

Bilateral investment treaties treatment of international capital movement: time for reform?

Hussein, Amr Abbas Mohamed Adel Abbas Aly

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Bilateral Investment Treaties Treatment of International Capital Movement: Time for Reform?

By

Amr Abbas Mohamed Adel Abbas Aly Hussein

Submitted for the Degree of Doctor of Philosophy

Supervised by Professor Takis Tridimas

Centre for Commercial Law Studies

Queen Mary

University of London

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Abstract

While the freedom to move capital is necessary for foreign investors, the power of the state to regulate capital transfers is necessary to prevent volatile capital from causing financial crises as well as to mitigate such crises when they occur. Thus, in regulating international capital movement, a balance should be made between the right to transfer funds and the state's right to protect the stability of its economy. It is in relation to achieving this balance that this thesis argues that bilateral investment treaties' (BITs) regulation of capital transfers is deficient, both substantively and procedurally.

On substance, this thesis identifies three substantive defects that affect obligations under BITs: absoluteness, immediacy, and breadth. First, many BITs adopt an absolute approach in liberalizing capital that does not permit any restrictions or exceptions, nor does it distinguish between different kinds of capital, or between the right to import capital and the right to repatriate capital. Second, the obligation to permit transfers is immediate and does not allow for a gradual liberalization of capital. Third, many BITs' terms and obligations are broad and therefore vague, such as the broad definition of investment, or the obligation to grant fair and equitable treatment, which is also broad and interpreted in a manner that restricts the regulatory powers of the host state.

Such results could have been partly mitigated if there were a dispute settlement mechanism with the power to create precedent and with it a clearer and more coherent body of rules. But BITs' investor-state arbitration is also deficient since it consists of ad hoc tribunals, which are not bound by precedent; and their decisions are not generally subject to substantive review. This leads to an inconsistent and incoherent body of law that protects neither the state's regulatory powers nor the legitimate expectation of investors.

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List of Abbreviations

BIT	Bilateral Investment Treaty
ECJ	European Court of Justice
FET	Fair and Equitable Treatment
FTA	Free Trade Agreement
GATS	The General Agreement on Trade in Services
ICC	International Chamber of Commerce
ICJ	International Court of Justice
ICSID	International Centre for Settlement of Investment Disputes
ILC	International Law Commission
IMF	International Monetary Fund
MAI	Multilateral Agreement on Investment
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
NT	National Treatment
OECD	Organization for Economic Co-operation and Development
OUP	Oxford University Press
SCC	Stockholm Chamber of Commerce
TRIMS	The Trade Related Investment Measures Agreement
UK	United Kingdom
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development

URR	Unremunerated Reserve Requirement
US	United States of America
World Bank	International Bank for Reconstruction and Development
WTO	World Trade Organization

Chapter One: Introduction

In the last three decades, financial crises have been cyclic in developing countries. Developed countries have also suffered from crises, perhaps most notably during the most recent global financial crisis.¹ Just as other financial crises that started in developing countries, there are two major characteristics of this most recent crisis: first, the minimal, or complete lack of, regulation of the market, or sector of the market, where the crisis started; and second, the liberalization of capital flows that led to the expansion of the crisis effect.² It is this latter characteristic that concerns this study.

The treatment of international movement of investment and capital is a controversial subject that is part of the debate over the relationship between the state, on the one hand, and private investment and business, on the other. This has always been controversial in the economic and political disciplines. It is correspondingly so in the legal discipline. It becomes even more complicated when the investment is foreign both politically—because of the different political interests involved, and legally—because international law in addition to national laws govern the state's regulation of the investment.

The regulation of international capital movement is not exclusively subject to national regimes. It is also subject to international law. It is thus important to analyze the international legal framework governing the movement of capital and the regulatory powers of the state.

One major characteristic of the existing international legal framework that applies to capital movement is that there are no comprehensive mandatory rules. No global multilateral treaty regulates international capital movement. No established principles exist in customary international law. The one multilateral treaty, the Articles of the International Monetary Fund, regulates movement of funds relating to current transactions and, by and large, leaves the

¹ In 2008, a credit crisis erupted in the United States and rapidly spread out to the whole global economy. IMF, *World Economic Outlook 2008: Financial Stress, Downturns, and Recoveries*, at 131-132 (IMF, 2008); see also UNCTAD, *The Global Economic Crisis: Systemic Failures and Multilateral Remedies* (UN, 2009).

² See UNCTAD, *supra* n. 1, at 4-18; see also chapter II.

regulation of capital movement to each country.³ It also does not have a mandatory dispute settlement mechanism nor does it permit individuals to seek remedies for its violation. Other multilateral treaties and instruments that deal with the capital movements are mostly not universal and are either regional like those of the European Communities, and/or lacking any enforcement mechanism as in the case of the OECD Codes of Capital movement.

Capital movements are also regulated under Bilateral Investment Treaties (BITs). In the last several decades, BITs have formed a complex web of treaties that apply to many international transactions. They play a paramount role in international investment law because of their dispute settlement mechanism. Although they are bilateral in nature, their effect is widespread because of their large number, the similar substantive obligations they impose, and the most favoured nation clauses they often incorporate. By the end of 2009, 2,750 BITs had been concluded worldwide.⁴ General features of this myriad of treaties include similar standards for the protection of investment, including the prohibition of expropriation of investment without compensation, and the regulation of issues of liquidation of investment and transfers of related capital.

In addition, most BITs include a dispute settlement mechanism that allows investors to seek remedies for any violation of their rights under BITs, or in relation to any dispute with the host state, through arbitration. The investor-state arbitration mechanism provided for in BITs does not require the investor's home state to raise the claim on behalf of investors. Arbitration can be initiated under BITs without further consent from the host state, on the basis that the host state has given its consent to arbitration in the treaty, and often without the requirement that local remedies have first been exhausted.

By consequence of the rights they grant, enforceable through binding investor-state arbitration, BITs have come to occupy the dominant position in regulating investment under international law. They have reduced investors' need to resort to their home state's diplomatic protection, as the International Court of Justice has noted.⁵ Accordingly, while there may be other treaties and

³ The IMF Articles only require the host state to impose capital controls in certain circumstances upon the IMF's request.

⁴ See UNCTAD, *World Investment Report 2010*, at 81 (2010).

⁵ *Case Concerning Ahmadou Sadio Diallo (Republic of Guinea v. Democratic Republic of the Congo)*, Judgement on Preliminary Objections, para. 88 (May 24, 2007) ("The Court is bound to note that, in contemporary international

instruments that regulate the movement of investment and capital in the international sphere, BITs are among the most important instruments that regulate the treatment of international investment and related capital. An analysis of the effect of any legal obligation or policy position adopted by BITs is, thus, important.

BITs generally impose obligations on the host state in relation to the treatment of investment and related capital. In that respect, investment is referred to broadly to include all kinds of assets and rights that have financial value. Correspondingly, the related capital subject to BITs is very broad in nature.⁶

This study examines the regulation of international capital movement under asymmetric BITs between developed and developing countries. It considers whether in regulating the transfer of funds these BITs have maintained a balance between the state's right to preserve its economy by regulating capital movement and the foreign investor's need to transfer capital related to its investment. It concludes that countries, especially developing countries, must be able to regulate international capital movements to prevent financial crises before they occur or to deal with their consequences after their onset. Notably, BITs were originally entered into in an asymmetric manner between developed and developing countries. Yet during the last decade many symmetric BITs between developing countries were made.⁷ These later BITs are not examined in this study.

During the last two decades, liberalization of capital movement was advocated by international financial institutions and many economic writings as the way to avoid distortions, and to promote efficiency in investment and economic growth. It is now apparent that there was little

law, the protection of the rights of companies and the rights of their shareholders, and the settlement of the associated disputes, are essentially governed by bilateral or multilateral agreements for the protection of foreign investments, such as the treaties for the promotion and protection of foreign investments, and the Washington Convention of 18 March 1965 on the Settlement of Investment Disputes between states and Nationals of Other states, which created an International Centre for Settlement of Investment Disputes (ICSID), and also by contracts between states and foreign investors. In that context, the role of diplomatic protection somewhat faded, as in practice recourse is only made to it in rare cases where treaty regimes do not exist or have proved inoperative.”), available at <http://www.icj-cij.org/docket/files/103/13856.pdf>.

⁶ See Chapter III.

⁷ See Rudolf Dolzer & Christoph Schreuer, *Principles of International Investment Law*, at 21 (OUP, 2008) (“ Within the past decade, the second key development is the fact that more and more developing states have negotiated BITs among themselves, altogether more than 600.”); UNCTAD, *International Investment Rule-Making: Stocktaking, Challenges and the Way Forward*, UNCTAD/ITE/IIT/2007/3, at 36 (UN, 2008) (“[B]y end 2007, more than 690 BITs had been concluded among developing countries, constituting about 27 percent of all BITs.”).

or no empirical evidence for this proposition. Nonetheless, BITs have led to the widespread liberalization of capital flows.

The main purpose of BITs is to protect and promote foreign investment. One aspect of their underlying rationale is that foreign direct investment can lead to the economic growth of the host state. In endeavouring to promote the free flow of capital needed for investment, asymmetric BITs generally provide for absolute, immediate, and broad obligations that cover all kinds of investment and capital. In doing so, they do not always distinguish between different kinds of capital, investment, investors or different circumstances of different countries.

What's more, asymmetric BITs do not explicitly provide for the host state's regulatory power to preserve its economy from volatile capital or to prevent and mitigate financial crises and balance of payment difficulties. This is notwithstanding that these exceptions explicitly exist in the main multilateral international treaties and instruments that deal with international movement of capital, such as the IMF Articles of Agreement.

The need for BITs emerged last century for political, economic and legal reasons. In this context, it is relevant to present a brief history of the relation between foreign investment and the host state which required this international law regulation. This will be followed with a brief description of the main trends as regards the treatment of capital movement under asymmetric BITs, the methodology of this study, and an outline of the thesis.

I. Necessity of BITs

During the colonial era, the colonies were governed (either *de jure* or *de facto*) by European and other colonial powers. When the merchants of colonial powers' were doing business in other countries during the eighteenth and nineteenth centuries, they had no need for international law protection under the theory that their nationals were not subject to the national laws and institutions of the host state. At that time under what were called "Capitulation Agreements" entered into with African and Asian countries, European and other developed countries investors and traders were not subject to local laws or judiciaries.⁸ In addition, developed countries used,

⁸ See Gus Van Harten, *Investment Treaty Arbitration and Public Law*, at 14-15 (OUP, 2007); Kenneth J. Vandavelde, *A Brief History of International Investment Agreements*, 12 U.C. Davis J. Int'l L. & Pol'y 157 (2005);

or threatened to use, force to protect their nationals' rights in other countries that they did not govern, to conclude international agreements and to adjudicate their nationals' claims by mixed arbitral panels.⁹

Last century, with the prohibition of the use of force in international economic affairs and the independence of African, Asian and Latin American countries, this changed. The main point of contention under international law was the control of the host state over its territory and property that existed in it. Particular bones of contention were whether the national treatment of foreign merchants was sufficient (i.e. that it was acceptable that foreign merchants were treated in the same way as domestic merchants) or whether there was a minimum standard that a foreign investor was entitled to under international law; as well as the principles governing the ability of a state to expropriate.¹⁰

Latin American countries sided with the Calvo Doctrine, under which a foreign investor was only entitled to treatment accorded to nationals. These countries also required foreign investors to give up all diplomatic protection from their home countries, and agree, in advance, that their sole remedy would be in the local courts of the host country.¹¹

At that time, customary international law maintained that there was a minimum standard that treatment of foreigners should not fall below, and that expropriation of foreign property must be for a public purpose and against the payment of prompt adequate compensation (the Hull Rule).¹²

Surya P Subedi, *International Investment Law: Reconciling Policy and Principle*, 7-8 (Hart Publishing Ltd, 2008); Jose E. Alvarez, *Contemporary Foreign Investment Law: An "Empire of Law" or the "Law of Empire"?* 60 Ala. L. Rev. 944, at 959 (2009). For example in Egypt until 1937, Europeans were not subject to local courts, but their disputes were decided by their home countries' Consular or a mixed court. See Stephen D. Sutton, *Emilio Augustin Maffezini v. Kingdom of Spain and the ICSID Secretary-General's Screening Power*, 21 *Arbitration International* 113, at 118-119 (2005).

⁹ See Harten, *supra* n. 8, at 15-16; Vandevelde, *supra* n. 8, at 160 (referring to U.S. practice in Latin America).

¹⁰ See Ian Brownlie, *Principles of Public International Law*, at 524-528 (7th ed., OUP, 2008).

¹¹ Georg Schwarzenberger & E. D. Brown, *A Manual of International Law*, at 144 (6th ed., Professional Books Ltd, 1976); Vandevelde, *supra* n. 7, at 159.

¹² See Kenneth J. Vandevelde, *Sustainable Liberalism and the International Investment Regime*, 19 *Mich. J. Int'l L.* 373, at 380 (1998); see also L. Oppenheim, *International Law: A Treatise*, at 641 (ed. H. Lauterpacht, 8th ed., Longmans, 1955) ([I]t is clear that the state is bound to respect certain fundamental rights of aliens resident within its territory"); Schwarzenberger & Brown, *supra* n. 11, 84 (noting that a minimum standard exists under international law to protect life, freedom and property of foreign nationals).

The first challenge to that customary international law on foreign investment (that is to say, the Hull Rule) was made by Mexico before World War II. The challenge emerged during the dispute between Mexico and the US over the expropriation of US nationals' property. The Mexican Minister of Foreign Affairs, relying on the Calvo Doctrine, contended that giving foreign investment better treatment than national investment would be a breach of the principle of equality. The Mexican Minister in a note dated August 3, 1938, declared explicitly that Mexico did not recognize the Hull Rule.¹³

Thereafter, newly independent developing countries continued their challenge to the then existing customary international law, primarily in the United Nations General Assembly through what became known as the New International Economic Order Resolutions. The UN General Assembly, in the 1960s and 1970s, issued many resolutions asserting the right of sovereign nations over their resources and their individual regulatory power over them.¹⁴ These resolutions, although not binding, reflected the positions of the newly independent countries. They departed from what was a well-settled customary international law relating to the treatment of foreign investors.¹⁵

By these efforts, developing countries brought into question the certainty over the Hull Rule as part of customary international law. In addition, there was an increase in the number of nationalizations and expropriation as newly independent countries sought to take back what, they alleged, the colonial powers had given away.¹⁶

Given the increased doubts over the extent of customary international law protection of foreign investment, the spread of expropriation, the rather weak or uncertain protection of private property, and generally, the weak rule of law in many newly independent states, it became necessary to devise a means to protect foreign investment.¹⁷ The state of the relevant customary international law was thus uncertain. There was no rule that protects a contract between an

¹³ Andrew T. Guzman, *Why LDCs sign Treaties That Hurt Them: Explaining the popularity of Bilateral Investment Treaties*, 38 Va J. Int'l L. 639, 646 (1998); Vandevelde, *supra* n. 12, at 380.

¹⁴ Peter Muchlinski, *Policy Issues*, in *The Oxford Handbook of International Investment Law*, at 4 (eds. Peter Muchlinski *et al.*, OUP, 2008).

¹⁵ Peter Muchlinski, *Multinational Enterprises and the Law*, at 618 (Blackwell Publishers Ltd, 1995); Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, at 11 (Kluwer Law International, 1995).

¹⁶ Guzman, *supra* n. 13, at 641, 647.

¹⁷ Stephan W. Schill, *The Multilateralization of International Investment Law*, 4-5 (Cambridge University Press, 2009).

investor and a host state under international law. The existing rules for the protection of foreign investment were ambiguous and they lacked consistent interpretation.¹⁸ Moreover, even if the existing international law rules protected foreign investment, there was no autonomous system for their enforcement.¹⁹

Meanwhile, a multitude of problems overwhelmed efforts directed at obtaining a multilateral agreement to protect and promote foreign investment. Private and public initiatives to conclude multilateral treaties to provide substantive protection to investment failed. The Organization for Economic Co-operation and Development (“OECD”) undertook work in the area of protecting and promoting foreign investment. That organization prepared a Draft Convention in 1967 on the Protection of Foreign Property, which was approved by all members through a decision.²⁰ However, the draft never came into force and was not even opened for signature. It did, however, serve as a model which most European BITs closely followed.²¹ This explains the similarities in substance between the European BITs.²² It is relevant to note, although as a something of an aside from this chronological account of events, that the OECD countries also initiated negotiations to enter into a multilateral investment agreement (MAI). The MAI negotiations failed in 1998 after strong opposition from different groups.²³

The 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other states, which established the International Centre for Settlement of Investment Disputes (ICSID),²⁴ was certainly a step towards some procedural regulation of investment. But it provided no substantive rules for the regulation of international investment.²⁵

These developments coincided with the increase of international capital movement and foreign investment in developing countries that took place in the 1970s. Between the early 1970s and

¹⁸ Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 Harv. Int'l L.J. 67, at 68 (2005); Guzman, *supra* n. 12, at 655.

¹⁹ Guzman, *supra* n. 13, at 655.

²⁰ *Draft Convention on the Protection of Foreign Property and Resolution of the Council of the OECD*, OECD Publication No. 23081(1967), reproduced in 7ILM 117(1968).

²¹ Dolzer & Stevens, *supra* n. 15, at 2-3.

²² *Id.*

²³ Peter Malanczuk, *state-state and Investor-state Dispute Settlement in the OECD Draft Multilateral Investment Agreement*, 3 JIEL 417, at 418 (2000).

²⁴ *International Convention for the settlement of Investment Disputes 1965*, entered into force on October 14, 1966.

²⁵ Andreas F. Lowenfeld, *Investment Agreements and International Law*, 42 Colum. J. Transnat'l L. 123, 125 (2003).

early 1990s, the increase of international capital movement was almost tenfold to developed countries and more than twentyfold to developing countries.²⁶ This puts into context the desire of developed capital exporting countries to restore the international law protection for foreign investment and ensure the freedom of capital movement.

Against this background, BITs began to become increasingly prominent in the international legal environment.²⁷ They can be understood as a policy reaction to the desire of developed capital exporting countries to provide substantive protection to their nationals' foreign investments.²⁸ The first BIT, made between Germany and Pakistan, entered into force on November 25, 1959.²⁹

Also, in this light, the 1980s and 1990s calls by developed countries and international financial organizations for the liberalization of international capital movements are not surprising.³⁰ The growth of capital movements, coupled with the prohibition of the use of force to protect national investment in other states, required an independent international law system that provides for substantive and procedural protection against the inherent risks of investing in developing countries.³¹ Starting in the mid 1980s, the prevailing neo-liberal ideology, advocated by the international financial institutions, entailed excluding government control and leaving the market as the leading and dominant power in the process of reform and encouragement of foreign investment.³²

Many developing countries, in the context of the scarcity of funds and capital flight that ensued in the 1980s, became convinced that capital brought by foreign investment was essential for their economic development.³³ Loans from international development organizations required that the

²⁶ Richard N. Cooper, *Should Capital Controls Be Banished*, Brookings Papers on Economic Activity vol No.1, at 97 (1999).

²⁷ Muchlinski, *supra* n. 15, 618. Indeed, one of the main reasons behind the initiation of the U.S. BITs program was to reiterate the existence of the Hull rule in state practice under customary international law and defeat the developing countries allegations and the UN General Assembly resolutions to the contrary. See Kenneth J. Vandavelde, *U.S. Bilateral Investment Treaties: The Second Wave*, 14 *MIJIL* 621, 625 (1993).

²⁸ Sol Picciotto, *Rights, Responsibilities and Regulation of International Business*, 42 *Colum. J. Transnat'l L.* 132, 136 (2003); Vandavelde, *supra* n. 12, at 382.

²⁹ Dolzer & Stevens, *supra* n. 15, at 1.

³⁰ See Picciotto, *supra* n. 27, 132.

³¹ Vandavelde, *supra* n. 12, at 382; Dolzer & Stevens, *supra* n. 15, at 11.

³² Tamara Lothian & Katharina Pistor, *Local Institutions, Foreign Investment and Alternative Strategies of Development: Some views from Practice*, 42 *Colum. J. Transnat'l L.* 101, at 114 (2003); Victor Mosoti, *Bilateral Investment Treaties and the Possibility of a Multilateral Framework on Investment at the WTO: Are Poor Economies Caught in Between?*, 26 *NW. J. INT'L L. & BUS.* 95, at 113 (2005).

³³ Vandavelde, *supra* n. 12, at 389.

recipient countries submit to strict conditionalities, which were themselves more drastic and painful to implement than any controls related to foreign direct investment.³⁴ In addition, the example of “the East Asian miracle”, which depended mainly on foreign investments, was an important factor in convincing developing countries of the importance of foreign investment.³⁵ The collapse of the Soviet Union also led most developing countries to discard planned economy and socialist strategies, and turn instead to free market system.³⁶

It was argued that to attract foreign investment developing countries should accept BITs. On the back of this argument, the number of BITs has surged to reach more than 2,750 such treaties worldwide. This in itself demonstrates the sea change in the way foreign investments and capital are perceived by developing countries. The desire to attract foreign capital, and the willingness to enter into BITs and issue laws to promote and protect foreign investment, is a radical change that has very significantly liberalised capital movements.³⁷ This change coincided with the liberalization of trade. Investment and trade are viewed as complimentary elements in the globalisation process of the world economy.³⁸

It should also be noted that the proliferation of BITs has not brought to a halt all multilateral efforts to regulate foreign investment and international capital movements. The Marrakesh Agreement establishing the World Trade Organization (WTO Agreement), of which an integral part is the multilateral trade agreement found in Annex 1,³⁹ includes some regulation of investment. The Trade Related Investment Measures Agreement (TRIMs), itself annexed to the WTO Agreement, restricts the imposition of some performance requirements by host states. The General Agreement on Trade in Services (GATS) seeks to reduce the barriers on the trade of services. In doing so, it regulates some aspects of investment. The GATS also imposes some

³⁴ *Id.* at 388-389. These conditions entailed adopting “strict macroeconomic structural adjustment policies that required painful reductions of budget deficits and currency devaluations.” *Id.*

³⁵ *Id.* at 389.

³⁶ *Id.* at 390; Robert Gilpin, *The Challenge of Global Capitalism, The World Economy in the 21st Century*, at 7 (Princeton University Press, 2000).

³⁷ Sabine Schlemmer-Schulte, *The World Bank Guidelines on the Treatment of Foreign Direct Investment*, in *Legal Aspects of Foreign Direct Investment*, at 88 (Daniel D. Bradlow & Alfred Escher eds., 1999)

³⁸ *Id.*

³⁹ The Marrakesh Agreement establishing the World Trade Organization, World Trade Organisation, *The Legal Texts, The Results of the Uruguay Round of Multilateral trade negotiations*, art. II (2) (Cambridge University Press, 1999) [hereinafter *WTO Agreement*].

restrictions on the imposition of capital controls against a Member's specific commitment.⁴⁰ One of the subjects of the Doha Round under the WTO was an investment agreement.⁴¹ The appropriateness and scope of the agreement remains at issue,⁴² and it is clear that the international regulation of investment and capital flows under the WTO umbrella is not yet settled.

II. BITs and Capital Movements

There are two separate targets pursued by asymmetric BITs, above and beyond the protection of foreign investment. The first is the promotion of foreign investment. Developing countries especially seek to attract foreign capital, technology and know how to advance their economic growth and development. The second is the liberalization of investment flows, which is desired principally by developed countries so as to allow their investors to select the investments they consider the most advantageous and/or profitable.⁴³

It is apparent from this that asymmetric BITs have as their objective somewhat more than a reinstatement of the Hull Rule in international law. Customary international law allows countries to regulate the entry of investment and capital as they see fit. It imposes no restriction on the state's powers to deny foreign investment the right to enter.⁴⁴ BITs, however, impose obligations with regard to capital movement related to investment which exceed anything that existed in customary international law. Many asymmetric BITs, including the German and US BITs, liberalize both inflows and outflows of capital related to investment. Most BITs do not interfere with the right of host countries to control the admission of investment.⁴⁵ They allow the host state to admit investment according to its laws and regulation, although many BITs do not require registration of the investment or other prior approvals from the host state. Some BITs (such as the UK BITs) grant the host state discretion to regulate the admission capital (i.e. inflows), but provide for the free repatriation of capital arising from investment (i.e. outflows).

⁴⁰ *WTO Agreement*, Annex 1B.

⁴¹ Doha WTO Ministerial 2001: Ministerial Declaration, WT/MIN(01)/DEC/1, (adopted on 14 November 2001).

⁴² WTO, Working Group on the Relationship between Trade and Investment, *Scope and Definitions: "Investment" and "Investor"* Note by the Secretariat, WT/WGTI/W/108 (21 March, 2002).

⁴³ Salacuse & Sullivan, *supra* n. 18, at 78-79.

⁴⁴ M. Sornarajah, *The International Law on Foreign Investment*, at 97 (Cambridge University Press, 2004); Don Wallace, Jr. & David B. Bailey, *Exceptions and Conditions: The Inevitability of National Treatment of Foreign Direct Investment with Increasingly Few and Narrow Exceptions*, 31 *Cornell Int'l L.J.* 615, 628 (1998).

⁴⁵ Picciotto, *supra* n. 28.

As will be discussed in detail below, the liberalization of capital flows is achieved through absolute, broad and immediate treaty obligations.

As indicated in the paragraph above, in its BITs, the US refused to distinguish between the right of investors to make investments in the territory of the host state and the protection of investment more generally. The US objective was to eliminate restrictions to establishing investments in the territory of treaty parties.⁴⁶ This was achieved by incorporating the principle of national treatment with regard to the right to enter the host state, together with a broad definition of investment embodied in most asymmetric BITs that includes foreign direct investment, portfolio investment and other kinds of investment and transactions.⁴⁷ Only a few business sectors were excluded from national treatment in these BITs.⁴⁸

Writings dedicated to the transfer of capital under BITs are few.⁴⁹ Hagan in an UNCTAD paper on transfers describes different transfer provisions under BITs in comparison with other multilateral agreements. He proposes the sequencing of liberalization, while maintaining temporary exceptions for balance of payment difficulties.⁵⁰ Waibel describes the relationship between BIT transfer provisions and exchange restrictions, and criticizes the liberalization in the absence of a balance of payment exception.⁵¹ Kolo and Wälde analyze the relationship between BIT obligations and exchange restrictions. They argue that while these restrictions may be legitimate in exceptional circumstances, they must be necessary, proportionate, non-discriminatory, and such that they will not cause severe hardship for the foreign investor.⁵² In addition, they argue that even if these conditions are met, exchange restrictions may be in violation of other BIT obligations such as fair and equitable treatment and the prohibition of

⁴⁶ Jose E. Alvarez, *Political Protectionism and United States International Investment Obligations in Conflict: The Hazards of Exon-Florio*, 30 Va. J. Int'l 1, 33 (1990).

