the treaty on barriers to investment entry and realize investment liberalization, other than the use of the ISDS provision by "potential" investors, is dispute settlement between Contracting Party States (State-to-State Dispute Settlement, SSDS, Inter-States Dispute Settlement).

Many of the investment treaties contain an SSDS provision in addition to the ISDS provision. For example, Article 17 of the Japan-Ukraine BIT provides as follows;

> 1. Each Contracting Party shall accord sympathetic consideration to, and shall afford adequate opportunity for consultations regarding, such representations as the other Contracting Party may make with respect to any matter affecting the operation of this Agreement.
>
> 2. Any dispute between the Contracting Parties as to the interpretation or application of this Agreement, not satisfactorily adjusted by diplomacy, shall be referred for decision to an arbitration board. Such arbitration board shall be composed of three arbitrators, with each Contracting Party appointing one arbitrator within a period of thirty (30) days from the date of receipt by either Contracting Party from the other Contracting Party of a note requesting arbitration of the dispute, and the third arbitrator to be agreed upon as President by the two arbitrators so chosen

[38] *PSEG v. Turkey*

within a further period of thirty (30) days, provided that the third arbitrator shall not be a national of either Contracting Party.

3. If the third arbitrator is not agreed upon between the arbitrators appointed by each Contracting Party within the further period of thirty (30) days referred to in paragraph 2, the Contracting Parties shall request the President of the International Court of Justice to appoint the third arbitrator who shall not be a national of either Contracting Party.

4. The arbitration board shall within a reasonable period of time reach its decision by a majority of votes. Such decision shall be final and binding.

5. Each Contracting Party shall bear the cost of the arbitrator of its choice and its representation in the arbitral proceedings. The cost of the President of the arbitration board in discharging his or her duties and the remaining costs of the arbitration board shall be borne equally by the Contracting Parties.

There are two possible patterns of dispute settlement between Contracting Party States under the SSDS. Substitute the claims of a particular investor of a Contracting Party State to another State and in cases of disputes related to the operation of investment treaties. The latter is important in realizing liberalization. In other words, it is a claim for breach of obligations under an investment treaty that is distinct from the interests of individual investors.

In the case of the "liberalized type" investment treaty, in other words, when activities prior to the establishment of the investment are also covered, if the domestic laws of the (potential) host country are not sufficiently developed and become barriers to entry, violations of the investment treaty may occur before individual investors suffer damage. In that case, as mentioned above, no investor is actually making an investment, and it would be impossible to rectify the violation of the provisions on liberalization of the investment treaty of the (potential) host country through the ISDS procedure. Therefore, it is conceivable that the other Contracting Party State, which is not the (potential) host country, may seek rectification under the SSDS provision.

In practice, however, the use of dispute settlement procedures between Contracting Party State under the SSDS provisions has been very limited[39]. These are only cases raised on behalf of specific domestic investors and on interpretation of the text of the treaty. Even in the latter case, a dispute over "entry barrier" directly related to investment liberalization was not raised under the SSDS. However, the fact that there are cases raised concerning the interpretation of the wording of the investment treaty provision indicates that barriers to entry for foreign investment in a one Contracting Party State may be subject to the dispute settle-

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[39] For example, *Italian Republic v. Republic of Cuba*, *Republic of Ecuador v. United States of America*. *See also*, Gaukrodger (2016)

ment procedures between Contracting Party States under the SSDS provision as a matter of interpretation and application of provisions related to the liberalization of the investment treaty. If the dispute settlement procedures under the SSDS are important for the realization of investment liberalization, measures should also be taken to ensure their active use.

III-3. Consultative and negotiating systems between the Contracting Party States to the investment treaties

In some cases, an investment treaty provides that the interpretation and application of the provisions of the investment treaty may be considered in consultation procedures between the Contracting Party States. For example, Article 48 (1) of the Model BIT of Canada and Article 12 of the Model BIT of Colombia in 2007 provide such procedures. And, many BITs and EPAs concluded by Japan include such provisions, e.g. Article 11 (1) of the Japan-Hong Kong BIT, Article 14 (1) of the Japan-South Korea BIT, Article 152 (1) of the Japan-Mexico EPA, Article 146 (1) of the Japan-Malaysia EPA, Article 108 (1) of the Japan-Brunei EPA, Article 140 (1) of the Japan-Indonesia EPA, Article 161 (1) of the Japan-Thailand EPA, Article 177 (1) of the Japan-Chile EPA, and Article 117 (1) of the Japan-Vietnam EPA. Even in the absence of an independent consultation clause, the SSDS provision usually states that disputes concerning the interpretation or application of the treaty should first be resolved through consultation. Therefore, it is possible to consider the issue of interpretation and application of the investment treaty through consultations between the Contracting Party States.

Discussions and negotiations between Contracting Party States are important in reducing barriers to foreign investments because the reduction of barriers has a mutual character. The liberalization of investment will be promoted by reducing mutual barriers to entry of foreign investments through negotiations. In addition, if liberalization is agreed in the investment treaty, a mechanism to monitor and evaluate the state of regulations on foreign investment by the contracting parties will be necessary. For example, in the case of investment treaties, a similar system to the WTO Trade Policy Review System (TPRM) could be developed by developing consultation procedures among the parties[40].

IV. Conclusion

Liberalization of investment with investment treaties is provided by expanding the definition of investment, expanding the scope of substantive provisions, and expanding the scope of dispute settlement (including potential investors, damages in pre-investment activities, and so on). In particular, recent investment treaties and the investment chapters of EPAs/FTAs have developed substantive rules to reduce barriers to investment liberalization,

[40] Although independent to the investment treaty, UNCTAD has a similar approach as Investment Policy Monitor. See UNCTAD Website at https://unctad.org/en/pages/publications/Investment-Policy-Monitor.aspx

such as regulations on foreign investment.

However, in order to make investment liberalization effective, there is a limit to the use of the ISDS provision, which has been used as a system against violations of investment treaties, to demand liability (compensation for damages), and it is necessary to establish and develop some system between the Contracting Party States. In addition, there is a limit to the liberalization of investment under the investment treaties, which has been concluded mainly as a bilateral treaty. It is desirable to establish international rules and international cooperation systems on investment liberalization in the "multilateral forum" such as the World Bank, OECD, UNCTAD, and WTO[41]. In such cases, it is necessary to consider not only rules for promoting investment liberalization itself, but also ensuring "transparency" in investment regulations and supporting the improvement of the investment environment[42].

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[41] One example is the initiatives in the Pacific Rim. *See*, Feldman, Monardes Vignolo and Rodriguez Chiffelle (2017), *See also* Sauvant and Chen (2013)

[42] *See*, Jacobs and Coolidge (2006)

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