⁴⁷ Mosoti, *supra* n. 32, at 116.

⁴⁸ Picciotto, *supra* n. 28, 137-138.

⁴⁹ See UNCTAD, *Transfer of Funds*, in UNCTAD Series on Issues in International Investment Agreements, UN Doc. UNCTA/ITE/IIT/20 (2000); Abba Kolo, *Investor Protection vs Host State Regulatory Autonomy During Economic Crisis: Treatment of Capital Transfers and Restrictions under Modern Investment Treaties*, 8 JWIT 457, (2007); Abba Kolo & Thomas Walde, *Capital Transfer Restrictions under Modern Investment Treaties*, in Standards of Investment Protection 205 (ed. August Reinisch, OUP, 2008); Michael Waibel, *BIT by BIT: The Silent Liberalization of the Capital Account*, in International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer 497 (eds. Christina Binder et al, OUP, 2009).

⁵⁰ See UNCTAD, *supra* n. 49.

⁵¹ See Waibel, *supra* n. 49.

⁵² Kolo, *supra* n. 49; Kolo & Walde, *supra* n. 49.

indirect expropriation. Also, most writings focus on restrictions on repatriation of capital, as opposed to admission of capital.

Gallagher's recent G-24 discussion paper analyzes the conflict between the US BITs' transfer provisions and the use of capital controls.⁵³ It recommends excluding short-term debt investment and portfolio investment from the application of BITs; allowing capital controls and balance of payments exceptions; and excluding investor-state arbitration in disputes relating to financial crises, instead having a system of state-to-state claims.⁵⁴

III. Methodology

This study takes an interdisciplinary approach, combining an analysis of economics and law. It surveys the economic debate relating to the liberalization of capital movement and analyzes the economic case for such liberalization, as well as the utility of capital controls. It proceeds to examine the role of asymmetric BITs between developed and developing countries in regulating international investment flows.

Asymmetric BITs have proliferated and exist in great number. Their provisions regulating transfers are often different. These factors limit the degree to which it is appropriate to generalize in terms of their study and analysis. For this reason, this study examines mainly three important groups of Model BITs and BITs: those of Germany, the UK and the US as representatives of asymmetric BITs. These countries were chosen for the following reasons:

- (i) Germany was the first country to conclude a BIT and is party to more BITs than most countries;⁵⁵
- (ii) both the German and UK Model BITs are representative of two types of BITs that grant discretion to states in admitting investment;

⁵³ Kevin Gallagher, *Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements*, G-24 Discussion Paper Series No. 58 (2010).

⁵⁴ *Id.* at 17-18.

⁵⁵ See UNCTAD, *Total number of Bilateral Investment Treaties concluded* (June 1, 2010), available at http://www.unctad.org/sections/dite_pccb/docs/bits_germany.pdf.

- (iii) the US Model BIT represents a different kind of BITs that imposes certain obligations on states in admitting foreign investment; and
- (iv) each of these groups of treaties represents a different approach to the regulation of capital transfers.

Each of the above countries has developed more than one Model BIT over time. This study focuses on the Model BITs used in the 1990s because: (1) this period was the time when the surge of entering into BITs started and (2) this period coincided with the prevalence of the liberalization of capital movement trend. The most recent US Model BIT of 2004 is also discussed because it represents a revised Model BIT devised by a developed country after it has had its own experience of investor-state arbitration.⁵⁶

While the analysis in this study starts with these models, BITs that follow the models and those that have different rules are also analyzed in order to identify and analyze the main trends in regulation of capital movements under asymmetric BITs.

As charted above, this study does not examine symmetric BITs (the so called south-south BITs), treaties or initiatives between developing countries, as well as other multilateral treaties, including regional arrangements and treaties.⁵⁷ Also, the subjects of human rights and

⁵⁶ In the case of the United States, under an investment chapter of a free trade agreement, namely the North American Free Trade Agreement (NAFTA).

⁵⁷ See for more details on south-south BITs UNCTAD, *South-South Cooperation in International Investment Arrangements*, UNCTAD/ITE/IIT/2005/3 (UN, 2005) (providing an overview of the south-south international investment agreements including BITs). While transfer of funds provisions in many south-south BITs tend to be more restrictive than in asymmetric BITs and allow more exceptions for balance of payment difficulties, these south-south BITs, generally, do not exclude the most favoured nation from applying to such provisions. This begs many questions including whether these provisions are effective. See Lauge Skovgaard Poulsen, *The Significance of South-South BITs for the International Investment Regime: A Quantitative Analysis*, 30 *Northwestern Journal of International Law & Business* 101, at 125-128 (2010) (examining national treatment and transfer of funds provisions in a sample of 303 BITs, of which 124 are symmetric BITs); see also Chapter V (discussing the application of MFN on different transfer provisions). A notable example of symmetric investment regional treaties is the Association of South-East Asian Nations (ASEAN) agreements on investment. See *ASEAN Agreement for the Promotion and Protection of Investments*, signed December 15 1987, (entered into force August 2, 1988); *Framework Agreement on the ASEAN Investment Area*, signed October 7, 1998, (entered into force May 25, 1999); *ASEAN Comprehensive Investment Agreement*, signed February 26, 2009. See for more details on ASEAN agreements, Kim Rooney, *Overview of the 2009 ASEAN Comprehensive Investment Agreement*, 4 DRI 169, (2010); Wisarn Pupphavesa, *Investment Liberalization and Facilitation: Contribution to the ASEAN Economic Community Blueprint, in Deepening Economic Integration in East Asia: The ASEAN Economic Community and Beyond* (ed. H. Soesastro, ERIA, 2008). Also, other symmetric treaties that aim at creating an alternative regime based on different ideological underpinnings from the free market system such as ALBA (Alternativa Bolivariana para los Pueblos de

corruption and their relation with liberalization of international capital movements, growth, and development under BITs are not examined in this study, which are discussed elsewhere.⁵⁸

IV. Theme and Structure

Asymmetric BITs state their support for the views that foreign investment brings economic growth, and that liberalization of investment is beneficial, in both non-binding statements in their preambles and in the form of legally binding obligations. Yet the relationship between foreign investment, economic growth and development is not simple. Foreign investment does not lead to economic growth and development by itself; this is not its main purpose; its main purpose is to make a profit. The component of liberalizing international capital movement in a market led development does not succeed without satisfying other conditions in the host state economy and its regulatory system. A balanced approach that recognizes the importance of the role of private investment, as well as the regulatory role of the state, in achieving development is warranted.

Neustra America) are not examined in this study. See for more details on ALBA, Larry Cata Backer & Augusto Molina, *Cuba and the Construction of Alternative Global Trade Systems: ALBA and Free Trade in the Americas*, 31 U. Pa. J. Int'l L. 379, (2010); Charles H Blake, *Dynamics of Economic Integration in Venezuela and Their Implications for the FTAA Process*, 15 Law & Bus. Rev. Am. 81, (2009).

⁵⁸ See for e.g. on the relation between human rights and investment protection, Cordula A. Meckenstock, *Investment Protection and Human Rights Regulation: Two Aims in a Relationship of Solvable Tension*, (Nomos Publisher, 2010) (examining the relation between protecting investment and human rights regulation especially in relation to stabilization clauses); Marc Jacop, *International Investment Agreements and Human Rights*, INEF Research Paper Series on Human Rights, Corporate Responsibility and Sustainable Development 03/2010 (INEF, 2010). Corruption is an important issue that affects the lives of many people especially in developing countries. According to the World Bank, "every year an estimated \$20-\$40 billion is stolen from developing countries through bribery, misappropriation of funds and other corrupt practices." World Bank, *Corruption Fighters Tackle Stolen Asset Recovery, Elimination of 'Safe Havens'*, (June 9, 2010) available at <http://go.worldbank.org/XEGRFILVY0>. Whether globalization in general and liberalizing international capital movement specifically reduces corruption by, inter alia, reducing the interference of government discretion and accordingly the opportunities of corruption is an open question, which is examined elsewhere. See for e.g., Dionsios A. Lalountas et al, *Corruption, Globalization and Development: How are These Three Phenomena Related?* 33 Journal of Policy Modeling 636 (2011) (analyzing cross-section data for 127 countries and concluding that globalization is effective in combating corruption in middle and high income countries, but has not effect on combating corruption in low income countries); Keith Blackburn et al, *Financial Liberalization, Bureaucratic Corruption and Economic Development*, 29 Journal of International Money and Finance 1321, at 1337 (2010). Notably, the international community has taken many steps to combat corruption including through international treaties. See for e.g. *United Nations Convention Against Corruption*, signed Dec. 9, 2003, UN Doc. A/58/422, (entered into force December 14, 2005); *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, OECD Doc. No. DAF/IME/BR(97)20, signed November 21, 1997, (entered into force December 17, 1997); *The Inter-American Convention against Corruption*, signed March 29, 1996, (entered into force March 6, 1997); *African Union Convention on Preventing and Combating Corruption*, signed July 11, 2003, (entered into force August 5, 2006); *Council of Europe Criminal Law Convention on Corruption*, signed January 27, 1999, CETS No. 173, (entered into force January 7, 2002); *Council for Europe Civil Law Convention on Corruption*, signed April 11, 1999, CETS No. 174, (entered into force January 11, 2003).

This study does not purport to propose an alternative to the free market system. Rather it provides a critique to a certain school of thought within the free market system in its treatment of the movement of international capital and the legal results of this direction in asymmetric BITs.

This study concludes that asymmetric BITs do not represent a balanced approach. It analyzes these BITs treatment of capital flows substantively and procedurally in conjunction with the analysis of the economic case for liberalizing capital movement and the use of capital controls.

Chapter two discusses the economics of the liberalization of capital movements and the use of capital controls. It discusses the main political and economic theories relating to the liberalization of international capital movements. The most prevalent school of thought during the 1980s and 1990s supported the liberalization of international capital movement and the abolition of capital controls under what was termed the “Washington Consensus.” This trend proposed lifting restrictions on capital movement on the ground that this would lead to efficiency and better allocation of investment, that is, allocation to its economically optimal utilization free from government interference. This is the rationale for the position adopted by many BITs with the aim of liberalizing capital movements. This rationale is analyzed, as are other theories which are critical of such liberalization. The analysis concludes that the supposed benefits of capital liberalization are double-edged. While liberalization of capital movements may produce economic growth, it does not ensure the sustainability of that growth. A certain advancement and maturity in the market of the liberalizing state is a precondition for such sustainability. The theoretical underpinning of liberalization, in particular its lack of empirical studies, is also called into question. The conclusion reached is that absolute and immediate capital liberalization is not suitable for all countries, especially developing countries. Rather regulation of capital movement and particularly capital inflows is necessary.

It also analyzes one mechanism used to regulate capital movements: capital controls. It evaluates their rationale and the case for their abolition. It also assesses their effectiveness and distinguishes between different kinds of capital controls. Almost all countries used capital controls at some point in history to protect their economy. While many developed countries have abolished capital controls, they still use them in financial crises. It is evident in recent

history that some countries have used capital controls to prevent the consequences of global financial crises from reaching their economies.

The thesis goes on to consider asymmetric BITs substantive treatment of capital transfers focusing on three aspects: breadth, absoluteness and immediacy. The breadth and immediacy of relevant BIT provisions is discussed in Chapters three. Chapter three discusses the breadth of the concept of investment, which is a key factor in determining the types of transactions protected by asymmetric BIT obligations. It also analyzes the breadth of the admission of investment provision. Investment is defined broadly in BITs to cover almost every asset and transaction that has economic value. This broad definition includes foreign direct investment, indirect investment and other transactions that are not considered investment in economic terms. The broad meaning given to investment leads to ambiguity and incoherence in practice. Two competing interpretations exist. The first maintains that every asset and transaction included in the treaty definition qualifies as investment. This has been adopted in most arbitral awards. The second interprets the treaty definition as limited to assets that have the characteristics of investment. This has been adopted in a minority of arbitral awards. The breadth of the investment definition is problematic because it extends the scope of BITs' protection, and its guarantee of capital transferability, in a manner that unnecessarily covers assets and property that are not rightly characterized as investment.

In addition, one way to restrict capital movement is by restricting the underlying investment. Most asymmetric BITs' admission provisions are broadly drafted and allow the admission of investment according to the host state's laws and regulations. These broad provisions have led to interpretations that find that foreign investors' violation of the registration requirement in the host state laws and regulation does not constitute violation of the BIT admission provision. The breadth of these admission provisions and their interpretation can result in the host state losing its discretion to require registration of investment and accordingly, its discretionary power to admit investment. Further, the admission of investment under US BITs is subject to national and most favoured nation treatment. This further restricts the state's discretionary powers to control admission of capital through restricting the underlying investment.

Chapter four analyzes the absoluteness, breadth and immediacy of the liberalization of capital in asymmetric BITs' capital transfer provisions. Absoluteness is demonstrated in the transfer provisions which liberalize the transfer of capital in absolute terms without permitting derogations or any restrictions by the host state. The transfer provisions are typically broad. They do not distinguish between different kinds of investment and capital in guaranteeing the transferability of related capital, which includes short-term capital. In addition, many asymmetric BITs guarantee both the transferability of capital inflows and outflows. This accordingly prevents the host state from regulating the admission of volatile capital. Unlike many multilateral agreements and international instruments that allow gradual liberalization, asymmetric BITs do not permit gradual liberalization to enable the host state's market to develop and to manage different kinds of capital.

Chapter five analyzes the breadth and absoluteness of two obligations and standards of treatment that affect the power of the host state to regulate capital: fair and equitable treatment, which is broadly defined and interpreted and most favoured nation treatment. Even when an asymmetric BIT does not cover the transfer of capital inflows or certain kinds of capital, national treatment and most favoured nation treatment provisions may broaden that BIT's scope to cover capital inflows. Also, even where exceptions or regulatory powers are included, the operation of other BITs' obligations like most favoured nation, national treatment, fair and equitable treatment and the prohibition of indirect expropriation may lead to diminishing the regulatory powers and exceptions reserved to the host state. This has led to incoherence and ambiguity that may unduly hinder the powers of the host state to regulate capital. This breadth results in ambiguity and incoherence in the application of BITs. This chapter also analyzes investor-state arbitration, the dispute resolution mechanism provided for under most BITs. Investor-state arbitration is broad in its scope since it covers disputes resulting from general regulatory measures on capital movements. It is a deficient and defective system, due to its *ad hoc* nature, lack of consistency, lack of authority to consider public interest and balancing factors, lack of accountability, and inability to correct wrong interpretations. These features do not permit the establishment of coherent, balanced and consistent rules to mitigate the substantive deficiencies in the treaty provisions themselves.

The concluding chapter notes that the regulation of capital movement under BITs is deficient, both substantively and procedurally--substantively, because of the way BITs' obligations are drafted, and procedurally because of the selection of ad hoc arbitration as the method of dispute settlement. Conclusions are drawn based on the analysis of the previous chapters. They highlight the principal themes of the substantive and procedural deficiencies. Some general reforms are proposed.

Chapter Two: Liberalization of International Capital Movements and Capital Controls

I. Introduction

In the late 1970's, Sir Joseph Gold commented on the debate over the use of capital controls, stating: "Most opinions about capital controls are expressions of the slogan that they are necessary evils in some circumstances, with some experts stressing the word 'necessary' and others the word 'evil'." ¹

The same comment can still be said today with regard to the debate involving the liberalization of capital movements and the use of capital controls. The issue of international capital movement liberalization is of great importance. It has invoked much controversy surrounding its economic benefits, costs, and its relationship to development. As Barry Eichengreen notes, "[i]t is hard to think of another issue over which there is more dispute or where the stakes for policy are higher."² It is surprising that liberalization was embraced without much reservation during the 1990s by many economists and international financial institutions. It is still being advocated, although with more caution—at least publicly—by the same groups today.

In order to establish the credibility of the arguments for and against international capital movement liberalization, it is important to discern the differences in ideologies and interests that lie behind many of the different approaches advocated, with regard to liberalization of capital movements and the use of capital controls. Most viewpoints concerning liberalization of capital movements are based on achieving growth and/or development. The same is true regarding international agreements that typically include development, economic growth or prosperity as a purpose in their preambles.³

¹ Joseph Gold, *International Capital Movement under the Law of the International Monetary Fund*. Vol. 21, at 1 (International Monetary Fund, 1977).

² Barry Eichengreen, *Capital Flows and Crises*, at 3 (Massachusetts Institute of Technology, 2003).

³ See Kenneth J. Vandavelde, *The Economics of Bilateral Investment Treaties*, 41 Harv. Int'l L.J. 469, at 471(2000). See, e.g., *Treaty Between the Government of the United States of America and the Government of the Republic of Azerbaijan Concerning the Encouragement and Reciprocal Protection of Investment*, signed August 1, 1997, (entered into force on August 2, 2001); *Agreement between the Government of the Arab Republic of Egypt and the Government of the People's Republic of China Concerning the Encouragement and Reciprocal Protection of Investments*, signed April 21, 1994 (using the word "prosperity").

Meanwhile, there has been a substantial increase in capital flows starting in the latter part of the 20th century.⁴ Substantial amounts of capital flows starting from mid 1980s led to varied results for developing countries. While some witnessed economic growth others witnessed episodes of financial crises and a decline in growth rates.⁵

This chapter analyses the debate surrounding liberalization of international capital movement and presents the case for and against the use of capital controls. In doing so, it discusses the different theories and ideologies behind different approaches, touching on the political economy of the players involved therein. The chapter begins with identifying the main approaches towards liberalization of capital movement and investment, along with the primary tools used to further each approach. The case for capital liberalization will be discussed, along with its ideological underpinnings and underlying economic arguments. The chapter then discusses capital controls and the reasons and criticisms for their use.

This chapter evaluates the evidence on capital movement liberalization and the use of capital controls. The key question is this: will the benefits of capital movement liberalization and the elimination of capital controls exceed the costs for developing countries? The answer depends on whether a one-model or a “one size fit all” approach is the right way to regulate international capital movements, and whether development is the viable strategy for such an approach.

II. Approaches to Foreign Investment and Capital Movement

After World War II (WW II) the idea of development was confined to economic growth, buoyed by the belief that growth would raise the quality of life for all people.⁶ Developing countries thereafter realized that growth is a necessary prerequisite for development, but not sufficient by itself to achieve equitable distribution of wealth.⁷

⁴ Eswar Prasad et al., *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, at 7 (IMF, 2003).

⁵ *Id.* at 6.

⁶ Enrique R. Carrasco & M. Ayhan Kose, *Income Distribution and the Bretton Woods Institutions: Promoting an Enabling Environment for Social Development*, in Symposium: Social Justice and Development: Critical Issues Facing the Bretton Woods System, 6 *Transnat'l L. &Contemp. Probs.* 1, at 10 (1996).

⁷ Carrasco & Kose, *supra* n.6, at 11.

By the middle of the twentieth century, three approaches toward foreign investment existed. First, developed states embraced the approach of “liberal investment policy” or “an economic nationalist policy,” maintaining that international law includes a requirement of an international minimum standard that must be accorded to foreign nationals.⁸

The second approach was advocated by newly independent developing countries, which came together to defend their national interests in a heretofore unprecedented display of power.⁹ The trend of independence of states in the 1960s coincided with the newly independent states assuming the ability to regulate economic activities in their jurisdiction.¹⁰ Most of these states were capital-importing developing states.¹¹ They declared their right to control foreign investment within their territories as a part of their economic independence.¹² Many sided with the Calvo doctrine- an “economic nationalist policy” that places the interest of foreign investors on the same level as local national entities.¹³

The third approach involved socialist states, which rejected the existence of any international legal protection for foreign investment and nationalized private property to control the economy.¹⁴

These approaches have shaped the current debate with regard to international regulation of capital movement and treatment of foreign investment, thus the identifying their origins is highly significant in understanding the discourse of this topic. The three trends invoked distinct ways in which the interests and ideologies of their proponents are enforced. While developing countries participated in the General Assembly of the UN to declare their positions and defending their interests, developed countries opted to use international agreements, programs and codes drafted and promoted by international financial organizations, to enforce their own set of interests. The third trend of socialist states lost momentum, however, with the fall of the Soviet Union.

⁸ Kenneth J. Vandavelde, *Sustainable Liberalism and the International Investment Regime*, 19 Mich. J. Int’l L. 373, at 381(1998); Malcolm N. Shaw, *International Law*, at 569 (4th ed., Cambridge University Press, 1997).

⁹ Andrew T. Guzman, *Why LDCs sign Treaties That Hurt Them: Explaining the popularity of Bilateral Investment Treaties*, 38 Va J. Int’l L. 639, 647 (1998)

¹⁰ Sol Picciotto, *Rights, Responsibilities and Regulation of International Business*, 42 Colum. J. Transnat’l L. 132, 136 (2003).

¹¹ *Id.*

¹² *Id.*

¹³ Vandavelde, *supra* n. 8, at 381.

¹⁴ *Id.*; Guzman, *supra* n. 9, at 646.

As for international financial institutions, most notably the Bretton Woods institutions, they adopted the neo-liberal stances, asserting that government intervention should be very limited because it causes distortions in the market.¹⁵ To enforce this, the Interim Committee of the IMF in 1997 suggested amending the Articles of the IMF to obligate member countries to accept the IMF power over capital transactions in order to liberalize capital account.¹⁶ The suggested amendment would have added the convertibility of capital transactions to the objectives of the IMF, such as current transactions.¹⁷ This suggestion failed as it coincided with the East Asian economic crisis, which forced many countries to reconsider the liberalization of capital account's shortcomings.

It is submitted that the current debate regarding the liberalization of international capital movements and the use of capital controls is shaped by different interests and ideologies that colours this debate under the guise of achieving development and efficient use of resources reaching a total growth.

A. Schools of Thoughts on Investment and Capital Movement

i. Economic Nationalism

Economic nationalism puts the political national interest of the host State above other considerations. The host State is allowed to interfere in the capital flows in order to preserve its national interests and advance domestic welfare.¹⁸

The main objective of this trend of thoughts is to promote political agenda of the state.¹⁹ For this reason, followers differ drastically on the content of the policies they feel should be pursued,

¹⁵ M. Sornarajah, *The International Law on Foreign Investment*, at 53 (Cambridge University Press, 2004); Carrasco & Kose, *supra* n. 6, at 28.

¹⁶ Richard N. Cooper, *Should Capital Controls Be Banished*, Brookings Papers on Economic Activity vol 1999 No.1, at 89 (1999); Charles Proctor, *Mann on the Legal Aspect of Money*, at 383 (OUP, 6th ed., 2005).

¹⁷ Cooper, *supra* n. 16, at 89.

¹⁸ Charles R.P. Pouncey, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. Rev. 505, at 539-540 (1998).

¹⁹ Kenneth J. Vandavelde, *The Political Economy of a Bilateral Investment Treaty*, 92 A.J.I.L. 621, at 622 (1998).

depending on where their States are standing at a particular moment. The differences are most drastic between developed and developing States.²⁰

Economic nationalists from developing countries use interventionist measures to attract foreign direct investment that will enhance the national policy and to restrict capital not conforming thereto.²¹ Since foreign investment may not achieve the promised development, they leave room for the State's regulation and interference. Additionally, because foreign investment may only benefit its owners without producing any benefit to the host State's economy, in terms of technology transfer, foreign currency reserve, or employment, the host State reserves the right to regulate such investment to insure its contribution to its welfare.²² This sect also supports restriction of outward investments to prevent capital outflows.²³

On the other hand, economic nationalists from developed States are concerned with protecting their investments abroad, for which they support promotional and protective measures.²⁴ At one point in time, protective measures involved the use of armed force. Now, economic sanctions and diplomatic pressure are utilized as along with promotional measures, which include providing insurance schemes for investment, information and finance, and financial aid to States that protect foreign investment.²⁵ For instance, Germany and France provide political risk insurance only to investments in States with which they have BITs.²⁶

In short, "[e]conomic nationalists are willing to regulate economic activity to the extent necessary to further national political policy."²⁷

²⁰ Generalization is used for the purpose of simplification. It is understood that between these two types of states there are differences in many stances that result of variant reasons that include variable political, economic and cultural structures and interests. Cf. Robert Hockett, *From "Mission-Creep" to Gestalt-Switch: Justice, Finance, the IFIS, and Globalization's Intended Beneficiaries*, 37 *Geo. Wash. Int'l L. Rev.* 167, at 172 (2005).

²¹ Vandavelde, *supra* n. 19, at 622.

²² *Id.* at 626.

²³ *Id.* at 623.

²⁴ *Id.*

²⁵ Vandavelde, *supra* n. 19, at 623.

²⁶ Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, at 12 (Kluwer Law International, 1995).

²⁷ Vandavelde, *supra* n. 19, at 623.

ii. Economic Liberalism and the “Washington consensus”

Economic liberalism subscribes to the idea of freedom of private persons organizing their affairs and economic relations without interference of the government which leads to the failure of achieving optimal use of resources.²⁸ It is acclaimed to be the most successful economic model in creating wealth, benefiting the middle classes people, maximizing production and advancing technology.²⁹ The latter two outcomes are related in that maximizing productivity is done by advancing technology.³⁰ In doing so, the system disregards less advanced means of production in what is known as “process of creative destruction”: it destroys the less advanced in order for the more advanced to develop.³¹ The system accommodates those who are able to adjust and adapt with the new advancement and accompanied changes in accordance with the “creative destruction” process.³²

According to this trend, having an international capitalist system and leaving the market forces to function unhindered by government intervention lead to the most efficient use of resources and best results for everyone.³³ Rationality assumes that each individual is making a decision that achieves his or her best interest to achieve the highest utility.³⁴ Thus, rationality results in the efficient use of resources as a result of the cumulative rational decisions of all individuals. This trend assumes that all individuals behave rationally to efficiently use their capital and accordingly achieve the maximum gain, resulting in an optimal allocation of resources.³⁵

This theory argues that the government role in the market should be very limited and confined to maintaining the rule of law, protecting contractual and private property rights, presiding over

²⁸ See John Blundell, *Waging the War of Ideas*, at 129-133, (The Institute of Economic Affairs, 2nd ed., 2003); Carrasco & Kose, *supra* n.6, at 25.; Vandeveld, *supra* n. 19, at 623; Kenneth Rogoff, *An Open Letter To Joseph Stiglitz*, (Washington D.C., July 2, 2002), available at <http://www.imf.org/external/np/vc/2002/070202.htm>.

²⁹ Robert Gilpin, *The Challenge of Global Capitalism: The World Economy in the 21st Century*, at 3 (Princeton University Press, 2000).

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ Vandeveld, *supra* n. 19, at 623; Gilpin, *supra* n. 29, at 19.

³⁴ Richard A. Posner, *Theories of Economic Regulation*, in *Readings in Social Welfare: Theory and Policy*, at 340 (ed., Robert Kuenne, Blackwell Publishing, 2000); Charles R. P. Pouncy, *Economic Justice and Economic Theory: Limiting the Reach of Neoclassical Ideology*, 14 *J. Law. & Pub. Pol’y* 11, at 17 (2002).

³⁵ Vandeveld, *supra* n. 3, at 473.; Pouncy, *supra* n. 18, at 540.; Carrasco & Kose, *supra* n.6, at 25.

fiscal policy, controlling inflation and rectifying market failures.³⁶ An independent legal system is required to limit government reach in the market, protect private rights from government meddling, “and to enforce bargained-for exchanges in the market.”³⁷

Consistent with this notion, the “Washington Consensus” played a vital role in applying this theory on the international economy. The Washington Consensus is a term coined by John Williamson that describes the agreement between Washington political institutions, the prominent international financial institutions (IMF and the World Bank) and Washington think tanks on the prescription for an efficient economy, which a developing state should follow.³⁸

The Consensus coincided with the end of communism and the old communist bloc aspiration as a prescription for a capital system.³⁹ The resulting set of policies is mainly an application of the neo-liberal theory. The IMF and the World Bank had a significant role in enforcing this neo-liberal paradigm by urging developing countries to take measures that included opening their markets to foreign capital.⁴⁰

The Washington Consensus mainly focuses on liberalizing trade, stabilizing macroeconomics and obtaining the correct prices.⁴¹ As observed by Aslund:

Standard measures were the minimization of the budget deficit, a broadening of the tax base and cutting of top tax rates, reorientation of public expenditures, a strict monetary policy, the liberalization of prices and foreign trade, deregulation, demonopolization, financial liberalization, the liberalization of foreign direct investment, unification of the exchange rate, the privatization of state enterprise, and the reinforcement of property rights. Democracy had proven beneficial to such reforms, and a social safety net for the poor was desirable.⁴²

³⁶ Anders Aslund, *Building Capitalism*, at 78 (Cambridge University Press, 2002); Vandavelde, *supra* n. 19, at 623-624.

³⁷ Vandavelde, *supra* n. 19, at 624; Guillermo Aguilar Alvarez & William W. Park, *The New Face of Investment Arbitration: NAFTA Chapter 11*, 28 *Yale J. Int'l L.* 365, at 369 (2003).

³⁸ Aslund, *supra* n. 36, at 72.; Moises Naim, *Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion?*, (Foreign Policy Magazine, October 26, 1999).

³⁹ Aslund, *supra* n. 36, at 70.; Gilpin, *supra* n. 29, at 7.

⁴⁰ Carrasco & Kose, *supra* n.6, at 35.

⁴¹ Joseph Stiglitz, *More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus*, (The 1998 WIDER Annual Lecture, January 7, 1998), available at <http://www.globalpolicy.org/socecon/bwi-wto/stig.htm>

⁴² Aslund, *supra* n. 36, at 72.

The liberalization of capital markets is one of the most controversial parts of the Washington Consensus.⁴³ Economic liberalism refers to this trend that advocates liberalization of capital movements based on the neo-liberal political economy stances. This is often referred to as the “economic theory”.⁴⁴

But the economic nationalism school of thought has an effect on this theory, as well as manifested within the position taken by the US. The US promotes the free movement of capital and the integration of financial markets in order to obtain the necessary funds from savings of other countries.⁴⁵ It is on the top of the capital importing countries list.⁴⁶ The US rate of savings is very low in comparison to most developed countries. For the US to keep the current rate of consumption and investment, the US has to use savings from other countries. It facilitates the borrowing process to produce a globalized world with integrated financial markets.⁴⁷

To substitute foreign savings with national savings will lead to decreased consumption, which would in turn lead to a recession.⁴⁸ In addition, Wall Street benefited from interconnected financial markets, without restrictions on capital movements, especially in emerging economies where the market was expanding faster than that of the US.⁴⁹

Another reason for US support for the free capital movement is the effect of such movements on the political economy of other countries. Other countries will be pushed to follow the US model of corporate structure and labour rules.⁵⁰ This is crucial as many systems, especially in Asia, which are based on long term relationships and tolerance on getting returns, weaken the competitive ability of American corporations.⁵¹

⁴³ Sebastian Edwards, *Capital Mobility, Capital Controls, and Globalization in the Twenty-First Century*, 579 *Annals* 261, at 262-263 (2002).

⁴⁴ See for e.g., *Id.* at 263.

⁴⁵ Robert Wade, *The Coming Fight Over Capital Flows*, 113 *Foreign Policy* 41, at 45 (1998).

⁴⁶ Jeffrey Lang, *The International Regulation of Foreign Direct Investment: Obstacles and Evolution*, 31 *Cornell Int'l L.J.* 455, at 456 (1998).

⁴⁷ Wade, *supra* n. 45, at 45 (1998); *CF.* Lang, *supra* n. 46, at 456.

⁴⁸ Wade, *supra* n. 45, at 45.

⁴⁹ *Id.* at 46.

⁵⁰ *Id.* at 47.

⁵¹ *Id.*

The convergence of interests between Wall Street and US corporations to lift capital controls and allow the free movement of capital compelled the US Treasury to push international organisations like the IMF and the WTO to include the liberalization of capital movements on their agendas.⁵² This manifested in the calls to amend the IMF Articles to include the power of the IMF to force members to liberalize capital movements.⁵³

Notably, BITs and many legal writings adopt the neo-liberal theory as representative of economics.⁵⁴ In addition, international financial organizations and national institutions encouraged this trend.⁵⁵ Although the Washington Consensus, as originally envisaged, advocates liberalizing foreign direct investment, the neo-liberal line, followed by the international financial institutions and many BITs, included liberalizing portfolio investment and short-term capital. Also, there were differences in some policies that were prescribed by the international financial institutions and in the way they were applied in different countries.⁵⁶

According to this neo-liberal consensus, in matters of foreign investment, the role of law should be confined to protect private rights and specifically foreign investors and should establish a legal environment accommodating to liberal market economy.⁵⁷ Economic development and growth can be achieved by integrating into the global economy, which results in greater prosperity.⁵⁸ Free transfer of capital and the elimination of barriers to capital movements are essential steps for economic development and growth for the whole global economy and maximizing productivity.⁵⁹

⁵² *Id.*

⁵³ *Id.*

⁵⁴ Pouncy, *supra* n. 34, at 25.; Johan Deprez, *Risk, Uncertainty, and Nonergodicity in the Determination of Investment-Backed Expectations: A Post Keynesian Alternative to Posnerian Doctrine in the Analysis of Regulatory Takings*, 34 Loy. L.A. L. Rev. 1221, at 1232 (2001).

⁵⁵ Tamara Lothian & Katharina Pistor, *Local Institutions, Foreign Investment and Alternative Strategies of Development: Some Views from Practice*, 42 Colum. J. Transnat'l L. 101, at 102 (2003) (referring to the World Bank, IMF, OECD and its Codes of Conduct and other national institutions like USAID (e.g. "Law and Development" projects).; *see also* Carrasco & Kose, *supra* n.6, at 23.

⁵⁶ Naim, *supra* n. 38.

⁵⁷ Lothian & Pistor, *supra* n. 55, at 101-102.

⁵⁸ Vandavelde, *supra* n. 19, at 625.

⁵⁹ Vandavelde, *supra* n. 3, at 478.; Chantal Thomas, *Globalization or Global Subordination?: How Latcrit Links the Local to Global and the Global to the Local: Globalization and the reproduction of Hierarchy*, 33 U.C. Davis L. Rev. 1451, at 1451 (2000); Vandavelde, *supra* n. 19, at 624-625.

This trend considers government interference in regulating economic relations “both normatively undesirable (under neo-liberal theories of development) and legally unacceptable (as evidenced by international arbitration awards).”⁶⁰ It diminishes governments’ power to regulate relations and limits legislatures’ ability to choose any other course.⁶¹ This “alone guarantees the basis for economic development, stability, and growth.”⁶²

Any disadvantage attributed to foreign investment is dismissed by liberal advocates as a result of government’s interference and regulation and not from any deficiency in the process of liberalization of capital movements. The ready answer is for governments to increase of deregulation.⁶³ Crises suffered by countries that liberalize capital movements are explained by claiming that these countries are being punished for wrong policies. These crises are justified by policy mistakes like unwarranted restrictive monetary and fiscal policies (Italy, UK and Spain 1992).⁶⁴ Mexico’s severe inflation and current account deficit are used to justify the attack on its currency and its crisis.⁶⁵ According to this trend, if countries take the “correct” policies, they can avoid speculative attacks that bring currency crises.⁶⁶

iii. Heterodox Economics, Socialist Economics, and Public Interest Theory of Regulation

Heterodox economics include different theories that are critical to economic liberalism and are mainly influenced by Marxism and the neoKeynesian economics.⁶⁷ The public interest theory assumes that government regulation serves the purpose of achieving public interest by curing market imperfections.⁶⁸ This is common point in all sects in this trend, which is the emphasis on

⁶⁰ Amr A. Shalakany, *Arbitration and the Third World: A Plea for Reassessing Bias Under the Specter of Neoliberalism*, 41 Harv. Int’l L.J. 419, at 425 (2000); see, e.g., *CMS Gas Transmission Company v. The Argentine Republic*, ICSID award no. ARB/01/8 (final award), para. 377 (May 12, 2005) (criticizing Argentina’s intervention and policies before and after its financial crisis).

⁶¹ Shalakany, *supra* n. 60, at 430.

⁶² Lothian & Pistor, *supra* n. 55, at 102.

⁶³ Vandeveld, *supra* n. 19, at 625.

⁶⁴ Eichengreen, *supra* n. 2, at 100.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ Carrasco & Kose, *supra* n.6, at 25.

⁶⁸ Jonathan R. Macey, *The ‘Demand’ for International Regulatory Cooperation: A Public-Choice Perspective*, in *Transatlantic Regulatory Cooperation: Legal Problems and Political Prospects*, at 149 (eds. George Bermann, Matthias Herdgen and Peter L. Lindseth, OUP, 2000); Posner, *supra* n. 34, at 336.; Jonathan R. Macey & Enrico

the role of the government as a key player in the economy and in income distribution in response to market inefficiency.⁶⁹ This trend stresses the inefficiency of the market alone and the need for the government interference in different forms, which may include regulation, to remedy such imperfections.⁷⁰

This school of thought finds that liberalization of international capital movement are problematic. The main contribution to this trend, in this context, is in revealing the weaknesses in the neo-liberal consensus on capital movements. This trend criticizes the neo-liberal's economists for presenting their theory as a scientific fact and doubts its foundations.⁷¹ It finds the "liberal consensus . . . a historically contingent one. Liberalism is no less vulnerable than competing ideologies to the adverse consequences of its failures."⁷²

Capital flows are negatively viewed as increasing the dependency of developing countries on developed ones and keeping them in an underdeveloped state.⁷³ This trend disagrees with the assumptions made by the neo-liberal economics on the efficiency and rationality of the market. It is more concerned with equitable distribution and public interest rather than efficiency and growth *per se*.⁷⁴

Many of the prescriptions proposed by the neo-liberal theory are based on inaccurate assumptions.⁷⁵ The main problem with liberalism is the assumption of the existence of efficient markets and rational investors. But efficient and competitive markets do not generally exist in developing countries, which are "characterized by extensive market failures."⁷⁶

Colombatto, *Public Choice Theory and the Transition Market Economy in Eastern Europe: Currency Convertibility and Exchange Rates*, 28 Cornell Int'l L.J. 387, at 400 (1995).

⁶⁹ See Carrasco & Kose, *supra* n.6, at 25-26.; Posner, *supra* n. 34, at 336.; Macey, *supra* n. 68, at 149.; Deprez, *supra* n. 54, at 1222.

⁷⁰ Posner, *supra* n. 34, at 336.

⁷¹ Pouncy, *supra* n. 34, at 17.; Deprez, *supra* n. 54, at 1235-1236.; Vandeveld, *supra* n. 3, at 472.

⁷² Vandeveld, *supra* n. 8, at 398.

⁷³ *Id.* at 377. (Originally, there was a different view on capital movement than the current one in Marxism. Capital movement was favourably viewed by Marx as beneficial to developing countries as the surplus which cannot find good return in industrialized countries will be used in developing countries for economic development and leading to capitalist state that ultimately transform to socialism).

⁷⁴ Pouncy, *supra* n. 18, at 560.

⁷⁵ Pouncy, *supra* n. 34, at 17.

⁷⁶ Vandeveld, *supra* n. 8, at 383-384 (1998).; Carrasco & Kose, *supra* n.6, at 25.

In addition, the rationality assumption is not totally accurate because decision making is more complex and involves other factors including availability of information, and, social and psychological factors, among others.⁷⁷

This trend also emphasizes the uncertainty of economics and the risks arising from advanced financial tools.⁷⁸ The liberalism trend assumes that the economic system ergodic: probabilities do not change by time as the structures do not change.⁷⁹ However, the economic system is rather nonergodic: probabilities differ from one point in time to another as structures change.⁸⁰ Moreover, the liberal theory does not deal with the issues of equitable distribution of wealth and economic justice.⁸¹ Rather, it is concerned with total growth and maximization of productivity.⁸²

B. Evaluation of the Case for Liberalizing International Capital Movement

i. Advantages of and Rationale for Liberalizing International Capital Movements

The advantages of liberalizing international capital movement are founded on both macroeconomic and microeconomic theory. The main argument for liberalizing capital movement offers the notion that liberalization will lead to the efficient allocation of international savings “and a better diversification of risk, hence greater economic growth and welfare.”⁸³ Many theoretical models assert that international financial integration leads to growth and development in developing countries.⁸⁴

Liberalizing capital movement achieves the most efficient use of resources which leads to greater growth for the entire global economy and provides essential capital developing countries need for development. Capital mobility affects the whole global economy and should not be

⁷⁷ Pouncy, *supra* n. 34, at 17-18.

⁷⁸ Pouncy, *supra* n. 18, at 512.

⁷⁹ Deprez, *supra* n. 54, at 1239.

⁸⁰ *Id.* at 1241-1242.

⁸¹ Vandeveld, *supra* n. 8, at 392.; Pouncy, *supra* n. 34, at 24.

⁸² Vandeveld, *supra* n. 8, at 392.

⁸³ Independent Evaluation Office, *The IMF's Approach to Capital Account Liberalization*, at 10 box 1.1.

(IMF, 2005).; Abdul Abiad & Ashoka Mody, *Financial Reform: What Shakes It? What Shapes It?*, Economic Issues No. 35, (IMF, 2005), available at <http://www.imf.org/external/pubs/ft/issues/issues35/>.

⁸⁴ Prasad et al., *supra* n. 4 at 5.

considered a national or domestic issue due to its global effect.⁸⁵ Accordingly, a global and comprehensive approach that results in global growth and development should be adopted. Liberalization leads to the best allocation of capital and helps to diversify risk, which leads to more economic growth and development.⁸⁶ This refers to the assumption that by liberalizing capital flows, capital will go to where it can achieve the maximum profit or lower risk.⁸⁷ This parallels the comparative advantage theory of free trade, where the benefit of free trade is maximized in all countries.⁸⁸ In addition, “[c]apital inflows can improve a country’s balance of payments, smooth temporary shocks to income and consumption, reduce borrowing costs, and spur economic growth.”⁸⁹

From a macro-economic perspective, capital inflows can help countries, especially developing countries, to increase investment and growth.⁹⁰ Increasing economic growth is the most successful and fastest way to fight poverty.⁹¹ Capital inflows are especially important for countries where the domestic savings fall short of their development needs.⁹² This is important given the decrease in the amount of Western sovereign aid to developing countries.⁹³ Additionally, foreign capital helps in increasing employment and transfer of technology.⁹⁴ Capital controls and restrictions on capital transfers deter foreign investment, thus, impeding growth potential and further stagnating developing countries.⁹⁵

⁸⁵ Michael Mussa, *IMF Economic Forum: Capital Account Liberalization: What’s the Best Stance* (October 2, 1998, IMF Washington, D.C.), available at <http://www.imf.org/external/np/tr/1998/tr981002a.htm>.

⁸⁶ Abiad & Mody, *supra* n. 83.; *The IMF’s Approach to Capital Account Liberalization Draft Issues Paper/Terms of Reference For an Evaluation by the Independent Evaluation Office (IEO)*, at 4, July 2004, <http://www.imf.org/external/np/ieo/2004/cal/070804.pdf> [hereinafter *IMF Approach*]; Stephany Griffith-Jones, *Global Capital Flows: Should they be Regulated*, at 137 (Macmillan Press LTD, 1998).

⁸⁷ Cooper, *supra* n. 16, at 102.

⁸⁸ *Cf. Id.*; Edwards, *supra* n. 43, at 263-264.

⁸⁹ R. Barry Johnston, *Sequencing Capital Account Liberalization*, vol. 35 (4) *Fin. & Dev.* (1998).

⁹⁰ Jones, *supra* n. 86, at 137.; Stephany Griffith-Jones & Jenny Kimmis, *Stabilizing Capital Flows to Developing Countries: The Role of Regulation*, in *Regulating International Business*, at 161 (ed., Sol Picciotto & Ruth Mayne, St. Martin’s Press, 1999) [Griffith-Jones & Jenny Kimmis, *Stabilizing Flows*].

⁹¹ Edwards, *supra* n. 43, at 262.

⁹² Jones & Kimmis, *supra* n. 90, at 161.; Cooper, *supra* n. 16, at 100.

⁹³ Aslund, *supra* n. 36, at 6.; Gilpin, *supra* n. 29, at 10.

⁹⁴ Jones & Kimmis, *supra* n. 90, at 161.

⁹⁵ Victor Mosoti, *Bilateral Investment Treaties and the Possibility of a Multilateral Framework on Investment at the WTO: Are Poor Economies Caught in Between?*, 26 *NW. J. INT’L L. & BUS.* 95, at 128 (2005).

It is argued that free transfer of capital supplements free trade in many respects. It avoids trade barriers through foreign direct investment.⁹⁶ From a micro-economic perspective, liberalization of capital movements increases the efficiency of production as it helps investors to obtain capital needed for investment for a lower price.⁹⁷ Through free movement of capital, investors are also able to diversify the risk of investment.⁹⁸

Freedom of capital movement allows for regulation of government policies, specifically monetary policies.⁹⁹ Investors will punish bad policies by refraining from investment or withdrawing investment from a country. In contrast, governments pursuing favourable policies will be rewarded with an increase in capital inflows and investment, which boosts the government economic program.¹⁰⁰ A problem that arises here, however, is that the investors are assumed to be the arbiters for what constitutes a good or bad policy. Private investors may not be qualified to decide whether a policy is good or bad. They tend to move as a herd, thus potentially leading to group think cases. It is the anticipation of profit that drives them and not the fundamentals of economic practice. In addition, good policies in the eyes of private investors translates to policies that increase profits for them. In practice, this means that the public interest may become less of a priority. It also encourages race to the bottom in prices between countries requiring foreign capital.¹⁰¹

It is further asserted that the economic system of any country may occasionally face financial shocks that affect the balance of payment equilibrium.¹⁰² In these cases, capital inflows will be needed to restore the balance of payment equilibrium.¹⁰³ It will be easier to attract private inflows to restore the balance of payment equilibrium when capital transfers are liberalized.¹⁰⁴ This is, however, limited to cases of countries with stable political systems and advanced financial markets.¹⁰⁵

⁹⁶ Vandeveldel, *supra* n. 19 , at 624.

⁹⁷ Jones, *supra* n. 86, at 137.; Jones & Kimmis, *supra* n. 90, at 161.; Cooper, *supra* n. 16, at 100.

⁹⁸ Cooper, *supra* n. 16 at 100.

⁹⁹ *Id.* at 102.

¹⁰⁰ *Id.*

¹⁰¹ See *infra*.

¹⁰² Cooper, *supra* n. 16, at 102.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

Furthermore, it is asserted that advances in technology and communication makes reversal of the trend of capital mobility liberalization inconceivable.¹⁰⁶ This is due to the advancement of communications and different jurisdictions involved, that attempts to restrict capital movement are condemned to be ineffective and unable to achieve their targets on the long run.¹⁰⁷ The issue thus becomes how to get the most benefit out of capital mobility and minimize the risks.¹⁰⁸

Finally, the principle of freedom of choice and democracy provides the last rationale for liberalizing capital movement. One of the basic principles of democratic societies is freedom.¹⁰⁹ Freedom is an absolute value that should be focused on as means of development.¹¹⁰ Different kinds of freedom uphold and maintain each other.¹¹¹ This includes the right of free choice to invest anywhere in any legitimate activity.¹¹² In this context, liberalization provides such freedom and equality for all who chose to partake.¹¹³

ii. Drawbacks of Liberalization of Capital Flows

There are many risks that arise from liberalization of international capital movements. Foreign investment and free moving capital flows usually raises some concerns for any nation from both micro and macro-economic point of views. It is riskier to developing States.

First, liberalization is associated with financial crises. Any country whether developed or developing may suffer from financial and currency crises.¹¹⁴ The possibility of arbitrary movement of capital that disrupts the economy even if the economic fundamentals exist and did

¹⁰⁶ Barry Eichengreen, *IMF Economic Forum: Capital Account Liberalization: What's the Best Stance* (October 2, 1998, IMF Washington, D.C.), available at <http://www.imf.org/external/np/tr/1998/tr981002a.htm>, [last visited January 8, 2005].

¹⁰⁷ Cf. Cooper, *supra* n. 16, at 102.

¹⁰⁸ Mussa, *supra* n. 85.

¹⁰⁹ Cooper, *supra* n. 16, at 101.

¹¹⁰ Amartya K. Sen, *What Is Development About?*, in *Frontiers of Development Economics : The Future in Perspective*, at 506 (Gerald M. Meier & Joseph E. Stiglitz eds., OUP, 2001); see in general Amartya Sen, *Development As Freedom* (Anchor Books, 2000).

¹¹¹ Sen, *supra* n. 110, at 506-507.

¹¹² Cooper, *supra* n. 16, at 101.

¹¹³ Hockett, *supra* n. 20, at 169.

¹¹⁴ Yilmaz Akyiiz & Andrew Cornford, *Capital Flows to Developing Countries and the Reform of the International Financial System*, UNCTAD/OSG/DP/142 No. 142, at 15 (1999); Prasad et al., *supra* n. 4, at 5.

not change may lead to inefficient allocation of resources.¹¹⁵ Many external reasons can provoke speculative attacks.

An important cause of any financial crisis is the way investors in the international capital market behave.¹¹⁶ Investors may lose their confidence in investing in a specific country or countries and start to rush out for a variety of reasons.¹¹⁷ The motives may be political or economic, internal or external, significant or insignificant.¹¹⁸ It does not matter the nature of the reasons that changed the perception of investors or the veracity thereof, so long as investors find it better to transfer their mobile investment away from the specific country or countries, it is up to the complete discretion of the investor.¹¹⁹ This behaviour is often an exaggerated reaction, which exacerbates the economy's position and the circumstance that was feared becomes reality simply because of the excessive reaction and not because of the underlying reason.¹²⁰

What makes this even more problematic is the herd behaviour feature of capital markets. Herd behaviour is one of the capital markets imperfections that creates crisis. Investors, lenders and fund managers who deal with short term investment typically focus more on the behaviour of their counterparts than to economic elements.¹²¹ The behaviour of other investors will affect the price of their assets or investment, a fundamental characteristic of supply and demand.¹²² In addition, the reputation of any fund can be damaged if it alone loses while others do not. In case these securities sustain loss, it is important for any fund manager to find their other counterparts in the same situation to be defended as it is a mistake made by all, and not simply a single investor's oversight.¹²³

Another reason for crises is the so-called "self-fulfilling attacks".¹²⁴ This refers to speculators attacks on the system to cause a change in the macroeconomic policy, which they anticipate and

¹¹⁵ Richard Cooper, *IMF Economic Forum: Capital Account Liberalization: What's the Best Stance* (October 2, 1998, IMF Washington, D.C.); Prasad et al., *supra* n. 4, at 10.

¹¹⁶ Johnston & Tamirisa, *supra* n. 247, at 164.

¹¹⁷ Jones & Kimmis, *supra* n. 90, at 165; Johnston, *supra* n. 89.

¹¹⁸ Jones & Kimmis, *supra* n. 90, at 165.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.* at 166.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

exploit.¹²⁵ They cause the crisis even though the economic elements are functioning well.¹²⁶ This can be illustrated by how a currency crisis begins. Investors and lenders, worried from depreciation in the currency, stop their activities and start transferring their capital out. By this, they share significantly in creating the currency crisis.¹²⁷ The contrary effect of the surge in inflows will follow. Exchange rates and assets' prices decrease.¹²⁸ To preserve the currency, governments have to increase interest rates, which results in further weakening of the banking system.¹²⁹

A different but related problem is the spill over or contagion problem. This refers to the effect of a crisis in one country that extends to other countries, which are in the same region, share similar economic circumstances, or are viewed as similarly situated without being warranted by their economic circumstances.¹³⁰ These associated countries may very well have an efficient and functioning economy. However, they become the victim of the change, as viewed by investors regarding investment in such economies.¹³¹

Another kind of drawbacks represents a combination of contagion and self fulfilling attaches. It happens when a devaluation of a country's currency lead to deterioration in its trading partners' positions due to decreased competitiveness, which may force the trading partners to devalue their currencies in order to preserve their competitiveness.¹³² Speculators may attack its trading partners in anticipation of devaluation of their currencies or in anticipation of external changes, which may cause currency crises.¹³³ The collapse of one country's currency may lead to another's collapse.¹³⁴ The anticipation that a country will defend its currency may lead to more speculative attacks.¹³⁵

One more drawback for developing countries is that they are more prone to crises when they liberalize capital movement. Crises in developed countries do not usually turn into financial

¹²⁵ *Id.*

¹²⁶ Eichengreen, *supra* n. 2, at 105.; Jones & Kimmis, *supra* n. 90, at 166.

¹²⁷ Jones & Kimmis, *supra* n. 90, at 165.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*; Prasad et al., *supra* n. 4, at 10.

¹³¹ Jones & Kimmis, *supra* n. 90, at 165.

¹³² Eichengreen, *supra* n. 2, at 106.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*, at 107.

market crises nor does financial disorder result in currency crises or payment difficulties in developed countries.¹³⁶ There are many reasons for this difference between developing and developed countries in the effect of crises, which make developing countries more vulnerable to financial crises.

The market trusts developed countries' economic systems and usually expects their system to bounce back.¹³⁷ To be sure, small devaluations in developing countries like Mexico, Thailand, Indonesia and Brazil in the 1990s resulted in loss of market confidence.¹³⁸ On the other hand, developed countries like Canada and Australia left their currencies to devalue without capital controls and the market expected that their currencies will recuperate naturally.¹³⁹

Additionally, the financial market of a developing country is, by and large, small, thus any middle-sized capital inflows or outflows may substantially affect prices.¹⁴⁰ The net external indebtedness of developing countries, which is mostly dominated in foreign exchange, usually exceeds that of developed countries.¹⁴¹ It is even worse if the external debt is held by the private sector as opposed to governments.¹⁴²

Second, investment may not guarantee growth either in the short term or the long one. The complete effect of the liberalization of capital movements on development and growth is not clear.¹⁴³ Moreover, there is some evidence that liberalization of international capital movements may lead to consumption volatility.¹⁴⁴

Third, other related but separate factors must be accounted for; like liberalization of current account, trade liberalization and macroeconomic imbalances, which may cause, if not harmonized with liberalization of capital account, distortion and certain financial crises.¹⁴⁵

¹³⁶ Akyiiz & Cornford, *supra* n. 114, at 16.

¹³⁷ Ronald I. McKinnon, *Limiting Moral Hazard and Reducing Risk in International Capital Flows: The Choice of an Exchange Rate Regime*, 579 *Annals* 200, at 214 (2002).

¹³⁸ *Id.*

¹³⁹ *Id.* at 212-214.

¹⁴⁰ Akyiiz & Cornford, *supra* n. 114, at 16.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ Eichengreen, *supra* n. 2, at 84.; Mosoti, *supra* n. 95, at 97-98.

¹⁴⁴ Prasad et al., *supra* n. 4, at 58.

¹⁴⁵ *Cf.* Eichengreen, *supra* n. 2, at 84-85.

Fourth, the liquidity-oriented attitude of investors that is reflected in the increase in short-term capital is troublesome.¹⁴⁶ There are many reasons for this. One being a lack of information to evaluate investment by stakeholders. Even qualified professionals who are able to evaluate investment worthiness do not depend on this evaluation to take their decision.¹⁴⁷

Indeed, the herd behaviour of investors does not support an informed decision. The anticipated expectation of other investors' behaviour that is the controlling element in a market that is concerned with liquidity and short-term investment and not with the worthiness of the investment in the long run.¹⁴⁸ For those qualified professionals and speculators, the most important element is to anticipate the behaviour of other investors and how the prices will move in order to make a short-term profit out of such expectations.¹⁴⁹ It is worth noting that large amounts of capital come from individuals. Given that individuals' behaviour is more volatile especially in cases of investing in developing countries, this leads to the conclusion that lifting all controls over short-term capital may lead to more instability.¹⁵⁰

If the economy cannot utilize capital inflows efficiently, the market will suspect the ability of the economy to repay its external debt and sustain capital inflows.¹⁵¹ Liberalization of capital movements may, without safeguards, tempt financial institutions to incur more foreign exchange debt risk.¹⁵²

Furthermore, unrestrained capital movements may lead to increase in exchange rate, with its negative impact on exports, current account deficit, and inflation.¹⁵³ The effect of large capital inflows or outflows on the economy of a country can be damaging to the host State's economy.¹⁵⁴ Free movements may jeopardize the ability of the government to manage its macroeconomic policy.¹⁵⁵ For one, they oblige countries to take certain measures that may not be accommodating to development and growth in order to satisfy foreign investors' expectation

¹⁴⁶ Jones, *supra* n. 86, at 3.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 2-3.

¹⁴⁹ *Id.* at 3.

¹⁵⁰ *Cf. Id.* at 54-55.

¹⁵¹ Johnston, *supra* n. 117.

¹⁵² *Id.*

¹⁵³ S. Neal McKnight, *Note: Stepping Stones to Reform: The Use of Capital Controls in Economic Liberalization*, 82 Va. L. Rev., at 876 (1996).

¹⁵⁴ Macey & Colombatto, *supra* n. 68, at 395.

¹⁵⁵ McKnight, *supra* n. 153, at 876.

of “market credibility”.¹⁵⁶ Consequently, market credibility has grown to be a main objective behind domestic policy in the 1990s. The expectation of increasing interest rates in case of rise in the investing risk in the country is an example for when the governments may be expected to do to satisfy investors’ expectation, although it may be counterproductive for growth and discourages further investment.¹⁵⁷

Finally, empirical evidence does not indicate a strong or significant correlation between international financial integration and growth in developing countries.¹⁵⁸ As the Evaluation Office of the IMF observes, “[w]hile the idea that free capital mobility enhances economic welfare is an appealing concept to many economists, there has been surprisingly little empirical evidence to date to either support or refute such a view conclusively.”¹⁵⁹

iii. Conclusion

The above summarizes main theories behind the debate over the liberalization and regulation of international capital movements. Liberalization of capital flows carries many benefits to the global economy, while also offering downfalls as well. The benefits are not guaranteed and further studies are required to establish optimal circumstances for capital movement liberalization.

Liberalization of capital movement trend tends to give the same value to all kinds of investment, which do not contribute equally to economic development.¹⁶⁰ Yet some empirical evidence reveals that there is a “hierarchy of volatility” between capital flows.¹⁶¹

Generalization about the advantages of capital liberalization -- without distinguishing between different kinds of capital flows and different kind of investors and the effect of these differences on development-- is incorrect. Immediate liberalization of all types of capital flows involves

¹⁵⁶ Jones, *supra* n. 86, at 4.

¹⁵⁷ *Id.*

¹⁵⁸ Prasad et al., *supra* n. 4 at 58.

¹⁵⁹ *IMF Approach*, *supra* n. 83, at 4.

¹⁶⁰ Lothian & Pistor, *supra* n. 55, at 111.

¹⁶¹ Jones, *supra* n. 86, at 38; Prasad et al., *supra* n. 4, at 8.

many risks and may not increase economic growth for the reasons explained in the previous section.¹⁶²

In this regard, one should distinguish between speculative short-term capital flows and long term capital, which is essential to realize the costs and benefits of liberalizing capital flows because their effect is not the same. Short-term capital is hardly sustainable as it depends on interest rate differentials, which do not normally last.¹⁶³ It is important to realize that a large component of international capital flows today consists of short-term capital and especially to developing countries.¹⁶⁴ But short-term capital flows are associated with instability and financial crises.¹⁶⁵ Long term capital and foreign direct investment are associated with stability and efficiency in terms of technology transfer and management know-how, productivity and growth.¹⁶⁶ Countries whose direct foreign investment component is larger are less susceptible to currency crises.¹⁶⁷

Furthermore, a country is at risk when it is dependent on covering an extremely large current account deficit with substantial capital flows.¹⁶⁸ This is significant because researches revealed that many professional experts in investing institutions view countries with substantial amount of “hot” (short-term) capital as high risk.¹⁶⁹ They prefer investing in countries with more “cold” capital flows.¹⁷⁰ Accordingly, the type of capital and its degree of volatility are of paramount importance in two respects. First, from a macroeconomic perspective, it is important to manage the risk of capital movements and to avoid currency crises.¹⁷¹ Secondly, it affects the decision-making process of foreign investors, which “influence both the level and the degree of permanence of inflows”.¹⁷²

Another distinction is made between institutional investors. Some studies found that certain institutions tend to create more instability than others in terms of volatility in investment

¹⁶² Joseph E. Stiglitz, *Article: Capital Market Liberalization and Exchange Rate Regimes: Risk without Reward*, 579 *Annals* 219, at 220; Johnston, *supra* n. 117.

¹⁶³ Jones, *supra* n. 86, at 5.

¹⁶⁴ Gilpin, *supra* n. 29, at 22.; Jones, *supra* n. 86, at 41.

¹⁶⁵ Gilpin, *supra* n. 29, at 22.

¹⁶⁶ Kenneth S. Rogoff, *Rethinking Capital Controls: When Should We Keep an Open Mind?*, vol. 39 *Fin. & Dev.* No. 4 (2002); Deprez, *supra* n. 54, at 1243.; Jones, *supra* n. 86, at 38, 137; Stiglitz, *supra* n. 41.

¹⁶⁷ Jones, *supra* n. 86, at 38.

¹⁶⁸ *Id.* at 39.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 40.

¹⁷² *Id.*

decisions.¹⁷³ For example it is asserted that mutual funds create more volatility than pension funds and insurance companies. One of the reasons put forth is that mutual funds have to respond short-term demand on capital redemption and accordingly are searching for short-term profit while the pension funds and insurance companies do not face the same conditions.¹⁷⁴

Accordingly, developing countries should seek to encourage institutional investors who tend to be more long-term oriented and discourage the short-term seeking ones due to their detrimental effect on real economy.¹⁷⁵ However, given the regulatory short term periodic checks on the long-term oriented institutional investors' performance, the distinction may lose its significance because these checks induce herding while seeking not to appear as performing inferior to other investors in the market.¹⁷⁶

In the same vein, another distinction based on whether the investor is national or foreigner indicates the distinction's effect on the stability of the domestic economy of a country. National investors are more affected by the local circumstances in the country whether they be political, economic or otherwise, which they are able to directly evaluate.¹⁷⁷ Accordingly, it is these expectations that guide the actions of national investors, rather than external circumstances.¹⁷⁸ Conversely, foreign investors tend to follow other countries and changes in other markets that can produce higher returns.¹⁷⁹ For this reason, capital provided by domestic investors tends to be more stable provided that the economic and political fundamentals of the country are satisfactory.¹⁸⁰

To conclude, enforcing economic theories under the sanction of international law that are not empirically substantiated should be cautioned. Many objections have been raised against using theoretical models, economic assumptions of rationality, laissez faire approach and dedication to the efficiency promoted by the neo-liberal theory among others.¹⁸¹

¹⁷³ *Id.* at 84.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* at 86.

¹⁷⁷ *Id.* at 88.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ Avery Wiener Katz, *Positivism and the Separation of Law and Economics*, 94 Mich. L. Rev. 2229, at 2229 (1996).

The problem with the Washington Consensus, as applied by international financial institution in its pursuit to further the neo-liberal ideology, is the total dependence on market mechanism to the total exclusion of governments' role. It ignores issues of fair distribution of wealth and the specific circumstances and needs peculiar to each developing country.¹⁸²

It is important to recognize that economic theories are not "hard science," and that they can be used to further certain ideologies and specific interests.¹⁸³ In the context of liberalizing capital movements, there is no decisive empirical proof on the neo-liberal consensus regarding the liberalization of capital movements.¹⁸⁴ The facts maintain that there is no solid scientific basis behind the claim of capital account liberalization and its promise of growth, efficiency and development.

The effect of liberalization differs from developing to developed countries. Notwithstanding the existence of economic fundamentals, a developing country is more prone to financial crisis and herd behaviour of investors. Benefits generated from the total liberalization of capital flows can prove to be minimal compared to the costs incurred by developing countries.¹⁸⁵ The so-called price often overweighs the promised benefits for developing countries.¹⁸⁶

Absolute and immediate capital liberalization is not suitable for all countries, especially developing countries. Rather regulation of capital movement and particularly capital inflows is necessary. A distinction between different kinds of capital is important. States should be able to regulate capital and restrict certain types of capital and may distinguish between types of investors, which can be done through registration or licensing like in India. The distinction between short-term and long-term capital can prove, however, to be too general. Not all short-term capital is undesirable. The different characteristics of various types of short-term capital result in different consequences. For example trade credits, an essential component of

¹⁸² Lothian & Pistor, *supra* n. 55, at 117.

¹⁸³ Timothy A. Canova, *The Disorders of Unrestricted Capital Mobility and the Limits of the Orthodox Imagination: A Critique of Robert Solomon, Money on the Move: The Revolution in International Finance since 1980* (Princeton University Press, 1999), 9 *Minn. J. Global Trade* 219, at 219 (2000).

¹⁸⁴ Independent Evaluation Office, *supra* n. 83, at 11.

¹⁸⁵ Cf. Edwards, *supra* n. 43, at 263.

¹⁸⁶ Rajesh Swaminathan, *Regulating Development: Structural Adjustment and the Case for National Enforcement of Economic and Social Rights*, 37 *Colum. J. Transnat'l L.* 161, at 177 (1998).

international trade, is a short term capital.¹⁸⁷ It should also be noted that with the quick advance of financial tools that combines many features of both kinds of flows and difficulty of getting accurate results from empirical researches in this field, this distinction and the results thereof should be taken with caution.¹⁸⁸ Nevertheless, in terms of economic policy strategy, States should seek long-term capital flows and try to discourage short-term capital flows.¹⁸⁹

Financial markets that contain asymmetric information cannot be an effective tool for creating welfare in case of liberalizing capital flows.¹⁹⁰ Especially in case of developing countries that are not sophisticated enough to process all the related information, there is no guarantee that capital inflows will be used efficiently.¹⁹¹ Development means not only economic growth but also equitable distribution of wealth, reduction of poverty and unemployment, transfer of technology and sustainable development, among others. Economic policies that do not target these ends are not made for development.

The supposed benefits of liberalization are double-edged. While liberalization may produce economic growth, it does not ensure the sustainability of that growth. The argument that liberalization of capital movement would lead to efficiency and better allocation of investment, that is, allocation to its economically optimal utilization free from government interference is not supported with empirical evidence and fails in several aspects. A certain advancement and maturity in the market of the liberalizing State is a precondition for such sustainability. Also, theoretical underpinning of liberalization lack of empirical studies. Some kinds of foreign investment, mainly foreign direct investment, is long-term oriented and may transfer capital, technology to the host State, contributing to its economic growth and development. Yet other kinds of investment and capital are volatile and do not contribute to growth or development of the host state.

In summary, there seems to be no economic theory that presents a policy that can achieve a balance between public and private interests in liberalizing capital movements and achieving efficient allocation of resources while reaching an equitable distribution of income, alleviating

¹⁸⁷ Rogoff, *supra* n. 166.

¹⁸⁸ See Jones, *supra* n. 86, at 38-39.

¹⁸⁹ Deprez, *supra* n. 54, at 1243; Jones, *supra* n. 86, at 39.

¹⁹⁰ Eichengreen, *supra* n. 2, at 50.

¹⁹¹ *Id.*

poverty for developing countries, and avoiding crises.¹⁹² The trend of the heterodox policies is very general without clear content and has not been successful in many instances.¹⁹³ Central planning led to recurring shortage and acute inefficient allocation of economic resources.¹⁹⁴ However, this trend does help in exposing the drawbacks of the liberalization of international capital movement under economic liberalism.

There still exists a balancing approach of allowing capital movement, but regulating it through government intervention to insure that speculative and non-productive capital does not increase the risks of crises. Developed States' practice of this theory demonstrates that they imposed capital controls and did not liberalize international capital movements suddenly without sequencing. This confirms the conclusion that "[w]ithout intervention, globalization may instead lead to increased socioeconomic inequality and economic volatility."¹⁹⁵

As noted by the Independent Evaluation office of the IMF:

Whatever the potential benefits of capital account liberalization may be, policy makers must weigh them against its associated risks and costs, including the diminished ability to pursue monetary autonomy and exchange rate stability simultaneously, the possibility that excessive capital inflows may make macroeconomic management more difficult, and the greater vulnerability to contagion from financial crises that erupt elsewhere. Recent experience also shows that, with a weak regulatory framework, large capital inflows can exceed the absorptive capacity of the banking system, leading to inappropriate lending decisions and subsequent financial system fragility. The critical issue thus seems to be how best to manage the process of liberalization so as to make sure that the benefits outweigh the risks. Recognition of the centrality of process has led to a policy-oriented literature on the sequencing and speed of liberalization.¹⁹⁶

One means to regulate capital movement is to impose capital controls. The imposition of capital controls is controversial and there is an array of capital controls, all with distinct effects, functions and forms.

¹⁹² Cf. Carrasco & Kose, *supra* n.6, at 41.

¹⁹³ *Id.*

¹⁹⁴ Macey & Colomatto, *supra* n. 68, at 388.

¹⁹⁵ Thomas, *supra* n. 59, at 1451.

¹⁹⁶ *IMF Approach*, at 5.

III. Capital Controls

Capital controls can be defined as government measures that directly or indirectly affect the amount of capital movements and their allocation.¹⁹⁷ The word “control” can have many interpretations. The terms “control” and “restriction” are by no means the same.¹⁹⁸ Control is a broader term than restriction. Control does not only mean hindering or restricting the movement of capital but also encompasses the notion of restrictions and other measures, which may influence the capital movement in a positive rather than negative way.¹⁹⁹

Other definitions focus on the restrictive nature of controls. Some define capital controls as measures that aim to suppress capital inflows or outflows or that which affect their form.²⁰⁰ In the same vein, capital controls are defined as “regulatory measures to control or limit the flow of capital across ... borders”.²⁰¹

Others apply the term capital controls to measures that restrict capital quantitatively as opposed to measures that affect the price of the capital movement.²⁰² They consider capital controls to be a part of capital restrictions, which include both quantitative restrictions (capital controls) and other price based restrictions.²⁰³

From herein, capital controls will be used to refer to measures that regulate capital movements to achieve certain policy purpose whether encouraging, discouraging, restricting capital inflows or capital outflows or certain types of capital.²⁰⁴ However, the main focus will be on capital controls that discourage or restrict capital movements.

¹⁹⁷ Cf. Gold, *supra* n. 1, at 5.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ Duncan E. Williams, *Policy Perspectives on The Use of Capital Controls in Emerging Market Nations: Lessons from the Asian Financial Crisis and a Look at the International Legal Regime*, 70 *Fordham L. Rev.* 561, at 561 (2001).

²⁰¹ McKnight, *supra* n. 153, at 859.

²⁰² Cooper, *supra* n. 16, at 91.

²⁰³ *Id.*

²⁰⁴ Cf. Jomo K. S., *Malaysia's September 1998 Controls: Background, Context, Impacts, Comparisons, Implications, Lessons*, at 23 (G-24 Discussion Paper Series No. 36, 2005).

A. Classification and Kinds of Capital Controls

Capital controls can be divided into two categories. The first is tax or market-based capital controls or indirect capital controls, which usually depends on imposing taxes whether directly or indirectly.²⁰⁵ The second is administrative controls or direct capital controls that impose quantitative limit or require authorization for capital movement.²⁰⁶

The distinction between both direct and indirect capital controls can be made by observing whether the measure restricts the freedom of the private parties to do the transaction or whether it merely influences the decision making process by affecting the cost or profit of the transaction.²⁰⁷ The former are direct controls and the latter are indirect controls.

i. Indirect Capital Controls

Indirect capital controls are used to influence the cost of capital movement transactions, or both the cost and volume of the transactions.²⁰⁸ These kinds of controls generally use taxation, whether explicit or implicit, to influence capital movements by encouraging or discouraging them by making a transaction either more or less expensive to conduct.²⁰⁹

Indirect capital controls affect the cost of international transfers through many avenues including imposing taxes on foreign transactions and repatriation of dividends and profits; restricting interest payment on foreign obligations; requiring minimum reserve for foreign obligations; and establishing a dual or multiple exchange rate systems.²¹⁰

Tax levied on capital inflows is a direct characteristic for this category. This category could include direct tax and indirect tax on specific transactions.²¹¹ The government may also apply

²⁰⁵ Hsiao-Tang Hsu, *Capital Control and Domestic Interest Rates: A generalized Model*, Vo. 23(3) Contemporary Economic Policy 456, at 456 (2005); McKnight, *supra* n. 153, at 884.

²⁰⁶ Tang Hsu, *supra* n. 205, at 456.; McKnight, *supra* n. 153, at 884.

²⁰⁷ Gold, *supra* n. 1, at 4-5; Williams, *supra* n. 200, at 573; Akira Ariyoshi, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Iván Canales-Kriljenko, & Andrei Kirilenko, *Capital Controls: Country Experiences with Their Use and Liberalization*, at 5 (IMF occasional paper 190, 2000) [hereinafter Ariyoshi, *Country Experience*].

²⁰⁸ Ariyoshi, *Country Experience supra* n. 207, at 7.; Tang Hsu, *supra* n. 205, at 456.

²⁰⁹ Williams, *supra* n. 200, at 573; Ariyoshi, *Country Experience, supra* n. 207, at 7.

²¹⁰ Ariyoshi, *Country Experience supra* n. 207, at 7; Williams, *supra* n. 200, at 573-574. Cf. Gold, *supra* n. 1, at 4 (putting multiple exchange rate under direct capital controls).

²¹¹ McKnight, *supra* n. 153, at 884-885.

different tax rates on foreign transactions or impose different exchange rates according to the type of transaction in order to encourage or discourage specific transactions.²¹²

Many indirect controls are hardly distinguishable from prudential measures. An example of such indirect controls is the restrictions imposed on private persons from taking foreign loans except after having a minimum credit rating.²¹³ Other examples of indirect controls are “provisions for commercial bank’s net balance in foreign currency, limitations on unpaid foreign currency option contracts ‘that discriminates between long and short currency positions or between residents and non-residents’”²¹⁴ These can be considered prudential measures as well.

Another market-based capital control is a particular form indirect taxation. In this case, the central bank or an equivalent authority imposes “a non-remunerated reserve requirement on banks and companies on obligations denominated in foreign currency.”²¹⁵

An example of an unremunerated reserve requirement (URR) is the URR used by Colombia and Chile to combat short-term capital inflows.²¹⁶ The Chilean URR was imposed in June 1991 until September 1998.²¹⁷ The URR directs foreign lenders to Chilean private persons to deposit an amount equal to a certain percentage of their loan in a non-interest generating account at the Chilean Central Bank for a certain time period.²¹⁸ At first, the time period for the deposit was between ninety days to one year depending on the maturity of the investment.²¹⁹ This was amended in 1992 to one year without regard to the maturity of investment.²²⁰ The URR scope changed over time to cover more investment, except for what was conceived as “nonspeculative foreign direct investment”.²²¹

²¹² Williams, *supra* n. 200, at 573.

²¹³ *Id.* at 574.

²¹⁴ *Id.* at 573 (footnote omitted).

²¹⁵ McKnight, *supra* n. 153, at 885.

²¹⁶ Jones, *supra* n. 86, at 87.

²¹⁷ Michael K. Ulan, *Should Developing Countries Restrict Capital Inflows?*, 579 *Annals* 249, 253 (2002).

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.* (Colombia also applied URR. However, Colombia was not successful like Chile).

ii. Direct or Administrative Capital Controls

Direct or administrative controls refer to a governmental direct interference in its regulatory capacity with the clear intent of directing capital flows.²²² These are straightforward controls. They are done through banning or restricting capital movements or underlying capital transactions. These controls encompass restrictions on certain transactions or a requirement of prior approval on certain transactions.²²³

Administrative controls are usually intended to directly shape the volume of capital flows. They oblige banks to control such flows.²²⁴ “The usual methods of ...direct controls are prohibitions, quantitative limits (quotas), rule-based or discretionary approval, and minimum-stay requirements for direct and portfolio investment.”²²⁵

These may be a complete ban of certain transfers, a requirement of authorization by the appropriate authorities for each transaction, or prescribing certain amount of foreign liability and/or credit that can be undertaken by banks and other private persons whether as borrowers or lenders.²²⁶

Administrative controls can take many forms, including (i) restricting capital access totally or from certain sectors; (ii) screening to decide to permit or reject it and may put some conditions to permit the access of the foreign investment (e.g. performance requirements)²²⁷; (iii) limiting foreign ownership; (iv) imposing maximum percentage of shareholding in corporations; (v) restricting the amount of obligations owed to foreigners.²²⁸; and (vi) requiring registration.²²⁹

An example of prior approval requirement to control capital and minimize speculation is the Taiwanese Qualified Foreign Institutional Investors.²³⁰ It restricts the ability of foreigners to

²²² Ariyoshi, *Country Experience* supra n. 207, at 7.

²²³ Williams, supra n. 200, at 572.

²²⁴ Ariyoshi, *Country Experience*, supra n. 207, at 7.

²²⁵ Williams, supra n. 200, at 572.

²²⁶ Gold, supra n. 1, at 4; Ariyoshi, *Country Experience*, supra n. 207, at 7.

²²⁷ Muchlinski, supra n. , at 63.

²²⁸ McKnight, supra n. 153, at 889.

²²⁹ UNCTAD, *Trends in International Investment Agreements: An Overview* in UNCTAD Series on issues in international Investment Agreements, UNCTAD/ITE/IIT/13, at 63 (1999).

²³⁰ Williams, supra n. 200, at 573.

deal in the Taiwanese stock exchange except those authorised by the Taiwanese security market regulatory agency.²³¹

iii. Exchange Controls

Exchange controls are frequently used to ensure enforcement of capital controls.²³² It is difficult to define exchange controls. A suggested definition offers that exchange controls are tools of monetary policy that restrict the ability to pay or transfer funds to non-residents.²³³ Classic exchange controls entail designating a national institution to exclusively regulate all foreign exchange allocation and operations.²³⁴ Originally, they were used to restrict capital outflows.²³⁵ Exchange controls are employed to preserve the country's balance of payment by restricting the demand on foreign exchange, to protect and stabilize the country's monetary resources, and to allocate foreign exchange to achieve maximum benefit.²³⁶

A method of enforcing exchange controls is to register all capital inflows upon its entry.²³⁷ This way, repatriation of returns and original capital is permitted on the basis of the value recorded in this registration.²³⁸ Exchange controls may involve limiting the ability to convert the national currency into foreign currencies.²³⁹

According to the IMF Articles, member countries may not enforce exchange contracts that are concluded in breach of exchange control regulations of another member country, which are related to the latter's currency.²⁴⁰ However, discriminatory and undue exchange controls are

²³¹ *Id.*

²³² Richard W. Edwards, *International Monetary Collaboration*, at 450 (Transnational Publishers, Inc., 1985); Cf. Jomo, *supra* n. 204, at 24.(maintaining that exchange controls can be kind of capital controls and may be used to ensure its enforcement. But this is not always the case; exchange controls may be used for restricting current account for balance of payment purposes).

²³³ Charles Proctor, *International Payment Obligations: A Legal Perspective*, at 225 (Butterworths, 1997).

²³⁴ A.A. Fatouros, *Government Guarantees to Foreign Investors*, at 47.

²³⁵ *Id.*

²³⁶ *Id.*; Proctor, *supra* n. 233, at 225.

²³⁷ Jeswald W. Salacuse, *Host Country Regulation of Joint Ventures and Foreign Investment Codes*, in *JOINT VENTURING ABROAD: A CASE STUDY*, at 118 (ed., David N. Goldsweig, ABA, 1985).

²³⁸ *Id.*

²³⁹ Hans Visser, *Exchange Rates and Development*, in *International Economic Law with a Human Face*, at 537 (ed. Friedl Weiss, Erik Denters & Paul de Waart, Kluwer Law International, 1998).

²⁴⁰ *Articles of Agreement of the International Monetary Fund*, adopted July 22, 1944, (entered into force Dec. 27, 1945).

denied effect in some national courts. English courts, for example, will not take into account foreign exchange controls that are imposed “in a discriminatory or oppressive manner”.²⁴¹

A multiple exchange rate system mainly offers certain transactions a better exchange rate than it offers to others.²⁴² Dual and multiple exchange rate systems seek to increase the cost of transactions on speculative transactions especially to avoid short-term inflows with high interest rates which the government perceives as overburdening residents.²⁴³ Dual and multiple exchange rate systems satisfy the demand of non-speculators for credit under normal exchange rates, while giving a higher exchange rate to such speculators.²⁴⁴ This requires imposing and monitoring foreign exchange transactions of residents and dealings of national currency by non-residents to distinguish between capital and current transactions.²⁴⁵ This is done through directing financial institutions not to lend to such speculators while allowing lending and foreign exchange transactions to foreign direct investment and trade activities.²⁴⁶

B. Reasons for Using Capital Controls

There are many reasons posited for using capital controls. In addition to the abovementioned concerns regarding liberalizations of international capital movements, there are additional reasons to impose capital controls. Foreign investment and capital flows may cause macro economic and balance of payments problems.²⁴⁷ There are many risks that arise from lifting all capital controls in an inefficient capital market. In a developing country where the banking system is not developed enough, the country may not be able to effectively utilise the inflows to its most efficient use.²⁴⁸ If the economy cannot utilize capital inflows efficiently, the market will expect the ability of the economy to repay its external debt and sustain capital inflows.²⁴⁹

The inexistence of efficient regulatory system and financial markets that can deal with such flows, especially in developing countries, is an obstacle for the efficient use of international

²⁴¹ Proctor, *supra* n. 233, at 237.

²⁴² Fatouros, *supra* n. 234, at 47; Salacuse, *supra* n. 237, at 119.

²⁴³ Ariyoshi, *Country Experience*, *supra* n. 207, at 7.

²⁴⁴ *Id.*

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ R. Barry Johnston & Natalia T. Tamirisa, *Why Do Countries Use Capital Controls?*, at 13 (IMF Working paper WP98/181, 1998).

²⁴⁸ McKnight, *supra* n. 153, at 878.

²⁴⁹ Johnston, *supra* n. 117.

capital.²⁵⁰ This problem can be illustrated in the Chilean experience in the late 1970s. Chile allowed the free capital inflows and was able to attract a large amount of capital. The banking system, with low supervision from the government, accumulated bad loans which was one of the reasons for the big recession that followed the 1980's debt crisis.²⁵¹ This is in addition to the prudential reasons.²⁵²

Argentina is another example. In the 1990s, Argentina followed the model set by the international financial institutions in terms of privatisation and liberalization of financial markets. Large amounts of capital inflows went to Argentina.²⁵³ The country was considered a model in applying the neo-liberal prescription of the Washington Consensus. However, services provided by foreign investors who took the public services' privatised companies, fell short of providing basic needs.²⁵⁴ Financial crisis erupted. Foreign investment failed to provide and sustain the growth and development needs of Argentina.²⁵⁵ Part of the reason had to do with the inefficiency or absence of governmental institutions capable of dealing with foreign investment and able to secure that foreign investment would contribute to the growth and development of the host country.²⁵⁶ Thus, the theoretical advantages that liberalizing capital movements will lead to advancing the domestic financial sector and accordingly decreasing the volatility seems to be realized only in developed countries which have institutions and market capable of benefiting from and sustaining capital movement.²⁵⁷

In addition, capital controls on inflows are used to minimize the need to use sterilization (and other monetary tools like fiscal policy) and to avoid making adjustments.²⁵⁸ Governments usually utilize two economic policy tools for countering the negative effect of capital inflows.²⁵⁹

The first is sterilization, which "principally refers to the use of open market operations by the central bank" for the purpose of decreasing the undesirable effect of capital inflows.²⁶⁰ It is an

²⁵⁰ Johnston & Tamirisa, *supra* n. 247, at 13.

²⁵¹ McKnight, *supra* n. 153, at 879.

²⁵² Johnston & Tamirisa, *supra* n. 247, at 13.

²⁵³ Lothian & Pistor, *supra* n. 55, at 112.

²⁵⁴ *Id.*

²⁵⁵ *Id.* at 113.

²⁵⁶ *Id.*

²⁵⁷ Prasad et al., *supra* n. 4, at 9.

²⁵⁸ Ariyoshi, *Country Experience*, *supra* n. 207, at 6.

²⁵⁹ McKnight, *supra* n. 153, 876.

operation where the national central bank sells securities dominated in the local currency to reduce the capital inflows effect on the country's money supply.²⁶¹ The sterilization aims at reducing money supply. A government may also issue bonds to absorb the excess of money.²⁶²

However, this can prove to be an expensive operation for the government due to the difference between the cost of the bonds and the revenue from foreign assets.²⁶³ Moreover, sterilization may lead to higher interest rate and result in more capital inflows benefitting from the higher interest rate, which exacerbates the problem.²⁶⁴

The second method is fiscal policy. Fiscal policy entails hard, political decisions for governments, which undermine its usefulness.²⁶⁵ In short, these economic tools may not be sufficient to halt the negative effect of large capital inflows.²⁶⁶

Capital controls are used to halt short-term capital inflows and increase the maturity thereof. A substantial amount of short-term capital inflows into a developing country can carry many risks. These flows are volatile and reversible, which may cause currency depreciation and collapse of the economy.²⁶⁷ This stems from the "maturity transformation" characteristic of capital markets.²⁶⁸

"Maturity transformation" refers to the fact that lenders want to have more liquid investment to be able to liquidate rapidly in case of risks or for more profitable opportunities, while borrowers want to have longer term liabilities.²⁶⁹ Financial institutions like banks come as intermediaries to accommodate the conflict of interests between borrowers and lenders.²⁷⁰ They usually do so by diversifying and using the "law of large numbers".²⁷¹ They rely on the assumption that not all customers will desire to withdraw all their money at the same time.²⁷² They accordingly keep

²⁶⁰ *Id.* 877.

²⁶¹ Ulan, *supra* n. 217, 253.

²⁶² McKnight, *supra* n. 153, 877.

²⁶³ Ariyoshi, *Country Experience*, *supra* n. 207, at 6.

²⁶⁴ McKnight, *supra* n. 153, 877 ; Ariyoshi, *Country Experience*, *supra* n. 207, at 6.

²⁶⁵ McKnight, *supra* n. 153, 877-878.

²⁶⁶ *Id.* 878.

²⁶⁷ Jones & Kimmis, *supra* n. 90, at 161.

²⁶⁸ Cooper, *supra* n. 16, at 100.

²⁶⁹ *Id.*

²⁷⁰ *Id.*

²⁷¹ *Id.*

²⁷² *Id.*

only the amount they expect that will be claimed liquid and lend the rest for terms longer than what their lenders want.²⁷³

This “maturity transformation” characteristic is not realized only in the banking system but also in an efficient capital market where securities holders can liquidate their securities in the secondary market while issuers use the raised funds to invest for a longer term.²⁷⁴ However, one of the often occurring characteristics of a liberalized financial system in developing countries is the sudden increase of claims to liquidity that exceed the financial system to provide which causes financial crisis.²⁷⁵ Surge of capital outflows usually follows. This destabilizes the macroeconomic tools, causing fluctuations in exchange rates and the assets’ prices.²⁷⁶ This is accompanied by unemployment and poverty;²⁷⁷ “new borrowing becomes more difficult, old loans become impossible to roll over, and aggregate demand slumps, wasting productive resources and lowering real income”²⁷⁸; resulting in all kinds of social, economic and political problems that may threaten a country’s stability. This is one of the consequences of the microeconomic advantages to foreign investors of liquidity and free capital movement which negatively affect the macroeconomics of the host country.

Capital controls are also traditionally used to manage balance of payment and macroeconomics.²⁷⁹ A country with a balance of payment problems usually uses capital controls to restrict capital outflows.²⁸⁰ From a macroeconomic perspective, capital controls are used to guard against destabilizing short-term capital flows and related instability in exchange rates, “asymmetric information problems”, and the investors’ herd behaviour.²⁸¹

Balance of payment justification for using capital controls is sometimes explained in terms of reducing the cost of domestic debt servicing to finance domestic projects when national savings fall short from while also keeping domestic interest rate low.²⁸² In the same vein, capital

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ *Id.*

²⁷⁶ Jones & Kimmis, *supra* n. 90, at 161.

²⁷⁷ *Id.*

²⁷⁸ Cooper, *supra* n. 16, at 100.

²⁷⁹ Johnston & Tamirisa, *supra* n. 247, at 13.

²⁸⁰ *Id.*

²⁸¹ *Id.* at 14.

²⁸² *Id.* at 13.

controls are used to reduce the effect of the difference between domestic and international interest rates while decreasing the pressure on exchange rates.²⁸³ This mode is criticized, since employing capital controls for lowering interest rates would, arguably, hurt existing investors in national assets and would decrease national saving.²⁸⁴ It is submitted, however, that the change in domestic interest rates will not have substantial effects on capital flows in case of effective capital controls in place.²⁸⁵ Nevertheless, this wedge may encourage avoidance thereof, and the effectiveness of capital controls will depend on the difference between the costs of and the profit from avoiding them.²⁸⁶

Another rationale forwarded is the desire to keep a level of “monetary and exchange rate policy autonomy” towards achieving national targets and lessening attacks on domestic currency exchange rate.²⁸⁷ Capital controls may be used to preserve the exchange rate system. Any exchange rate system needs to regulate the national banking system’s short-term foreign exchange liabilities.²⁸⁸ The foreign exchange market is a huge market and its turnover by far exceeds trade in goods and services. The trading in the foreign exchange market in one day exceeds the total global central banks reserve.²⁸⁹ Regulation may include imposing exchange controls on short-term capital inflows.²⁹⁰ The movement of short-term capital can drain international reserves, causing considerable instability in interest rates, which could potentially destroy the fixed exchange rate regime.²⁹¹ A country that wants to keep a fixed exchange rate regime may use capital controls for that purpose.²⁹² Capital controls “lengthen the period of time for which a currency peg can be maintained given the stance of monetary and fiscal policies...”²⁹³

²⁸³ Ariyoshi, *Country Experience*, *supra* n. 207, at 15.

²⁸⁴ Johnston & Tamirisa, *supra* n. 247, at 13.

²⁸⁵ Ariyoshi, *Country Experience*, *supra* n. 207, at 5.

²⁸⁶ *Id.*

²⁸⁷ Johnston & Tamirisa, *supra* n. 247, at 13. (emphasis omitted); Ariyoshi, *Country Experience*, *supra* n. 207, at 5.

²⁸⁸ McKinnon, *supra* n. 137, at 202.

²⁸⁹ William R. White, *The Tobin Tax: A Solution to Today’s International Monetary Instability?*, 1999 Colum. Bus. L. Rev. 365, at 365 (1999).

²⁹⁰ McKinnon, *supra* n. 137, at 202.

²⁹¹ Johnston & Tamirisa, *supra* n. 247, at 14.

²⁹² *Id.*; Macey & Colomatto, *supra* n. 68, at 397.

²⁹³ Eichengreen, *supra* n. 2, at 104.

Recent experiences suggest that if there is capital mobility, it is not feasible to have fixed but adjustable rates.²⁹⁴ It is argued that free capital movement also does not fit with floating exchange rates in most countries, other than in developed countries like the US and the EU, that do not have the same advanced capital markets nor as diversified an economy.²⁹⁵ Speculative attacks on any currency, even developed countries' currencies, can destroy the macroeconomic policy of any country.²⁹⁶

In addition to developing countries' currency crises like Mexico in 1994, the 1990s saw currency crises in developed countries, such as in Italy and the UK in 1992, France in 1993, and Spain in 1995.²⁹⁷ Such speculative attacks led Sweden to change its policies in 1992 after failing to defend its currency begs.²⁹⁸ The United States was not immune from the effect of exchange rate changes either. Between 1994-1995, the US had to change some of its strategic targets as the dollar was deteriorating against the Yen.²⁹⁹ Capital controls can be used as a temporary tool to avoid such consequences.³⁰⁰

Capital controls can be used to preserve the stability of the financial system by restricting national entities from assuming substantial foreign exchange liability, or by changing the nature of liabilities of financial institutions from short-term to long term ones.³⁰¹ Banks and other domestic financial actors may have an incentive to borrow for a short-term foreign exchange to benefit from differences in interest rates in cases of begged or fixed exchange rates.³⁰² The fixed or begged exchange rate provides a kind of implied guarantee.³⁰³ In addition, some research has found that pegging the exchange rate in order to halt inflation distorts capital market.³⁰⁴ It is argued that a pegged exchange rate, coupled with domestic inflation, leads to increase in capital inflows since foreign investors stand to gain more than national investors. An established

²⁹⁴ Geoffrey Wood, *The IMF in a Changing World*, in Sir Joseph Gold Memorial Series International Monetary and Financial Law Upon Entering the New Millennium a Tribute to Sir Joseph and Ruth Gold, (ed. Joseph J. Norton and Mads Andenas, The British Institute of International and Comparative Law, 2002); Cooper, *supra* n. 115.

²⁹⁵ Cooper, *supra* n. 115.

²⁹⁶ Eichengreen, *supra* n. 2, at 99.

²⁹⁷ *Id.*

²⁹⁸ *Id.*

²⁹⁹ *Id.*

³⁰⁰ Johnston & Tamirisa, *supra* n. 247, at 14.

³⁰¹ *Id.* at 15.

³⁰² McKinnon, *supra* n. 137, at 202.; Ariyoshi, *Country Experience*, *supra* n. 207, at 5.

³⁰³ Ariyoshi, *Country Experience*, *supra* n. 207, at 5.

³⁰⁴ McKinnon, *supra* n. 137, at 201.

exchange controls can solve this problem.³⁰⁵ This is more acute in developing countries where interest rates are usually higher than those in developed countries. This gives banks and other lenders in these countries more incentive to borrow foreign exchange from developed countries to benefit from the difference.³⁰⁶

In addition, when the government uses interest rates and exchange rates concurrently in pursuing contradictory internal and external balance targets, capital controls can be used to resolve this conflict of targets.³⁰⁷ Controls on outflows, in general, aims at preventing currency depreciation without resorting to tough measures like pursuing restrictive monetary policy.³⁰⁸ In contrast, capital controls on capital inflows are used to prevent a currency appreciation as a result of surge in capital inflows, while keeping national “monetary conditions” under control.³⁰⁹

Using capital controls for prudential reasons is justified on the grounds that international transactions inherently involve different kinds of risk than that of national transactions.³¹⁰ To allow the trade and listing of foreign securities, different sets of conditions are required other than just those required from national securities.³¹¹ This is due to the possible existence of different regulatory and accounting systems, and difficulties relating to enforcement in other jurisdictions.³¹²

C. Problems Associated with Capital Controls

Many problems are associated with the use of capital controls, which relate to their effectiveness and efficiency. First, it is asserted that capital controls cause distortions, create corruption, and are almost always (after a certain time) evaded or avoided.³¹³

³⁰⁵ *Id.*

³⁰⁶ *Id.* at 203-204 (2002).

³⁰⁷ Johnston & Tamirisa, *supra* n. 247, at 13-14.

³⁰⁸ *Id.* at 14.

³⁰⁹ *Id.*

³¹⁰ *Id.* at 15.

³¹¹ *Id.*

³¹² *Id.*

³¹³ Rogoff, *supra* n. 166; Reuven Glick & Michael Hutchison, Capital Controls and Exchange Rate Instability in Developing Economies, at 3 (Federal Reserve Bank of San Francisco Working Paper PB00-05, 2002) available at <http://www.frbsf.org/publications/economics/pbcpapers/2000/pb00-05.pdf>.

Second, capital controls are always condemned by their critics to fail, whether in the policy target they want to achieve or in their general effectiveness. Some evidence shows that capital controls are not effective in assisting the balance of payment position against capital outflows.³¹⁴ To keep capital controls effective and sustainable, the government must be able to extensively interfere in the trade and financial systems, which entails negative consequences.³¹⁵ The government also must stay disciplined in order to restrain unwarranted surges in capital inflows during boom times.³¹⁶

Third, the classical theory on capital controls on inflows maintains that capital controls lead to an increase in interests, thus influencing the country welfare and productivity.³¹⁷ This is because imposing capital controls raises the cost of capital, and hence, the interests increase to compensate for this cost and output fall. However, data on countries applying capital controls reveals different results: in some countries, interest rates increased, while in others, they decreased.³¹⁸ Research on the effect of liberalizing capital movements and capital controls has led to contradictory results with many methodological problems.³¹⁹ Capital controls may destabilize the economy and cause financial crises since they may increase capital outflows and discourage foreign investors from investing in the country in the future.³²⁰ Furthermore, it is asserted that capital controls are not effective in countering capital outflows.³²¹ And by lifting capital controls, a country sends a positive sign to foreign investors, which is responded to by more capital inflows.³²²

Yet these inflows may not be sustainable from the start.³²³ China is an example to the contrary. China attracts investment more than any other country, except for the US, although it imposed

³¹⁴ Johnston & Tamirisa, *supra* n. 247, at 13.

³¹⁵ Rogoff, *supra* n. 166.

³¹⁶ *Id.*

³¹⁷ Tang Hsu, *supra* n. 205, at 456.

³¹⁸ *Id.*

³¹⁹ Stiglitz, *supra* n. 162, at 221; Ariyoshi, *Country Experience*, *supra* n. 207.

³²⁰ Glick & Hutchison, *supra* n. 313, at 3.

³²¹ Johnston, *supra* n. 117.

³²² *Id.*

³²³ *Id.*

certain performance requirements on some types of foreign investment and had many restrictions on capital movement.³²⁴

Furthermore, it is intrinsically problematic to ascertain the effect of capital controls from statistical and econometric studies.³²⁵ There is no means to identify the effect of capital controls with certainty or to precisely distinguish it from the effect of other factors that influence the economy.³²⁶ There are many reasons for this, including the extreme difficulty of quantifying the effect of capital controls and separating the effect thereof from other different political and external factors that affect capital movements, and the unavailability of accurate records on capital accounts.³²⁷

D. Cost based capital controls: A compromise stance?

From the economic liberalism school, a trend emerged that recognizes that the immediate and radical capital liberalization movement is not the best method, neither economically nor politically. This trend recognizes the risk inherent in some kinds of capital movements.³²⁸ It cautions from immediate and total liberalization and finds that gradual liberalization -- in other words, “sequencing” -- is more suitable for developing countries.³²⁹

The IMF started to show some support for “sequencing” in capital account liberalization after the Asian Crisis.³³⁰ Many conditions are prerequisite for such liberalization. These include adequate institutions and existence of macroeconomic fundamentals.³³¹ However, it is submitted that there is no proof of a model “for the optimal pace and sequencing of integration.”³³² Yet regulation of certain sectors is crucial.

³²⁴ George O. White III, *Foreigners at the Gate: Sweeping Revolutionary Changes on the Central Kingdom's Landscape--Foreign Direct Investment Regulations & Dispute Resolution Mechanism in the People's Republic of China*, 3 Rich. J. Global L. & Bus. 95, at 97-98, 106-107 (2003).

³²⁵ Ariyoshi, *Country Experience*, *supra* n. 207, at 3.

³²⁶ Natalia T. Tamirisa, *Do Macroeconomic Effects of Capital Controls Vary by Their Type? Evidence from Malaysia*, at 3 (IMF Working Paper WP/04/3 2004).

³²⁷ Ariyoshi, *Country Experience*, *supra* n. 207, at 3.

³²⁸ Mussa, *supra* n. 85.

³²⁹ Prasad et al., *supra* n. 4, at 5.; Mussa, *supra* n. 85.

³³⁰ Independent Evaluation Office, *supra* n. 83, at 22.

³³¹ Prasad et al., *supra* n. 4, at 5.

³³² *Id.*

There could be three players who may default on credits, namely sovereigns, banks and other private persons.³³³ The banking system is crucial for any domestic economy, and its foreign exchange denominated debt is a matter of concern for any government.³³⁴ Its collapse results in the inability to finance national economy. In case of a threat to the banking system, the government has to bail it out. Accordingly, the government has to regulate this system so that it does not undertake excessive risk, which threatens the whole economy.³³⁵ The regulation of government may take the form of capital controls. However, this trend distinguishes between cost based capital controls and other controls that are in the nature of total prohibitions.

According to this trend, increasing the cost of capital mobility for certain transactions is a middle way to combine private and public interest.³³⁶ After research on Chile's URR revealed its effect in increasing the maturity of capital flows, the IMF staff seemed to agree on the use of indirect capital controls temporarily.³³⁷ However, they stayed unequivocally opposed to the use of administrative capital controls, especially on capital outflows.³³⁸

This trend recognizes the special problem faced by developing countries' economies. As discussed earlier, the nature of financial crises and the consequences thereof are not the same for developed and developing countries.³³⁹ It acknowledges that the liberalization of economy, and specifically, financial liberalization, have notably taken place before crises.³⁴⁰ Almost all currency crises are triggered by a surge in capital inflows, followed by a reverse surge in capital outflows.³⁴¹

Yet foreign direct investment should be liberalized since it does not pose the same risks and generate more benefits than costs.³⁴² Evidence shows that portfolio and bank loans flows are volatile and increase the risk of financial crises, in contrast to foreign direct investment.³⁴³ A

³³³ Although sovereign default is the most drastic one, it is not relevant to the subject of this thesis and will not be discussed.

³³⁴ Mussa, *supra* n. 85.

³³⁵ *Id.*

³³⁶ Eichengreen, *supra* n. 106.

³³⁷ Independent Evaluation Office, *supra* n. 83, at 27.

³³⁸ *Id.*

³³⁹ Akyiiz & Cornford, *supra* n. 114, at 15.

³⁴⁰ *Id.* at 16.

³⁴¹ *Id.*

³⁴² Mussa, *supra* n. 85.

³⁴³ Prasad et al., *supra* n. 4, at 8.

segment in this trend distinguishes between credit portfolio investment and equity portfolio investment. The international equity portfolio flows affect the prices of equities and may cause instability in managing economic policy (Hong Kong is an example).³⁴⁴ However, this instability, according to this trend, does not cause drastic economic crisis.³⁴⁵ A reversal of foreign investment in equities may also create problems for countries with fixed exchange rates.³⁴⁶ However, it is asserted that this is due to the intrinsic nature of a fixed exchange rate system and not foreign investment.³⁴⁷ It is the international credit portfolio investment that causes such crisis.³⁴⁸

To conclude, even in the liberal trend, it is recognized that capital controls are necessary. This trend promotes the use of one kind of capital controls that allows the movement of capital although makes it more expensive and thus reduces the short-term gain incentive for volatile capital.

E. Evaluation of Capital Controls and East Asian Crisis

One of the tools to regulate capital movements is capital controls. They have been used by developed countries successfully before they liberalized capital movements. They still keep the option to use them in crises. Capital controls on inflows are especially important to prevent volatile capital. Other macroeconomic tools may not be available to the country. Recent empirical economic research and the most recent financial crisis have both shown that countries which used capital controls on inflows were able to avoid the consequences of the financial crises.³⁴⁹

Moreover, although some studies confirm that investment and liberalization of capital flows movement lead to growth, others find that they do not inevitably result in economic growth. For example, some studies in Africa conclude that investment does not lead to growth, neither in the

³⁴⁴ Mussa, *supra* n. 85.

³⁴⁵ *Id.*

³⁴⁶ Rogoff, *supra* n. 166.

³⁴⁷ *Id.*

³⁴⁸ Mussa, *supra* n. 85.

³⁴⁹ Jonathan D. Ostry, Atish R. Gosh, et al, *Capital Inflows: The Role of Controls*, IMF Staff Position Note No. SPN/10/04, at 13 (2010).

short term nor in the long term.³⁵⁰ Other conditions must exist before liberalizing the capital movement to reach the goals of growth and development such as advanced regulatory and mature market must exist. Efficiency and growth have no inherent value. It depends on the purpose it serves for the society and the society conditions.³⁵¹

The assertion that economic liberalization and the integration of the economies into a global economy is an inevitable process that cannot be reversed is not true.³⁵² If this liberalization lacks the required political foundation and equitable legal and economic system that ensure its sustainability, it may not advance and could be reversed.³⁵³

The liberalism trend's justification of economic crisis as a result of the bad policies of host States is not true in all cases. Many States that did not have monetary and fiscal imbalances have suffered from speculative attacks that caused currency turmoil.³⁵⁴ As explained above, many speculative attacks are "self-fulfilling" that attack a sustainable exchange rate system.³⁵⁵

The system has to be fair and equitable in order to be sustainable.³⁵⁶ To be fair and equitable, it must, while rewarding the innovative and productive, accommodate the needs and conditions of the most vulnerable. It must be sustainable and not under the risk of changing moods of speculative capital. Crises usually follow capital liberalization in developing countries. There is no way, either, to accurately anticipate financial and currency crises. It seems, from the economic literature, that there is no one correct policy to be followed, since speculative attacks can cause currency turmoil even if there are no macroeconomic imbalances and the economic fundamentals are good.³⁵⁷

In short, the "one-size-fits-all" mode is not working.³⁵⁸ In 2002, the then IMF economic counsellor and director of the IMF's Research Department submits that the IMF, in many instances, did not properly warn developing countries about the dangers of opening their markets

³⁵⁰ Mosoti, *supra* n. 95, at 97-98.

³⁵¹ Katz, *supra* n. 181, at 2245.

³⁵² Gilpin, *supra* n. 29, at 13.

³⁵³ *Cf. Id.* at 13-14.

³⁵⁴ Eichengreen, *supra* n. 2, at 105.

³⁵⁵ *Id.* at 100.

³⁵⁶ Gilpin, *supra* n. 29, at 4.

³⁵⁷ Eichengreen, *supra* n. 2, at 102-103.

³⁵⁸ Lothian & Pistor, *supra* n. 55, at 117.

to short-term capital without suitable financial systems or adequate macroeconomic fundamentals already in place.³⁵⁹ He admits that developing countries are losing more from the liberalization of capital movements.³⁶⁰ He ends up, however, standing conclusively against using capital controls, although he cautions that more research is still required.³⁶¹

This stance seems hard to defend objectively. As mentioned above, there is no conclusive empirical proof on the beneficial effect liberalization of capital movements. There are many other distortions and inefficiencies that may hinder the benefits that may arise from international capital liberalization and lifting capital controls, while keeping only their risks to be shouldered by vulnerable economies. An example of other distortions is when protected industries exist in an economy. Capital liberalization may lead to the flow of capital to these industries to benefit from the protection, although there may not be a comparative advantage in this industry.³⁶²

The economic analysis of uncertainty helps to explain financial crises in this context.³⁶³ The analysis shows how new forms of capital inflows are not reasonably reliable for a country that seeks a sustainable capital flows for achieving growth and development.³⁶⁴ It also serves as an indicator for developing economies of the high risk they undertake in the process of liberalization and deregulation.³⁶⁵ The uncertainty is high regarding new financial tools not previously experimented. Uncertainty is even higher in unregulated markets or insufficiently regulated markets.³⁶⁶

This explains episodes of financial crises that have coincided with deregulation and financial tools advancement.³⁶⁷ When there is a high rate of uncertainty, investors lose confidence easily and the smallest remote incidence may lead to reactions that are not proportionate.³⁶⁸ A little devaluation and decline in the circumstances of a state in Mexico resulted in high surge of capital

³⁵⁹ Kenneth S. Rogoff, *The IMF Strikes Back*, 134 *Foreign Policy* 38, at 43-44 (2003), available at <http://www.foreignpolicy.com/Ning/archive/archive/134/rogoff2.qxd.pdf>; Rogoff, *supra* n. 166.

³⁶⁰ Rogoff, *supra* n. 359, at 43-44; Rogoff, *supra* n. 166.

³⁶¹ *Id.*

³⁶² Eichengreen, *supra* n. 2, at 49.

³⁶³ Jones, *supra* n. 86, at 9.

³⁶⁴ *Id.* at 10.

³⁶⁵ *Id.*

³⁶⁶ *Id.* at 9.

³⁶⁷ *Id.* at 10.

³⁶⁸ *Id.*

outflows.³⁶⁹ This necessitates retaining an “adequate regulation and supervision to avoid excessively risky behaviour by financial intermediaries”.³⁷⁰ However, developing countries, in general, do not have the adequate institutions to deal with large capital flows, and are more vulnerable to financial and currency crises.³⁷¹

It is useful at this point to discuss the application of capital controls during a crisis and its effect. East Asia’s economic growth and crisis teach many lessons. Some viewed the success to support pursuing a liberal policy. The crisis showed the amount of controversy and uncertainty that surrounds the liberalization of capital movements, and the conflict between much academic economic literature on the subject and what was presented by international financial institutions as the economic advice. The East Asian crisis is informative regarding the risks of lifting all capital controls. It also showed the different political interests from the international community.

The crisis started in Thailand and soon progressed to Indonesia.³⁷² It soon reached Korea, Brazil, and Russia, all of which have liberalized capital movements.³⁷³ A substantial amount of capital inflows entered these economies, changing their “macroeconomic variables.”³⁷⁴ The account deficit was not in a public sector deficit, but rather a private sector deficit. These countries had strong functioning economies with high prospects of return for investments.³⁷⁵

One of the causes of the crisis was the excessive and partly inefficient investment rather than excessive consumption. This substantially increased exchange rates and assets’ prices.³⁷⁶ Accordingly, the purchasing power of domestic currencies increased as the imports began to cost less, which meant an increase in real income. With the increase in the value of assets, the wealth increased as well.³⁷⁷ Banks lent more with the consequential increase in consumption and private investment.³⁷⁸ The increase in both consumption and investment quickly reduced the

³⁶⁹ *Id.*

³⁷⁰ *Id.*

³⁷¹ *Cf. Edwards, supra n. 43, at 263.*

³⁷² Jared Levinson, *Proceedings Of The 1999 Symposium: Regulation Of International Capital Markets : "Fragile, Handle With Care": Indonesia And The Issue Of Capital Controls In A Nation Facing Disintegration*, 17 *Wis. Int'l L.J.* 529, 532 (1999).

³⁷³ *See Stiglitz, supra n. 162., at 220; Jones & Kimmis, supra n. 90, at 164.*

³⁷⁴ *Id.*

³⁷⁵ *Id.*

³⁷⁶ *Id.*

³⁷⁷ *Id.*

³⁷⁸ *Id.* 164.-165.

balance of payment current account.³⁷⁹ This usually is not viewed as problematic so long as investors are still satisfied with investing and expecting high returns with little risk. This sustains until such expectation ceases to be true. The crisis may be primarily caused by loss of confidence as opposed to macro-economic inefficiency.³⁸⁰

When the Asian crisis took place, along with what followed in Russia and Latin American countries, the varied interests between different nations appeared in the way they individually explained the crisis reasons as well as the prescribed solutions they suggested.³⁸¹

The so called “crony capitalism” term was introduced to explain the failure of the liberal system during the East Asian crisis. The term refers to the alleged corruption in the banking system that allowed the misallocation of resources.³⁸² The US advocated for the view that the crisis happened because of the bad policies of the suffering countries. The US advocated a “new global financial architecture”.³⁸³ This architecture includes enhancing transparency and accountability in the financial system, using international standards, and freedom of capital movement.³⁸⁴

The IMF leaned toward this theory. Accordingly, the IMF conditioned its bailouts to Indonesia, South Korea, and Thailand on further liberalizing capital movements.³⁸⁵ It also insisted that the Asian countries must reduce the domestic demand by raising interest rates and decreasing government’s expenditure.³⁸⁶

On the other hand, Asia and the European Union considered that the cause of the financial crisis was the reforms advocated by the IMF to liberalize capital movements. In the 1990’s, upon advice from the IMF, the Asian governments, liberalized capital movements that increased speculative capital in stock market and property market.³⁸⁷ The capital inflows consisted of loans to local firms, which were not adequately regulated due to the hasty move towards financial deregulation. This led to incurring a huge debt to foreigners in the absence of

³⁷⁹ *Id.* at 165.

³⁸⁰ *Id.*

³⁸¹ Wade, *supra* n. 45, at 43.

³⁸² *Id.*

³⁸³ *Id.* at 44.

³⁸⁴ *Id.*

³⁸⁵ *Id.* at 43 (1998); Lang, *supra* n. 46, at 465.

³⁸⁶ Wade, *supra* n. 45, at 44.

³⁸⁷ *Id.* at 43.

government supervision.³⁸⁸ The European Union, accordingly, found that the solution to prevent the reoccurrence of such crises is involving governments in the regulation of the financial market and international capital movements.³⁸⁹ There should be different rules for different groups of countries according to their monetary position and other factors. Each group of countries has different protection rules from capital movements. Governments should be able to regulate capital movements and impose capital controls.³⁹⁰

Many Asian countries agreed with the European Union's stance.³⁹¹ For instance, in September 1998, Malaysia imposed foreign exchange restrictions to halt the attacks on its currency and the shortage of foreign reserve it was suffering as a result thereof.³⁹² Malaysia also wanted to keep the increase domestic demand and decrease interest rates while keeping the national currency from collapsing.³⁹³

In the same vein, Hong Kong restricted some speculative dealings in its currency and stocks to halt speculative attacks thereon.³⁹⁴ Taiwan followed suit by introducing restrictions on capital inflows and outflows.³⁹⁵ And Japan expressed its wish that the Group of Seven reconsider its policy that encourages the liberalization of capital movements.³⁹⁶

Asian countries, having just witnessed the financial crisis, regarded free capital movements a threat to their economic stability. Capital controls were needed, especially with the inexperience of these countries with capital markets and the lack of adequate regulation of the banking system and financial market. Establishing such systems takes many years, during which capital controls are required to keep the system from collapsing.³⁹⁷

Meanwhile, these countries were taking expansionary monetary and fiscal policies to recover from the crisis. Capital controls were needed to avoid a surge of outflows of capital as a result of

³⁸⁸ *Id.*

³⁸⁹ *Id.* at 43-44.

³⁹⁰ *Id.* at 44.

³⁹¹ *Id.*

³⁹² Cooper, *supra* n. 16, at 89.

³⁹³ Wade, *supra* n. 45, at 48.

³⁹⁴ *Id.*

³⁹⁵ *Id.*

³⁹⁶ *Id.* at 48-49.

³⁹⁷ *Id.* at 49.

investors anticipating lower interest rates or inflation.³⁹⁸ Moreover, Asian countries, in general, have huge domestic savings and do not need foreign capital.³⁹⁹

The instability seems to be an intrinsic characteristic of free international capital movement system.⁴⁰⁰ India and China escaped the Asian crisis because of the capital controls they had in place.⁴⁰¹ And Malaysia had a shorter downturn because it imposed capital controls.⁴⁰² Since there is no effective means utilised on the international level to ensure the stability of the financial system and prevent crises, developing countries should retain their regulatory autonomy to prescribe policies regarding international capital movements.⁴⁰³ One of the means available is capital controls.

In a study by the IMF on five countries⁴⁰⁴ that applied controls on capital inflows, it was found that controls were effective in establishing the wedge between domestic and international interest rates; nevertheless, three of the five countries (Brazil, Chile, and Colombia) were not able to keep their exchange rates without change under continuous rising pressure from the market.⁴⁰⁵ Real exchange rates increased in all five countries, but more substantially in the three aforementioned countries with the increase in the external current account deficit.⁴⁰⁶ The same study also found that controls on inflows decreased the amount of inflows in Malaysia and Thailand, and were able to decrease the short term capital inflows in all five countries.⁴⁰⁷ Two countries (Brazil and Chile) had to continue sterilization operations, thus incurring the administrative costs.⁴⁰⁸

As mentioned above Malaysia is an example of a successful use of capital controls during crises. It is important to look to the Malaysian experience in using capital controls before and during the Asian crisis. Malaysia imposed capital controls on short-term inflows in 1994 to maintain

³⁹⁸ *Id.*

³⁹⁹ *Id.*

⁴⁰⁰ Akyiiz & Cornford, *supra* n. 114, at 41.

⁴⁰¹ Stiglitz, *supra* n. 162, at 220; *cf.* Ariyoshi, *Country Experience supra* n. 207, at 29.

⁴⁰² Stiglitz, *supra* n. 162, at 221.

⁴⁰³ Akyiiz & Cornford, *supra* n. 114, at 41.

⁴⁰⁴ Brazil, Chile, Colombia, Malaysia, and Thailand.

⁴⁰⁵ Ariyoshi, *Country Experience supra* n. 207, at 15.

⁴⁰⁶ *Id.* at 15-16.

⁴⁰⁷ *Id.* at 16.

⁴⁰⁸ Ariyoshi, *Country Experience, supra* n. 207, at 16.

monetary control during a time where inflation was increasing.⁴⁰⁹ Malaysia also begged its currency to the US dollar.⁴¹⁰ During the Asian crisis, Malaysia “adopted a combination of administrative (prohibition of non-resident purchases of money market securities and non-trade-related swap transactions with nonresidents) and regulatory measures (asymmetric limits on banks’ external liability positions for nontrade purposes and reserve requirements on ringgit funds of foreign banks).”⁴¹¹

Malaysia amended its capital account regulation, not as a result of routine reviews, but instead used capital controls as a policy tool to halt the negative consequences of short-term flows on its economy.⁴¹² Many economists thought the rate of the peg was devaluated.⁴¹³ A study of the Malaysian capital controls shows that, in contrast to the liberal theory of capital controls, the imposition of capital controls in Malaysia was followed by increase in output and decrease in interest rates.⁴¹⁴ This is because the difference between the theory and real data is that the theory does not account for the lessening of external debt and moral hazard. The reduction of external debt may counter the costs of capital controls and lead to a decrease in interest rates and increase of output.⁴¹⁵ The assumption rests on the basis of whether and to what extent the economy borrowing is rated upon its external debt level. If the debt level affects the borrowing rate of the economy, capital controls will result in a decrease of interest rate and an increase of output. This is because the reduction of external debt will outweigh the required increase in rate of return because of capital controls. Conversely, if the economy’s borrowing rate is more independent of the external debt level, then the required rate of return will increase accompanied with decrease in output.⁴¹⁶ This study concludes that capital controls do not inherently negatively affect the economy.⁴¹⁷

The East Asian crisis confirm the necessity of capital controls. States that used capital controls in inflows before the crises like India and China avoided the financial crisis negative

⁴⁰⁹ Tamirisa, *supra* n. 326, at 3.

⁴¹⁰ Tamirisa, *supra* n. 326, at 4.

⁴¹¹ Ariyoshi, *Country Experience*, *supra* n. , at 13-14.

⁴¹² Tamirisa, *supra* n. 326, at 7.

⁴¹³ *Id.* at 4.

⁴¹⁴ Tang Hsu, *supra* n. 205, at 457.

⁴¹⁵ *Id.*

⁴¹⁶ *Id.* at 463.

⁴¹⁷ *Id.*

consequences. Countries like Malaysia that imposed capital controls on outflows after the crisis were able to recover in a shorter time. Similarly, recent research confirms that “the empirical evidence suggests that the use of capital controls was associated with avoiding some of the worst growth outcome associated with financial fragility.”⁴¹⁸

V. Conclusion

While liberalizing international capital movement can potentially drive global development and growth, regulation is essential to quell the imperfections of the market and equalize the differences in economic power and advancement of structures in different States. Without regulation, the benefits of liberalization will be transferred unevenly to the already developed and rich, while the risks transfer to the poor and underdeveloped.⁴¹⁹

This is countered that liberal reform includes social assistance and plans for unemployment insurance. Some studies found that growth led to more equitable distribution.⁴²⁰ Nonetheless, the social assistance plans are not always successful in developing countries with their limited resources. Meanwhile, international financial aid falls short from developing countries needs.⁴²¹

Neo-liberals tend to ignore the externalities effect on developing countries. This economic principle does not allow for a true prediction for its prescription as it relies on certain theoretical assumptions that may not come true and on uncontrollable factors that cannot be guaranteed.⁴²² Neo-liberal theorists offer their diagnosis and prescription of a free market without government’s interference in the regulation of international capital of movement as if it is an objective and neutral science, with no external factors. Yet no empirical research proves that the liberalization of international capital movements lead to economic growth.

Fair or equitable distribution, for the most part, does not concern neo-liberal economists who focus primarily on efficiency.⁴²³ They ignore the possibility that their prescriptions of

⁴¹⁸ Jonathan D. Ostry, Atish R. Gosh, et al, *Capital Inflows: The Role of Controls*, IMF Staff Position Note No. SPN/10/04, at 13 (2010).

⁴¹⁹ Hockett, *supra* n. 20, at 167-168.

⁴²⁰ See Aslund, *supra* n. 36, at 78.; Vandeveld, *supra* n. 8, at 392.

⁴²¹ Aslund, *supra* n. 36, at 82.

⁴²² Cf. Canova, *supra* n. 183, at 219.

⁴²³ Katz, *supra* n. 181, at 2247.

liberalizing international capital movements may lead to increasing the wealth of certain communities in the world without benefiting the already deprived communities.⁴²⁴

Also, the growth of the global economy alone does not ensure fair or equal distribution of the results of this growth.⁴²⁵ Many developing countries liberalize capital movements not because of an ideological conviction, but rather as a means for attracting capital needed for development and/or in compliance with structural adjustments imposed by international financial institutions.⁴²⁶

Yet many countries that do not follow the neo-liberal prescription on liberalizing international capital movement attract foreign investment.⁴²⁷ And they have been very successful in gradually maintaining economic growth while minimizing the risk of financial crises. India is but one example. Thus, the neoliberal argument of lifting all barriers on international capital movement will attract foreign capital is incorrect. In addition, the law protection component of the Washington Consensus has a minimal weight in the foreign investors' decision to invest in certain countries, even though it may affect thereafter the mode of entrance.⁴²⁸

What attracts foreign investment and capital is profit opportunities.⁴²⁹ Factors like availability of raw materials, the size of the host country market and geographical proximity of the country with the target market are the main criteria that control the decision to invest in a certain country.⁴³⁰

Liberalizing capital movement to achieve efficient allocation of resources and generating more benefit than costs is an argument that does not recognize who will get the most benefit and who has to live with the costs and risk. Most benefits go to the financial community of investors through the ability to take the best opportunities to profit while simultaneously being able to withdraw money quickly if troubles appear. The combination of allowing short-term capital and banning the use of restrictions on capital outflows only benefits foreign investors while leaving the risk to fall solely on the host state.

⁴²⁴ Cf. Thomas, *supra* n. 59, at 1451.

⁴²⁵ *Id.*

⁴²⁶ Vandeveld, *supra* n. 8, at 390.

⁴²⁷ Lothian & Pistor, *supra* n. 55, at 109.

⁴²⁸ *Id.*

⁴²⁹ Dolzer & Stevens, *supra* n. 26, at 12.

⁴³⁰ Lothian & Pistor, *supra* n. 55, at 109.

Finally, it is submitted that lifting barriers on international capital movement is not likely to attract sustainable foreign capital and may not accordingly achieve the required growth and development.⁴³¹ The liberal legal agreement model represented by BITs that liberalize capital movements fails to address the problems of market failure and equitable distribution.⁴³² This model cannot maintain the liberal economic system sustainability.

To carry its promise, differences between economies must be taken into account and distinct kinds of capital and investor must be treated accordingly. For one, regulation of short term capital is required to avoid crises. Considering what types of investors might be also important for admitting capital. Integration of different economies must only be allowed gradually until compatibility is achieved. This ensures that the realization of the required efficiencies while minimizing the risks of financial crises. Western Europe after World War II have used gradual transformation to liberalize capital movement.⁴³³ In doing so, there existed interventionist governments with competent institutions and high public finance (the Marshal Plan). This is a characteristic that is lacking in many developing States.⁴³⁴

It is important to note that the current account convertibility mandated by the IMF Articles (Article VIII) was applied by European countries in 1961.⁴³⁵ As for controls on capital transfers, they stayed far longer. Imposing capital controls was wide spread in most developed countries after the WWII.⁴³⁶ They were in effect in many countries including those in Western Europe. The controls in the United Kingdom that were imposed at the beginning of World War II were only lifted in 1979.⁴³⁷ And they are still considered a legal option in certain situations in European Community.

Furthermore, OECD States did not agree to restrict their ability to regulate the right of establishment and capital inflows until 1984 under the *OECD Code of Liberalisation of Capital*

⁴³¹ A good example for the case of a country that did not dismantle all capital controls is China.

⁴³² Vandeveld, *supra* n. 8, at 395.

⁴³³ Carrasco & Kose, *supra* n.6, at 25.

⁴³⁴ See Aslund, *supra* n. 36, at 71.

⁴³⁵ Cooper, *supra* n. 16, at 95.

⁴³⁶ Glick & Hutchison, *supra* n. 313, at 2.

⁴³⁷ Cooper, *supra* n. 16, at 95.

Movements, which deals with admission and establishment of investment.⁴³⁸ Even if capital controls were distorted, removing them might not lead to development since there are other distortions.

Following certain economic ideology without decisive empirical proof based on highly controversial foundations should not be forced via international political mechanisms or international legal obligations. The latter can be more disastrous given the legal obligation required and the mandatory enforcement dispute settlement used to enforce the economic theory under legal sanction.

BITs and other regional agreements that include capital liberalization do not provide means to enforce the promised gains of liberalizations: development, technology transfer, capital movement, performance requirement, and the ability to change types of investment. They only provide obligations on the host State to provide certain rights and minimum treatment to foreign investors, and allow capital related to investment to move freely in and out of the host State. And investment is broadly defined to include foreign direct investment as well as short term and speculative investment. On the other hand, they do not prohibit the home country from restricting the ability of investors to invest or transfer technology.⁴³⁹

To conclude, immediate and complete liberalization of capital movements is not a viable option for many countries, especially developed countries. The use of capital controls on the inflows of capital is necessary to avoid volatile short-term capital. Also, the use of capital controls on outflows in case of financial crisis is a legitimate policy tool that should be available to states.

⁴³⁸ See Franziska Tschofen, *II. Multilateral Approaches to the Treatment of Foreign Investment*, in Ibrahim F. I Shihata, *Legal Treatment of Foreign Investment: The World Bank Guidelines*, at 273 (Martinus Nijhoff Publishers, 1993); OECD, *OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations: User's Guide 2007*, at 7 (OECD, 2007).

⁴³⁹ Cf. Dolzer & Stevens, *supra* n. 26, at 18.

Chapter Three: Breadth of Investment and its Admission Clauses under BITs

I. Introduction

The concept of investment is a prominent factor in determining the types of transactions protected by BITs obligations. The content of the term investment determines the scope of the coverage of the BIT. It also determines the scope of protected capital relating to such investment that BITs mandate its transferability.

The definition of investment is important to identify the capital that is protected and entitled to transfer under BITs. While most BITs define investment, they do not define capital. It is thus important to identify what constitutes investment to identify what funds benefit from BITs transfer of funds provisions. The breadth of the concept of investment affects directly the scope of the obligation to transfer capital under BITs. If the investment is defined and interpreted broadly, the covered capital would be similarly broad.

Most BITs generally define investment and the definition is broad. Some BITs define investment as every asset, while others define investment as every investment. Both of these types include non-exhaustive lists of what is included in the definition of investment. These lists are also broad and cover a wide range of assets and transactions. These broad definitions of investment have created ambiguity of the subject of protection and led to different interpretations. Two competing interpretations exist. The first maintains that every asset and transaction included in the treaty definition qualifies as investment. This has been adopted in most arbitral awards. The second interprets the treaty definition as limited to assets that have the characteristics of investment, which is followed by a minority of arbitral awards. As a result of this, some recent BITs, such as the US BITs, have specified that the assets must have certain characteristics to be considered investment.

BITs definition also affects the kind of transactions that is subject to BITs admission rules. Under international law, a sovereign country, as an attribute of sovereignty, has the right to control and regulate the transfer of foreign investment into its territory. Such right is not

restricted, unless otherwise provided in an international treaty.¹ This right is treated in BITs. Yet, it is also broadly drafted in many BITs.

Under BITs, there are two types of treatment of the host State's sovereign power to regulate the entrance of foreign investment. Both are broad. Most BITs permit the admission of investment subject to the host State's domestic laws. While this regulation of investment's admission is conceptually clear, its breadth and application do not reflect its conceptual clarity. Case law is inconsistent. Admission of investment provisions have sometimes been interpreted in a manner that narrows the extent of host State discretionary powers considerably in certain instances, while maintaining it in other cases.

Some case law, as discussed further below, holds that even when the host State requires certain approvals or registration in order for a foreign investment to enter its territory, foreign investors that do not comply with such requirements may still be considered to have a valid investment that is protected under BITs and entitled to all the BITs rights, which may include the right to receive capital transfers. This is because the admission clauses in these BITs do not specifically refer to registration or prior approvals requirements under the host state laws.

Furthermore, some BITs purport to limit the ability of States to regulate the admission of investment. A minority of BITs grant national treatment (NT) and most favoured nation treatment (MFN) at the admission phase. These BITs typically include a list of exceptions that provides that admission of investments in certain sectors or activities is not subject to national treatment and MFN obligations.

One way to restrict capital movement is by restricting the underlying investment. Thus, it may be even more difficult to regulate capital inflows indirectly by regulating the underlying investment in domestic law. This is because even under BITs that leave the power of admission to host state laws, such regulation may not be enforceable.

This chapter analyzes the concept of investment, related capital, and investment different interpretations under BITs. It also analyzes BITs' admission of investment provisions. The analysis seeks to answer the following questions. Is the investment definition in BITs necessary

¹ Ian Brownlie, *Principles of Public International Law*, at 520 (OUP, 2008).

to protect and promote investment or is it broader than what is necessary? The answer to this question affects the investment entitled to admission and capital transfers. If the definition is broad, this broadens the ambit of the capital entitled to transfers. The second question is: what is the effect of the broad drafting of admission clauses in BITs on the ability of states to regulate the admission of capital? The admission of foreign investment is important since an important way to regulate capital is by regulating the underlying investment and because admission of foreign investment gives rights to investors to repatriate capital arising from that investment. If the breadth of the admission clauses restricts the ability of the host state unduly or unexpectedly, it negatively affects its ability to use one of its monetary policy tools to regulate investment. The analysis will mainly be based on three countries model BITs, namely: Germany, the UK and the US.

II. Definition of Investment

A. General

The ordinary meaning of investment refers to the expansion of capital or resources to acquire or establish certain asset in order to gain profit over a certain amount of time.² Brownlie refers to “the nature of an investment as a form of expenditure or transfer of funds for the precise purpose of obtaining a return.”³ Investment thus entails an action, which is payment of money or allocation of certain assets; and the asset that will generate the profit over time. The term investment typically is identified with either these two: the action or “process” of purchasing or establishing the profit-generating asset; or the profit generating asset itself.⁴

² See Oxford English Dictionary (2nd ed., 1989) (“The conversion of money or circulating capital into some species of property from, which an income or profit is expected to be derived in the ordinary course of trade or business.”). Cf. Martin Hunter & Alexei Barbuk, *Reflections on the Definition of an ‘Investment’*, in Global Reflections on International Law, Commerce and Dispute Resolution, at 384 (Gerald Aksen et al ed., ICC Publishing, 2005); Jeswald W. Salacuse, *The Law of Investment Treaties*, at 18 (OUP, 2010); *Malaysian Historical Salvors SDN BHD v. The Government of Malaysia*, ICSID Case No. ARB/05/10 (Decision on Annulment), para. 57 (Apr. 16, 2009) (“The ‘ordinary meaning’ of the term ‘investment’ is the commitment of money or other assets for the purpose of providing a return.”) [hereinafter *MHS Annulment*].

³ *CME Czech Republic B.V. v. Czech Republic*, UNCITRAL (Award), para. 34 (Mar. 14, 2003) (Separate Opinion of Ian Brownlie) [hereinafter *CME Award*]

⁴ Salacuse, *supra* n. 2 , at 18.; Noah Rubins, *The Notion of ‘Investment’ in International Investment Arbitration, in Arbitrating Foreign Investment Disputes*, at 284 (ed. Norbert Horn, Kluwer Law International, 2004). See also Oxford English Dictionary (2nd ed., 1989) (“An amount of money invested in some species of property; also, A form of property viewed as a vehicle in which money may be invested.”)

On the other hand, there is a lack of a common legal definition of investment.⁵ Different treaties contain different definitions and formulations for the term investment. Some treaties, like the International Centre for Settlement of Investment Disputes (ICSID) Convention, do not even define investment.

The ICSID Convention only provides that “[t]he Jurisdiction of the Centre shall extend to any legal dispute arising directly from investment.”⁶ This led to different interpretations for this term in legal writings and arbitral awards.⁷ Two main trends under ICSID exist; subjective interpretation and objective interpretation of the term investment.⁸

One is a subjective trend. It relies on the parties’ definition of investment and their consent to the jurisdiction of the ICSID to evidence the existence of an investment.⁹ If the parties agree that certain transactions constitute investment, then there is an investment under ICSID.

The second trend, the objective trend, defines investment under ICSID Convention with reference to the common characteristics of investment.¹⁰ Investment by and large has the following characteristics: (i) commitment of funds or resources; (ii) “a certain duration;” (iii) expectation of profit; and (iii) “assumption of risk.”¹¹

To start, any investment requires funding or other contribution; like technical knowledge or know how. Also, an investment requires certain “extended duration,” which distinguishes it

⁵ Patrick Juillard, *Freedom of Establishment, Freedom of Capital Movements, and Freedom of Investment*, in Liber Amicorum Ibrahim F.I. Shihata : International Finance and Development Law, at 453-454 (Sabine Schlemmer-Schulte & Ko-Yung Tung eds., Kluwer Law International, 2001); Rudolf Dolzer & Christoph Schreuer, *Principles of International Investment Law*, at 60 (OUP, 2008).

⁶ Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, done at Washington DC on 18 March 1965, art. 25(1) (*entered into force* 14 Oct. 1966).

⁷ For more details on the definition of investment under ICSID see Emmanuel Gaillard, *Identify of Define? Reflections on the Evolution of the Concept of Investment in ICSID Practice*, in International Investment Law for the 21st Century : Essays in Honour of Christoph Schreuer, at 403-416 (eds. Christina Binder et al, OUP, 2009).

⁸ *MHS Annulment*, para. 62 (Dissenting Opinion of Judge Mohamed Shahabuddeen).

⁹ Farouk Yala, *The Notion of “Investment” in ICSID Case Law: A Drifting Jurisdictional Requirement? Some “Un-Conventional” Thoughts on Salini, SGS and Mihaly*, 22 J. Int’l Arb. 105, at 106 (2005); Walid Ben Hamida, *The Mihaly v. Sri Lanka Case: Some Thoughts relating to the Status of Pre-Investment Expenditures*, in International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law, at 53 (ed. Todd Weiler, Cameron May Ltd, 2005).

¹⁰ Yala, *supra* n. 9, at 106.; Hamida, *supra* n. 9, at 53.

¹¹ See Christoph Schreuer et al., *The ICSID Convention: A Commentary*, at 128 (Cambridge University Press, 2nd ed., 2009); Rubins, *supra* n. 4, at 297-298.; Yala, *supra* n. 9, at 106.; *Joy Mining Machinery Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/03/11 (Award), para. 53 (Aug. 6, 2004) [hereinafter, *Joy Mining Award*].

from a normal sale of good transaction for example.¹² The expectation to make profit from the assets is an integral part of any investment, even if no profit was realized.¹³ Finally, an investment entails certain assumption of risk that the assets will not generate the expected profit over the extended period.¹⁴ This distinguishes it from a contractual risk that the other party will not satisfy its obligation under a purchase agreement for example.¹⁵

Under ICSID Convention, many tribunals and commentators found that the above are the characteristics of investment, and some added the requirement that investment contributes to the host State development relying on the preamble of the ICSID Convention that refers to development of the host State.¹⁶ For example, in *Fedax*, the ICSID tribunal noted that investment is “described as involving a certain duration, a certain regularity of profit and return, assumption of risk, a substantial commitment and a significance of the host State’s development.”¹⁷ Similarly in *Salini v. Morocco (Salini I)*¹⁸, the tribunal found for an investment to qualify as such under ICSID Convention, the following should exist: “contributions, a certain duration of performance of the contract and a participation in the risks of the transaction. In reading the Convention's preamble, one may add the contribution to the economic development of the host State of the investment as an additional condition.”¹⁹

B. Investment under BITs

As for BITs, investment is the subject of its protection, and BITs generally include a definition of investment. This definition limits the subject matter of the BIT, the capital regulated thereby and the dispute settlement mechanism contained in such BIT.²⁰ Yet the definition is typically very broad.

¹² Rubins, *supra* n. 4, at 297.

¹³ *Id.*

¹⁴ *Id.* at 298.

¹⁵ *Id.*

¹⁶ *See for e.g.* Schreuer et al., *supra* n. 11, at 128.

¹⁷ *Fedax N.V. v. Venezuela*, ICSID case no. ARB/96/3, Decision of the Tribunal on Objections to Jurisdiction of 11 July 1997, 37 ILM 1378, at 1387, para. 43 (1998) [hereinafter *Fedax Jurisdiction*].

¹⁸ *Salini et al. v. Morocco*, ICSID Case No. ARB/00/4 (Decision on Jurisdiction), 42 ILM 609, (July 23, 2001) [Hereinafter, *Salini Jurisdiction*].

¹⁹ *Salini Jurisdiction*, para. 52 (citations omitted).

²⁰ Ursula Kriebaum & Christoph Schreuer, *The Concept of Property in Human Rights Law and International Investment Law*, in Human Rights, Democracy and the Rule of Law Liber amicorum Luzius Wildhaber, at 744 (S. Breitenmoser et al eds., Nomos Verlagsgesellschaft, 2007).

Generally, BITs refer to the profit-generating asset in their definition of investment and not to process of investment. Two main trends exist in defining investment under BITs. These two trends exist in the Model BITs and BITs that follow them, which refer either to “every kind of assets” or to “every kind of investment” in defining investment.²¹ The former is very broad, while the latter is defining investment as investment, which is ambiguous. Both trends typically follow the definition by a non-exhaustive list of what is considered covered in the term investment. The Model BITs, as most modern BITs, follow one of these trends.

The German Model BIT definition of investment includes any type of asset.²² A non-exhaustive list is provided, which includes a broad spectrum of assets such as property rights, securities, money and performance claims, intellectual property and concessions. It states:

[T]he term ‘investments’ comprises every kind of asset, in particular:

- (a) movable and immovable property as well as any other rights in rem, such as mortgages, liens and pledges;
 - (b) shares of companies and other kinds of interest in companies;
 - (c) claims to money which has been used to create an economic value or claims to any performance having an economic value;
 - (d) intellectual property rights, in particular copyrights, patents, utility-model patents, industrial designs, trade-marks, trade-names, trade and business secrets, technical processes, know-how, and good will;
 - (e) business concessions under public law, including concessions to search for, extract and exploit natural resources;
- any alteration of the form in which assets are invested shall not affect their classification as investment.²³

²¹ See for e.g. *Treaty between the United States of America and the Republic of Panama Concerning the Treatment and Protection of Investments*, 21 I.L.M. 1227, signed October 27, 1982, art I (d) (defining investment as “every kind of investment”); *Treaty between the Federal Republic of Germany and the Democratic Socialist Republic of Sri Lanka Concerning the Promotion and Reciprocal Protection of Investment*, signed February 7, 2000, art. 1(1) (defining investment as “every kind of asset”) [hereinafter *Germany-Sri Lanka BIT*]; *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United Republic of Tanzania for the Promotion and Protection of Investments*, signed January 7, 1994, art. 1(a) (entered into force on August 2, 1996) (defining investment as “every kind of investment”).

²² *Model Treaty between the Federal Republic of Germany and ... Concerning the Encouragement and Reciprocal Protection of Investments*, (February, 1991), reprinted in Rudolf Dolzer & Margrete Stevens, *BILATERAL INVESTMENT TREATIES*, art. 1 (1) (Kluwer Law International, 1995) [hereinafter *German Model BIT*].

²³ *Id.* See also *Germany-Sri Lanka BIT*, art. 1(1) (“[T]he term ‘investments’ comprises every kind of asset”); *Treaty between the Federal Republic of Germany and the Federal Democratic Republic of Ethiopia concerning the Encouragement and Reciprocal Protection of Investments*, signed Jan. 19, 2004, art. 1(1) (entered into force May 4, 2006) (“[T]he term ‘investments’ comprises every kind of asset”); *Treaty Between the Kingdom of Lesotho and the Federal Republic of Germany Concerning the Encouragement and Reciprocal Protection of Investments*, signed Nov. 11, 1982, art. 1(1) (entered into force Aug. 17, 1985) (“The term ‘investments’ shall comprise every kind of asset”).

Some German BITs restrict this definition. For example, the China-German BIT limits the investment definition by adding the qualifier “invested” to assets.²⁴ It states: “‘investment’ means every kind of asset *invested* directly or indirectly by investors of one Contracting Party in the territory of the other Contracting Party”²⁵ The term “invested” entails employing these assets to produce income to profit from such asset. It is not enough to own the asset; it must be used to produce income. The BIT’s Protocol explicitly requires that the investment purpose be for “lasting economic relations;” “in connection with an enterprise;” and the ability to “exercise effective influence its management.”²⁶ It states: “For the avoidance of doubt, the Contracting Parties agree that investments as defined in Article 1 are those made for the purpose of establishing lasting economic relations in connection with an enterprise, especially those which allow to exercise effective influence in its management.”²⁷

Another variance from the German model BIT’s definition exists in the German-India BIT, which states: “‘Investment’ means every kind of asset *invested in accordance with the national laws* of the Contracting Party where the investment is made”²⁸ This definition thus qualifies the investment to an asset that is “invested,” and is made in accordance with the host State law. Investment that is made in violation of host State law will not be covered.²⁹

Similar to the German Model BIT, but differently worded, the Model UK BIT states that “‘investment’ means every kind of asset”, and follows that with a non-exhaustive list of what is included in the definition.³⁰ The non-exhaustive list refers to all property rights on movables and

²⁴ See *Mytilineos Holdings SA v. Serbia and Montenegro and Serbia*, UNCITRAL (Partial Award on Jurisdiction), para. 7 (Sept. 6, 2006) (Dobrosav Mitrovic dissent) [hereinafter *Mytilineos Jurisdiction*].

²⁵ *Agreement between the People's Republic of China and the Federal Republic of Germany on the Encouragement and Reciprocal Protection of Investments*, signed Dec. 1, 2003, art. 1(1) (entered into force Nov. 11, 2005) (emphasis added) [hereinafter *China-German BIT*]

²⁶ See Norah Gallacher & Wenhua Shan, *Chinese Investment Treaties: Policies and Practice*, at 59 (OUP, 2009) (The China-German BIT “introduces three additional ‘objective tests’ to the term ‘investment’ defined under the ‘definition’ provision, namely ‘lasting economic relations’, ‘connection with an enterprise,’ and ‘effective influence in management’ tests.”).

²⁷ *China-German BIT*, protocol ad. art. 1(a).

²⁸ *Agreement between the Federal Republic of Germany and the Republic of India for the Promotion and Protection of Investment*, signed July 10, 1995, art. 1 (b) (entered into force July 13 1998) (emphasis added) [hereinafter *India-German BIT*].

²⁹ Cf. *BG Group Plc v. Argentina*, UNCITRAL (Award), para. 117 (Dec. 24, 2007) (finding that a similar provision in the Argentina-UK BIT is in effect a *renvoi* to host State law) [hereinafter *BG Award*] But see *infra* for awards finding that such requirement means only that the investment must be legal.

³⁰ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of for the Promotion and Protection of Investments*, art. 1 (a) [hereinafter *UK Model BIT*]

immovable property, securities, contract rights, intellectual property rights, and any change in the form which these assets are invested. It states:

“investment’ means every kind of asset and in particular, though not exclusively, includes:

- (i) movable and immovable property and any other property rights such as mortgages, liens or pledges;
- (ii) shares in and stock and debentures of a company and any other form of participation in a company;
- (iii) claims to money or to any performance under contract having a financial value;
- (iv) intellectual property rights, goodwill, technical processes and know-how;
- (v) business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources.

A change in the form in which assets are invested does not affect their character as investments and the term “investment’ includes all investments, whether made before or after the date of entry into force of this Agreement.³¹

The term “every kind of asset” is qualified in some UK BITs. The UK-Argentina BIT for example qualifies the assets to those defined as such under the host State law. It provides that “‘investment’ means every kind of asset *defined in accordance with the laws and regulations of the Contracting Party in whose territory the investment is made* and admitted in accordance with this Agreement and in particular”³² In *BG*, the tribunal found that this provision constitutes a *renvoi* to the host State law, which “requires th[e] tribunal to apply the laws of Argentina to the interpretation of this part of the definition of ‘investment’ in the Argentina-UK BIT.”³³

³¹ *Id.*. See also, *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Moldova for the Promotion and Protection of Investments*, signed Mar. 19, 1996, art 1 (a) (entered into force on July 30, 1998) (including similar definition) [hereinafter *UK-Moldova BIT*]; *Agreement Between The Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ecuador for the Promotion and Protection of Investments*, signed May 10, 1994, art. 1 (a) (entered into force Aug 24, 1995) (including similar definition) [hereinafter *UK-Ecuador BIT*]; *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of El Salvador for the Promotion and Protection of Investments*, signed Oct. 14, 1999, art. 1 (a) (entered into force Dec. 1, 2000) (containing similar definition) [hereinafter *UK-Salvador BIT*] Cf. *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of Bangladesh for the Promotion and Protection of Investments*, signed June 19, 1980, art. 1 (a) (entered into force June 19, 1980) (containing similar definition, but without referring to the change in the form of the invested assets); *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investment*, signed June 11, 1975, art. 1 (a) (entered into force Feb. 24, 1976) (containing similar definition, but without referring to the change in the form of the invested assets) [hereinafter *UK-Egypt BIT*].

³² *Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Argentina for the Promotion and Protection Of Investments*, signed Dec. 11, 1990, art. 1(a) (entered into force Feb. 19, 1993) (emphasis added).

³³ *BG Award*, para. 117, available at http://ita.law.uvic.ca/documents/BG-award_000.pdf.

Not all UK BITs define investment as “every kind of asset” though. The UK-Tunisia BIT defines investment as follows: “‘investment’ means every kind of investment admitted into the territory of one Contracting Party in accordance with its laws and regulations”³⁴ This definition is similar to the definition of investment under US BITs, which is discussed below. This definition also qualifies the protected investment to that admitted in accordance to the host State law.

As for the US Model BITs, investment definition has developed with time in different US model BITs and US BITs that followed them. Until 2004, the investment definition under the US model BITs and BITs was circular; defining investment as “every kind of investment.”³⁵ This was followed by a non-exhaustive list of what the investment or its form could include. While this approach is similar to the German and UK Model BITs, the investment definition refers to “every kind of investment,” instead of “every kind of asset.” The 1992 US Model BIT for example states:

“investment” means every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and service and investment contracts; and includes:

- (i) tangible and intangible property, including rights, such as mortgages, liens and pledges;
- (ii) a company or shares of stock or other interests in a company or interests in the assets thereof;
- (iii) a claim to money or a claim to performance having economic value, and associated with an investment;
- (iv) intellectual property which includes, inter alia, rights relating to: literary and artistic works, including sound recordings, inventions in all fields of human endeavour, industrial designs, semiconductor mask works, trade secrets, know-how, and confidential business information, and trade marks, service marks, and trade names; and
- (v) any right conferred by law or contract, and any licenses and permits pursuant to law.³⁶

³⁴ *Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Tunisian Republic for the Promotion and Protection of Investments*, signed Mar. 14, 1989, art. 1(a) (entered into force Jan. 4, 1990).

³⁵ Kenneth J. Vandeveld, *U.S. International Investment Agreements*, at 114-115 (OUP, 2009).

³⁶ *Treaty Between the United States of America andConcerning the Encouragement and Reciprocal Protection of Investment*, art. IV (February 1992), reprinted in Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, (Kluwer Law International, 1995).[hereinafter *US Model BIT 1992*], art. 1(a). *See also Treaty between the United States of America and the Republic of Ecuador Concerning the Encouragement and Reciprocal Protection of Investment*, signed Aug 27, 1993, art. I (a) (entered into force May 11, 1997) (containing a similar definition) [hereinafter *US -Ecuador BIT*] ; *Treaty Between the United States of America and the Republic of Bulgaria Concerning the Encouragement and Reciprocal Protection of Investment*, signed Sept. 23, 1992, art. I (a) (entered into force June 2, 1994) (containing a similar definition) [hereinafter *US-Bulgaria BIT*]

On the other hand, unlike the other Model BITs, the US Model BIT of 2004 explicitly states that an asset must have the characteristics of an investment to qualify as investment. It identifies certain characteristics as examples, like extending capital, expectation of profit and risk taking. The US Model BIT of 2004 defines investment as “every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk.”³⁷ It provides for a similar list of “forms that an investment may take” as the US Model BIT of 1994.³⁸ Vandeveldel notes that “the 2004 model continues the US practice of limiting investment to those assets that have the character of an investment, but it differs from earlier models in seeking to identify some of the characteristics of an investment.”³⁹

Aside from the US Model BIT of 2004, the definitions contained in the Model BITs are very broad and their ambit appears limitless. As shown above, the definition of investment in the Model BITs does not limit the asset-based definition of investment. This broad definition of investment in modern BITs is a source of tension and challenges in several investment disputes. It includes “movable and immovable property” including ownership of real estate and other rights thereon like mortgage.⁴⁰ It refers to assets and legal rights that have monetary value, which do not qualify as investment in an economic sense, neither direct nor indirect investment.⁴¹ It follows that almost any kind of property under these treaties could be considered an investment. There is, thus, a tension between the concepts of investment and property under BITs and may broaden the scope of what is protected by BITs in a way that was not anticipated by state parties. It also affects the balance in favour of broadening BITs to regulate civil and commercial transactions that are not investment, which unduly encroaches on the host state’s regulatory powers.

³⁷ *2004 Model BIT: Treaty Between the Government of The United States of America and the Government of [Country] concerning the encouragement and Reciprocal Protection of Investment*, art. 1, available at http://www.ustr.gov/assets/Trade_Sectors/Investment/Model_BIT/asset_upload_file847_6897.pdf [hereinafter *US Model BIT 2004*]

³⁸ *Id.*

³⁹ Vandeveldel, *supra* n. 35, at 122.

⁴⁰ Thomas Pollan, *Legal Framework for the Admission of FDI*, at 32 (Eleven International Publishing, 2006).

⁴¹ F. A. Mann, *British Treaties for the Promotion and Protection of Investments*, 52 BYIL 241, at 243 (1981) (referring to the definition of investment under UK BITs); Roberto Echandi, *A New Generation of International Investment Agreements in the Americas: Impact of Investor-State Dispute Settlement over investment Rule-Making*, Fourth Annual Conference of the Euro-Latin Study Network on Integration and Trade, at 13 (October 20, 2006); Alan Redfern et al., *Law and Practice of International Commercial Arbitration*, at 481 (Sweet & Maxwell, 2004).

Two trends in jurisprudence exist for what qualifies as investment under BITs. One accepts that each asset that has an economic value qualifies as investment, and especially those stated in the non-exhaustive list of assets. This trend is referred to as the literal interpretation. The other trend requires that assets must have the characteristics of investment to qualify as investment. This is referred to as the contextual interpretation. In addition to these two interpretations, the issue of whether investment made in violation of the host State laws could be considered investment under BITs is also discussed.

i. Literal Interpretation

The first trend adopts a broad interpretation of investment based on a literal interpretation to the broad language in the investment definition in BITs. It adopts a textual reading that interprets the definition of investment to mean any asset that has a financial value and any asset stated in the non exhaustive list in the BIT. This interpretation does not limit the notion of investment to assets that have the characteristics of investment.

A textual interpretation of the UK Model BIT that states, “Investment means every kind of asset,” leads to the conclusion that any asset qualifies as investment.⁴² Indeed, many UK and other BITs provisions defining investment were generally interpreted to mean that each asset in the non-exhaustive list *per se* qualifies as an investment under BITs so long as it has economic value by many tribunals and commentators.⁴³ Even for US BITs that use “every kind of investment” instead of “every kind of asset” to define investment, many commentators and tribunals do not acknowledge any difference in interpretation.⁴⁴

Schlemmer, for example, describes the US-Honduras BIT definition of investment as “a typical ‘asset-based’ definition [that] is used in a significant number of BITs.”⁴⁵ The US-Honduras BIT

⁴² See *MHS Annulment*, paras. 60-61 (finding that a contract constitutes an investment as this term is defined under the UK-Malaysia BIT.)

⁴³ See e.g. *CMS Gas Transmission Co. v. Argentine Republic*, ICSID Case No. ARB/01/8 (Annulment Decision), para. 72 (25 Sept. 2007) (noting that the U.S.-Argentine BIT “definition of ‘investment’ is very broad, as already observed by various ICSID Tribunals in comparable cases.”); *Azurix Corp. v. Argentine Republic*, ICSID Case No. ARB/01/12 (Decision on Jurisdiction), para. 63 (December 8, 2003) (noting that each item in the non-exhaustive list “qualif[ies] as an investment.”) [hereinafter *Azurix Jurisdiction*.]; *Mytilineos Jurisdiction*, paras. 106, 109.

⁴⁴ See, e.g., *Azurix Jurisdiction* (finding that the U.S.-Argentina BIT’s investment definition means that any right and any item in the non-exhaustive list constituted an investment under the BIT.)

⁴⁵ Engela C. Schlemmer, *Investment, Investor, Nationality, and Shareholders*, in *The Oxford Handbook of International Investment Law*, at 55 (eds. Peter Muchlinski *et al.*, OUP, 2008).

defines investment as “every kind of investment,” and follows this with a non-exhaustive list of what such investment consists or takes the form of.⁴⁶ Dolzer and Schreuer maintain that an asset would be considered an investment if it is included in a BIT’s non-exhaustive list of assets in the definition of investment.⁴⁷

Many arbitral tribunals have also adopted this interpretation. In *Fedax*, the tribunal accepted that investment is not limited to certain characteristics under BITs, and found that promissory notes that were endorsed to foreigners constituted an investment for the purpose of the BIT. The claim arose from promissory notes issued by Venezuela to local corporations, which were denominated in US dollars.⁴⁸ The claimant was an endorsee of these promissory notes. The tribunal quoted the Netherland-Venezuela BIT’s definition of investment, which is similar to the German Model BIT definition that states that investment “shall comprise every kind of asset and more particularly though not exclusively . . . titles to money, to other asset or to any performance having an economic value”⁴⁹ It noted that the term “title to money” was not qualified in the BIT to either foreign direct investment or portfolio investment.⁵⁰ It reasoned that the “broad definition of investment” is the norm in BITs and other agreements, and limiting the term is the exception.⁵¹

Fedax tribunal further stressed that “only very exceptionally do bilateral investment treaties explicitly relate the definition of the assets or transaction included in this concept to questions such as the existence of a lasting economic relation, or specifically associate titles to money and similar transaction strictly to a concept of investment.”⁵² It concluded that a loan qualified as investment under the BIT, and a promissory note is an evidence of the existence of the loan.⁵³

⁴⁶ *Agreement between the Government of the United States of America and the Government of the Republic of Honduras Concerning the Encouragement and Reciprocal Protection of Investment*, signed July 1, 1995, art. I(d) (entered into force July 11, 2001) [hereinafter *U.S.-Honduras BIT*].

⁴⁷ Dolzer & Schreuer, *supra* n.5, at 63 (“Most bilateral treaties contain a general phrase defining investment (such as ‘all assets’) and several groups of illustrative categories. *No special problem will arise if the investment in question is covered by one of the illustrative categories.*”) (emphasis added).

⁴⁸ *Fedax Jurisdiction*.

⁴⁹ *Id.* para. 31 (quoting the BIT between the Netherlands and Venezuela).

⁵⁰ *Id.* para. 32 (“The Tribunal notes in particular that titles to money in this definition are not in any way restricted to forms of direct foreign investment or portfolio investment”)

⁵¹ *Id.* para. 34 (“A broad definition of investment such as that included in the Agreement is not at all an exceptional situation.”).

⁵² *Id.*

⁵³ *Id.* para. 37.

Fedax thus stands for the proposition that under BITs asset-based definition of investment an asset is considered an investment without regard to the characteristics of investment, the ordinary or economic meaning of the term. It thus did not examine whether the promissory note or the underlying transaction, the loan, have the characteristics of investment to qualify as such under the BIT. The tribunal found, and Venezuela admitted, that the underlying transaction for which the promissory notes were issued would have qualified as an investment under the BIT if it was undertaken by the foreign investor. However, the foreign investor was an endorsee who bought the debt and was not a party to the underlying transaction. The tribunal did not find any reason to treat the endorsement differently considering that since the promissory notes were denominated in US dollars“, their eventual international circulation and availability to foreign investors was contemplated from the outset.”⁵⁴

In another ICSID case, the tribunal found that any item in the non-exhaustive list qualifies as investment under a BIT’s asset-based investment definition. In *Salini v. Morocco (Salini I)*⁵⁵, a dispute under the BIT between Italy and Morocco, claimants were a group of Italian companies that were contracted to build a highway in Morocco. After delivering the highway, a dispute arose over certain technical and financial issues relating to the performance of the contract. The BIT states that “the term ‘investment’ designates all categories of assets invested . . . by a natural or legal person, including the Government of the other Contracting Party, in accordance with the laws and regulations of the aforementioned party.”⁵⁶ A non-exhaustive list of what is included in the term “investment” follows, which includes “rights to any contractual benefit having an economic value”; and “any right of an economic nature conferred by law or by contract”⁵⁷ The claimants argued that their contractual rights were investment under the aforementioned provisions of the BIT.⁵⁸

Morocco contended that interpreting the term “investment” to mean any contractual right “dilute the notion of investment into a broader notion of economic rights.”⁵⁹ It further explained that the reference to “in accordance with the laws and regulations” of the host State in the definition of

⁵⁴ *Id.* para.39

⁵⁵ *Salini I Jurisdiction.*

⁵⁶ *Id.* (quoting article 1 of the BIT between Italy and Morocco).

⁵⁷ *Id.*

⁵⁸ *Id.* para. 37.

⁵⁹ *Id.* Para 38.

investment indicates a *renvoi* to the host State laws for the definition of investment.

Accordingly, Moroccan laws govern the definition of investment. Under its law, this contract would not qualify as an investment, but rather a “contract of services.”⁶⁰

The tribunal agreed with the claimants, finding that the “construction contract create[d] a right” that is included in the contractual rights stated in the non-exhaustive list.⁶¹ It further rejected Morocco’s argument, finding that the provision to follow the laws and regulations of the host State “refer[red] to the validity of the investment and not to its definition.”⁶² The tribunal reasoned that this provision denies the protection of the BIT to “illegal” investments.⁶³ It does not shape the definition of investment in any other way. It accordingly found that the construction contract was an investment under the BIT.

In another case, the tribunal explicitly stated that an asset-based definition means that anything with economic value qualifies as investment. In *Mytilineos*, under the Greece-Yugoslavia BIT, the dispute arose from several contracts concluded between the claimant and a host State corporation, which included sale contract, extending loans to the corporation and a priority to purchase the corporation shares if it was privatized.⁶⁴ The corporation did not satisfy its obligations under the contracts and was subject to privatization. The host State argued that these were commercial contracts between private parties and not investment contracts, and accordingly do not qualify as investment.⁶⁵ The tribunal rejected this argument.

The tribunal first noted that the BIT’s definition of investment which refers to “every kind of asset” includes anything that has economic value.⁶⁶ It further added that under such definition that includes “claims to money or any other claim under contract” that has an economic value, “there is no reason why claims arising from pure commercial activities, such as sales contracts, should be excluded from such a broad definition of investment.”⁶⁷

⁶⁰ *Id.*

⁶¹ *Id.* para. 45.

⁶² *Id.* para. 46.

⁶³ *Id.*

⁶⁴ *Mytilineos Jurisdiction*, para. 27.

⁶⁵ *Id.* para. 52.

⁶⁶ *Id.* para. 106.

⁶⁷ *Id.* para. 109.

The tribunal quoted with approval an UNCTAD paper for the proposal that “a BIT stating that ‘investment includes ‘every kind of asset’ suggest[s] that the term embraces everything of economic value, virtually without limitation.’”⁶⁸ It reasoned that the “fact that some investment treaties narrow the notion of what constitutes an investment,” like the US recent BITs, “reinforces the impression that a broad investment definition such as the one contained in Article 1 of the Greece-Serbia and Montenegro BIT may cover assets and activities that go beyond what is traditionally included in the notion of foreign direct and indirect investment.”⁶⁹

Another ICSID tribunal found that an asset is per se an investment under an asset-based definition. In *Bayindir*⁷⁰, a dispute under the BIT between Turkey and Pakistan, the tribunal interpreted the term investment under the BIT. The claimant investment arises from construction of six motorway lanes under a construction agreement with a public company. The BIT states that the “term ‘investment’, in conformity with the hosting Party’s laws and regulations, shall include every kind of asset”, and follows this by a non-exhaustive list of what is included in the term investment.⁷¹ The claimant argued the laws and regulations of the host State are relevant only for the validity of the investment and not for its definitions. It added that term investment as defined in the BIT “embraces everything of economic value, virtually without limitation.”⁷² Pakistan argued that the conformity with the host State law should be interpreted as a qualification to the term investment, which must be interpreted under the host State laws.⁷³ It further contended that the claimant has not made a financial contribution since one third of the project price was advanced by the public company, which covered the claimant’s costs.

The tribunal agreed with the claimant that the term investment under the BIT is “very broad”.⁷⁴ It explained that using the words “every kind of asset” in defining investment is “[p]ossibly the broadest’ among similar general definitions contained in BITs.”⁷⁵ It stated that the claimant’s contribution by training of engineers and supplying equipments and personnel to the project “has

⁶⁸ *Id.* para. 106.

⁶⁹ *Id.*

⁷⁰ *Bayindir Insaat Turizm Ticaret ve Sanayi A.S. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/03/29 (Decision on Jurisdiction) (Nov. 14, 2005) [hereinafter *Bayindir Jurisdiction*].

⁷¹ *Id.*, para. 105 (Nov. 14, 2005) (quoting the BIT between Pakistan and Turkey).

⁷² *Id.* para. 112.

⁷³ *Id.* para. 106.

⁷⁴ *Id.* para. 113.

⁷⁵ *Id.* (quoting Noah Rubins, *The Notion of ‘Investment’ in International Investment Arbitration*, in *Arbitrating Foreign Investment Disputes*, at 292 (ed. Norbert Horn, Kluwer Law International, 2004).

an economic value and falls within the meaning of ‘every kind of asset’ according to Article I(2) of the BIT.”⁷⁶ It further found that claimant’s bank guarantees in the amount of the advance payment and paid commissions for issuing these guarantees constituted “a substantial financial contribution to the Project.”⁷⁷

The tribunal concluded that the claimant “did contribute ‘assets’ within the meaning of the general definition of investment set forth in . . . the BIT.”⁷⁸ *Bayindir*’s analysis, accordingly, equated the term “asset” with investment under the BIT.

In yet another ICSID award, the tribunal found that any contractual right and any item in the non-exhaustive list constitutes an investment under a US BIT that defined investment as every kind of investment. In *Azurix*, a dispute under US-Argentina BIT, the claimant made its investment through two foreign companies that established a local company for the purpose of undertaking a concession to supply water in the Province of Buenos Aires.⁷⁹ Argentina contended that the dispute over the concession agreement rights is a contractual dispute, and such agreement could not constitute an investment.⁸⁰ The tribunal rejected this argument, maintaining that the “concession contract qualifie[d] as an investment for purpose of the [Argentina-U.S.] BIT given the wide meaning conferred upon this term in the BIT that includes ‘any right conferred by law or contract.’”⁸¹

The tribunal further elaborated on its interpretation of the term “investment” under the BIT. It confirmed that each item stated in the non-exhaustive list qualify separately as investment. It stated:

The definition of investment lists a “company”, “shares of stock” and, in a separate category, “any right conferred by law or contract”. A company, shares held in a company or rights under a contract, any contract, qualify as an investment. Provided the direct or indirect ownership or control is established, rights under a contract held by a local company constitute an investment protected by the BIT. *The definition in Article I.1(a) simply lists examples of what an investment is, the list is not exhaustive and each item is*

⁷⁶ *Id.* paras. 116.

⁷⁷ *Id.* paras. 119-120.

⁷⁸ *Id.* para.121.

⁷⁹ *Azurix Jurisdiction.*

⁸⁰ *Id.* para. 59.

⁸¹ *Id.* para. 62.

independent from each other. The only condition is that, whatever the form an investment may take, it must be directly or indirectly owned or controlled by nationals or companies of the other party to the BIT.⁸²

Furthermore, in an SCC case, the tribunal confirmed that any asset that has a financial value would constitute an investment under a UK BIT. In *Nagel*, a case under the UK-Czech BIT, the tribunal interpreted the meaning of investment under the BIT.⁸³ The definition of investment under the UK-Czech BIT is similar to the definition in the UK Model BIT. It states “the term ‘investment’ means every kind of asset belonging to an investor of one Contracting Party in the territory of the other Contracting Party . . . in any sector of economic activity” This is followed by a non-exhaustive list of what is included under the definition of investment. The tribunal noted that under the UK-Czech BIT “an ‘investment’ is defined as an ‘asset’.”⁸⁴ It referred to the non-exhaustive list that followed the definition in reaching the conclusion that the common feature between all the items in the list is that they all must have “a financial value.”⁸⁵ It concluded that “a claim can be accepted as an ‘asset’ if it has a financial value.”⁸⁶

The above line of cases adopts the proposition that any asset, and any item in the non-exhaustive list, is considered an investment under the BIT as long as it has economic value. This led to finding promissory notes, operating licence, infrastructure contracts, service agreements, loans, banking operations, and minority shareholding in a company investment under BITs.⁸⁷ Many of these cases did not examine the word “invested” that follows the word “assets” in the some BITs definition of investment or whether an asset is considered an investment under the host State law.

⁸² *Id.* para. 63 (emphasis added).

⁸³ *Nagel v. Czech Republic*, Award SCC Case No 49/2002, September 9, 2003 [hereinafter *Nagel Award*]

⁸⁴ *Id.*

⁸⁵ *Id.* (“The examples given all seem to relate to rights or claims which have a financial value. In sub-paragraph (iii) the words ‘having a financial value’ are expressly mentioned, but financial value seems to be an underlying concept also in regard to movable and immovable property in sub-paragraph (i), shares and similar rights in sub-paragraph (ii), intellectual property rights in sub-paragraph (iv) and business concessions etc. in sub-paragraph (v).”)

⁸⁶ *Id.*

⁸⁷ See for e.g. *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt*, para. 101, ICSID ARB/99/6, para. 100 (April 12, 2002) (an operating and importation licence was deemed an investment under the Egypt-Greece BIT, because the BIT’s definition of investment included “business concessions conferred by law or under contract.”); *Eurecko B.V. v. Republic of Poland*, UNCITRAL (Partial Award), (Aug. 19, 2005) (finding that corporate governance rights and rights to acquire shares qualified as investment under Netherland-Poland BIT); *ADC Affiliate Ltd and ADC & ADC Management Ltd v. Hungary*, ICSID Case No. ARB/03/16 (Award) (Oct. 2, 2006) (finding that the “totality” of contractual rights, finance and a promissory note constituted an investment under Cyprus-Hungary BIT); *Sempra Energy International v. the Argentine Republic*, ICSID Case No. ARB/02/16 (Award) (Sept. 28, 2007) (finding a shareholder’s loan constituted an investment).

Awards that did examine such argument rejected the interpretation that assets must be “invested”, i.e., used in a profit-making activity. They also rejected that assets must qualify as investment under the host State law in order to be considered investment if the definition refers to the host State law.

In *Mytilineos*, for example, the Greece-Yugoslavia BIT defined investment “as every kind of asset *invested* by an investor.”⁸⁸ The respondent argued that the term “asset” was qualified by the term “invested,” which required that the asset was invested “in the sense of an activity, of entering the economy of the host State or contributing to its economy.”⁸⁹ The tribunal found that such interpretation is tenable because other BITs that have similar definition do not include the term “invested” after the word “asset” in their definitions.⁹⁰ However, it rejected this interpretation because it would “unduly restrict and unpredictably limit the meaning of an otherwise clear and straightforward investment definition.”⁹¹ The tribunal reasoned that the “core” of the investment definition is the words “every kind of asset.”⁹²

Likewise, in *Saluka*, the tribunal rejected an argument that the term “invested” qualified “every kind of assets,” finding that this was an incorrect interpretation seeking to substitute the definition of investment in the BIT with the economic definition of the term investment.⁹³ It found that the word “invested” does not add a substantive qualification of the term “assets.” It stated:

To a considerable extent, this argument seeks to replace the definition of an “investment” in Article 2 of the Treaty with a definition which looks more to the economic processes involved in the making of investments. However, the Tribunal’s jurisdiction is governed by Article 1 of the Treaty, and nothing in that Article has the effect of importing into the definition of “investment” the meaning which that term might bear as an economic process, in the sense of making a substantial contribution to the local economy or to the wellbeing of a company operating within it. Although the chapeau of Article 2 refers to “every kind of asset invested”, the use of that term in that place does not require, in addition to the very broad terms in which “investments” are defined in the Article, the satisfaction of a requirement based on the meaning of “investing” as an economic process: the chapeau needs to contain a verb which is apt for the various specific kinds of investments which are listed, and since all of them are being defined as various

⁸⁸ *Mytilineos Jurisdiction*, para. 126 (quoting the Greece-Yugoslavia BIT).

⁸⁹ *Id.* paras. 126-127.

⁹⁰ *Id.* para. 127.

⁹¹ *Id.* para. 129.

⁹² *Id.*

⁹³ *Saluka Investments BV (The Netherlands) v. The Czech Republic*, UNCITRAL (Partial Award), para. 211 (Mar. 17, 2006).

kinds of investment it is in the context appropriate to use the verb “invested” without thereby adding further substantive conditions.

To sum up, this trend interprets the term investment broadly to mean that asset, and especially any asset mentioned non-exhaustive list, constitutes an investment. Such asset does not need to meet the characteristics of investments, nor be invested, i.e. participating in a profit making activity. Yet it is submitted that this is not what investment means, nor what BITs are supposed to protect. This broad interpretation stems from a broadly defined definition. It extends BITs protection to any transaction or asset that has economic value. Capital related to these assets and transactions would be entitled to all rights under BITs, including the right to transfer capital.

ii. Contextual Interpretation

The second trend looks to the ordinary meaning of investment and the general purpose of BITs to protect investment, rather than the literal interpretation of the BITs’ definition of investment. It reconciles the use of the term investment with the definition of that term under BITs in accordance with the ordinary meaning of the words and its object and purpose as mandated by the Vienna Convention.

Assets that have the characteristics of investment are considered investment. As for other assets that do not, this interpretation distinguishes between the situation where these assets are included in an investment, i.e. utilised along other assets that have the characteristics of investment either alone or in combination with the other assets and when these assets or rights exist separately. In other words, these assets although included in the non-exhaustive list in the BIT’s definition of investment, they must be “invested” or a part of an “investment.”⁹⁴ This interpretation satisfies the ordinary meaning of investment and the purpose of BITs to protect investment not property.

Admittedly, this interpretation is a more persuasive interpretation in some Model BITs and BITs than others. The Model German BIT is an example where the term “investment” might be taken as including only investment that has the characteristics of an investment. Unlike the UK Model BIT, it does not define investment using the term “*means every kind of asset,*” but rather states

⁹⁴ See *Mytilineos Jurisdiction*, para. 50 (respondent host State arguing that the assets must be “invested” to qualify as investment under the BIT that defines investment as “every kind of asset invested.”)

that the term investment “*comprises* every kind of assets.” The meaning of the word “comprise” is to “include” or “contain”.⁹⁵ These assets cannot be classified as investment if they were not included, invested or contained in an investment.

And the reason of including a non-exhaustive list is not to qualify each item as investment *per se*; rather it is to indicate that they will be protected under the BIT if they were invested or included in an investment. As Rubins notes, the broad reference is meant to accommodate the developing nature of modern investment.⁹⁶ Additionally, the last part in the definition of investment under the German Model BIT and the other Model BITs referring to the “alteration of the form in which assets *are invested*” supports this interpretation.⁹⁷ It is not the existence of the assets in the host country *per se* that qualifies as investment, but rather investing these assets that makes qualifies them as investment. The act of investing the assets means that the assets are being utilized in activities that have the characteristics of investment.

The UK Mode BIT on the other hand does not use the word “comprise,” but uses “*means* every kind of asset,” which suggests that any asset qualifies as investment. Yet, it does not state “every asset,” but rather “every *kind* of asset,” which suggests that the purpose is to include any investment whatever its form. This interpretation finds support in the UK Mode BIT language similar to that of the German Model BIT, which states: “A change in the form in which assets *are invested* does not affect their character as investments”⁹⁸ Accordingly, it could be argued that the same interpretation can apply to the UK Model BIT.

Furthermore, the US Model BITs that refer to “every kind of investment” in its definition of investment appear to emphasize that only assets that have the characteristics of investment are covered by this definition. This is confirmed by the language used in the leading to the non-exhaustive list, which refers to “investment *consisting or taking the form of*” these assets. This language suggests that the each asset in the list is not *per se* an investment, but rather it would be

⁹⁵ Webster’s New World Dictionary of the American Language 292 (David B. Guralnik ed., 2nd ed. The World Publishing Company, 1976).

⁹⁶ See Rubins, *supra* n. 4, at 284.; OECD, *Definition of Investor and Investment in International Investment Agreements*, DAF/INV/WP/WD(2007)1/REV2, at 38 (2007), available at <http://www.iccmex.org.mx/intranet/documentos/07-12%20Definition%20Investor%20-%20Investment.pdf> [last visited November 28, 2008].

⁹⁷ *German Model BIT*, art. 1(1) (emphasis added).

⁹⁸ *UK Model BIT*, art. (1) (a)(emphasis added).

considered so if it is a part of an investment or has the characteristics of investment. The core term here is “investment,” and these assets are only included if they are part of an investment. It is submitted that the circularity in the definition was on purpose to emphasise that only “investment”-as this term is distinguished from property with certain characteristics- is subject of BITs. Meanwhile, it attains the flexibility of covering all kind of investment as it develops with time.⁹⁹ Vandavelde thus notes:

The most common definition of “investment” in the European BITs has been “every kind of asset.” The purpose of the BITs, however, was to protect investment, not all U.S.-owned property in the territory of the BIT party. U.S. negotiators thus wished to make clear that an asset would be covered by the definition only if it had the character of an investment. ... In effect, the treaty applies to all investment and to nothing more and nothing less. Despite its circularity, this phrase was thought to convey the flexibility that BIT drafters wanted to incorporate into the definition.¹⁰⁰

Consistent with this, Brownlie in his separate opinion in *CME*, noted that the Netherlands-Czech BIT, which contained an asset based definition, protects only “investment” and not “property rights.”¹⁰¹ He added that simply finding a commercial activity or an interest of an investor cannot be equated with investment.¹⁰² The definition of investment under the Netherlands-Czech BIT is similar to the German Model BIT. It states “the term ‘investments’ shall comprise every kind of asset invested either directly or through an investor of a third State”¹⁰³

In addition in an ICSID award, the tribunal followed a contextual interpretation under a UK BIT that followed the Model UK BIT to decide whether a transaction qualified as an investment under both the applicable BIT and ICSID Convention. In *Joy Mining*, a dispute under the UK-Egypt BIT that arose from a contract entered between the claimant, Joy Mining Machinery

⁹⁹ Vandavelde, *supra* n. 35, at 114-115. It should be noted that some variance in the investment definition of the pre-2004 U.S. exists, as while most U.S. BITs before 2004 define investment as “every kind of investment,” the Cameron-U.S. BIT defines investment as “every kind of asset.” *Treaty Between the United States of America and the Republic of Cameroon Concerning the Reciprocal Encouragement and Protection of Investment*, signed Feb 26, 1986, art. 1(b) (entered into force Apr. 6, 1989).

¹⁰⁰ Vandavelde, *supra* n. 35, at 114-115.

¹⁰¹ *CME Award*, para. 73.

¹⁰² *Id.* para. 74.

¹⁰³ *Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic*, signed Apr. 29, 1991, art. (entered into force Oct. 1, 1992).

Limited and an Egyptian public sector company to replace equipments used in mining.¹⁰⁴ The claimant provided performance guarantees under the agreement. The contracted equipment was installed. After the installation there were problems in the functioning of the equipment. Each party accused the other for the malfunctioning of the equipment. The claimant was paid the full price pursuant to the contract.¹⁰⁵ However, the performance guarantees were never released. The claimant had to renew them to avoid drawing down on them.¹⁰⁶

The claimant asserted that bank guarantees qualify as an asset under the investment definition of the UK-Egypt BIT. In addition, the bank guarantees are also included in the investment definition as “claims to money or to any performance under contract having a financial value.”¹⁰⁷

The tribunal framed the issue as whether the bank guarantee constituted an investment under the BIT.¹⁰⁸ The tribunal found that a bank guarantee is merely a contingent liability and cannot be qualified as an asset, even under the broad definition in the BIT.¹⁰⁹ The tribunal rejected also the contention that the bank guarantee qualifies as a claim of money or performance that has a financial value, noting that “[e]ven if a claim to return of performance and related guarantees has a financial value it cannot amount to recharacterizing as an investment dispute a dispute which in essence concerns a contingent liability.”¹¹⁰

It then analyzed whether the underlying transaction or the bank guarantees qualify as investment under ICSID Convention. It found that an investment “should have a certain duration, a regularity of profit and return, an element of risk, a substantial commitment and that that it should constitute a significant contribution to the host State’s development.”¹¹¹ The transaction in this case did not satisfy these characteristics.¹¹²

¹⁰⁴ *Joy Mining Award*, paras. 15-16.

¹⁰⁵ *Id.* para. 19.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* para. 46 (quoting *UK-Egypt BIT*).

¹⁰⁸ *Id.* paras. 42-43.

¹⁰⁹ *Id.* paras. 44-45 (“To conclude that a contingent liability is an asset under Article 1(a) of the Treaty and hence a protected investment, would really go far beyond the concept of investment, even if broadly defined, as this and other treaties normally do.”).

¹¹⁰ *Id.* para. 47

¹¹¹ *Id.* para. 53.

¹¹² *Id.* para. 55-57.

The tribunal appears to have adopted an objective interpretation to what investment means. Under ICSID Convention, it affirmed the objective criteria, while rejecting the subjective criteria, indicating that under ICSID Convention there is a limit on what parties can define as investment.¹¹³ It applied the characteristics of investment test to the underlying transaction and the bank guarantee to examine if they qualify as investment under the ICSID Convention. Also, it rejected an interpretation that would have considered any obligation that has a financial value an investment under the BIT. Yet, the tribunal stopped short of finding that the contextual interpretation applies to the definition of investment under the BIT. It did not examine the underlying transaction to decide whether it qualified as an investment under the BIT as it did under ICSID Convention. It only examined whether the bank guarantee qualifies as an investment under the BIT.

In a more illustrative case of this interpretation, an UNCITRAL tribunal under the auspices of the Permanent Court of Arbitration adopted the objective interpretation of investment under a BIT, which has a definition of investment similar to the German Model BIT's. In *Romak*, under Switzerland-Uzbekistan BIT, the BIT adopted an asset-based definition of investment.¹¹⁴ It states that “‘investments’ shall include every kind of assets,” and followed this with a non-exhaustive list.¹¹⁵ The non-exhaustive list includes “claims to money or to any performance having an economic value;” and “concessions under public law.”¹¹⁶

The dispute arose from wheat supply transactions. The claimant entered into several contracts to sell wheat to various Uzbek corporations. After supplying the wheat, no payment was made. The claimant initiated arbitration against these corporations under the contract, and it was successful in obtaining an arbitral award for the payment of its dues under the contracts. However, the claimant's attempts to enforce the award in Uzbekistan failed. The claimant argued that the terms “every kind of asset” is broad to include its rights under the contract and the arbitral award, and that “right to payment” under the contract and the arbitral award are thus

¹¹³ *Id.* paras. 49-50.

¹¹⁴ *Romak S.A. v. The Republic of Uzbekistan*, UNCITRAL PCA Case No. AA280 (Award), para. 174 (Nov. 26, 2009) [hereinafter *Romak Award*].

¹¹⁵ *Id.*

¹¹⁶ *Id.*

investment under the BIT.¹¹⁷ It further alleged that its asset would qualify as an investment if it is covered by one or more of the assets described in the non-exhaustive list.¹¹⁸

In rejecting this argument, the tribunal started its analysis by stating the ordinary meaning of investment as “the commitment of funds or other assets with the purpose to receive a profit, or ‘return,’ from that commitment of capital.”¹¹⁹ It also defined asset as “property of any kind.”¹²⁰ The tribunal rejected this interpretation, which “deprives the term ‘investments’ of any inherent meaning.”¹²¹ It explained that there are other assets that might qualify as investment but are not included in the list, as it is not an exhaustive list.¹²² In order to find whether such assets qualify as investment, investment must have an inherent meaning that should not be ignored.¹²³

The tribunal further stated, quoting the BIT’s preamble, that the claimant’s interpretation ignores the purpose and object of the BIT. The object is to encourage foreign investment to achieve economic prosperity and cooperation, which “suggests an intent to protect a particular kind of assets, distinguishing them from mere ordinary commercial transactions.”¹²⁴ Thus, to only look whether an asset is included in the list that follows the definition would not conform to the object and purpose of the BIT.¹²⁵

What’s more, the reading advanced by the claimant, the tribunal noted, leads to a result that is “manifestly absurd or unreasonable.”¹²⁶ Such result would not leave any distinction between investment and ordinary commercial transactions.¹²⁷ Also, any arbitral award would be considered an investment under the “claim to money” or “right given by decision of the authority” categories. Such result “would create, *de facto*, a new instance of review of State court decisions” every time enforcement of an arbitral award is refused, without regard to the

¹¹⁷ *Id.* paras. 175, 209.

¹¹⁸ *Id.* para. 178.

¹¹⁹ *Id.* para. 177.

¹²⁰ *Id.* para. 175.

¹²¹ *Id.* para. 180.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* paras. 181, 189.

¹²⁵ *Id.* para. 183.

¹²⁶ *Id.* para. 184 (quoting the Vienna Convention on the Law of Treaties).

¹²⁷ *Id.* para. 185.

underlying dispute, and under different rules and instrument than that normally applies to such enforcement.¹²⁸

Finally, the tribunal noted that this interpretation would convert every contract between a foreigner and the State into an investment, and similarly any award or decision in favour of the foreigner, which could not be the intention of the State parties to the BIT to have all their contractual obligations adjudicated under BITs without regard to the choice of law and forum in such contract.¹²⁹

The tribunal concluded that investment “has an intrinsic meaning” separate from the categories of assets in the non-exhaustive list; which may or may not qualify to be an investment.¹³⁰ It emphasized that an investment “entail[s] a contribution that extends over a certain period of time and that involves some risk.”¹³¹ It acknowledged the right of State parties to a BIT to call an investment an asset that does not meet such meaning.¹³² “However, in such cases, the wording of the instrument in question must leave no room for doubt that the intention of the contracting States was to accord to the term ‘investment’ an extraordinary and counterintuitive meaning.”¹³³ The tribunal applied its interpretation and found that the supply contract and the arbitral award which were “inextricably linked” did not qualify as investment under the BIT.¹³⁴

In reaching this result, the tribunal explained its understanding of the characteristics of investment. First, the contribution can consist of committing anything with an “economic value,” whether it is “in cash, kind or labor.”¹³⁵ The supply of wheat did not qualify as contribution because it was one sale of good for immediate payment and not a contribution in kind in an investment.¹³⁶

The second characteristic is duration. No certain minimum duration, the tribunal noted, is required to find an investment, but rather all circumstances together with the whole commitment

¹²⁸ *Id.* para. 186.

¹²⁹ *Id.* para. 187.

¹³⁰ *Id.* para. 188.

¹³¹ *Id.* para. 207.(emphasis in original).

¹³² *Id.* para. 205.

¹³³ *Id.*.

¹³⁴ *Id.* para. 211.

¹³⁵ *Id.* para. 214.

¹³⁶ *Id.* paras. 215, 221-222.

of the investor should be evaluated.¹³⁷ The claimant delivered wheat under the contract for a period of five months. The tribunal found that such period did not qualify as duration typical for investment and no prior or subsequent transactions were made by the claimant.¹³⁸

Third, the risk element in investment, the tribunal distinguished between normal risk that exists in every commercial transaction like the risk that the other party would not fulfil its end of the bargain, and the “investment risk.”¹³⁹ The former does not constitute an element of investment. The latter does. “Investment risk,” unlike the normal commercial risk, involves not knowing whether the investment would lead to profit and how much contribution the investor might have to commit even if all other parties have fulfilled their legal obligations.¹⁴⁰ Since in this case only commercial risk existed, while there was no investment risk, the tribunal found that this element was not satisfied.¹⁴¹

In conclusion, this interpretation looks to the ordinary meaning of the term investment in the context of the object and purpose of the BIT. Only an asset or an accumulation of assets that satisfies the characteristics of investment is considered an investment under this interpretation unless the relevant BIT language explicitly requires different interpretation. This interpretation is preferred as it conforms to BITs objective to protect investment and not property. It is also a more balanced interpretation that allows the host state to distinguish between different kinds of economic transactions and enables it to regulate capital that arises from transactions that do not qualify as investment.

iii. Capital

The term capital is not defined in the Model BITs and BITs in general. In economics, this term refers to the assets and goods that produce other goods and services.¹⁴² While the funds or money strictly are not the same as capital, capital almost always include use of funds whether to buy the capital; as a result of capital use; or after sale of such capital. Such funds are often

¹³⁷ *Id.* para. 225.

¹³⁸ *Id.* paras. 226-227.

¹³⁹ *Id.* paras. 229-230.

¹⁴⁰ *Id.* para. 230.

¹⁴¹ *Id.* para. 231.

¹⁴² N. Gregory Mankiw, *Principles of Economics*, 406-407 (4th ed. Thomson Southwestern, 2007) (capital means “the stock of equipment and structure used for production. [It] represents the accumulation of the goods produced in the past that are being used in the present to produce new goods and services.”)

referred to as capital. The term capital thus is used to refer to funds used to make and develop an investment, compared to funds used to settle instant commercial transactions.¹⁴³

This term is generally used in BITs to refer to the currency or funds used to fund the investment in the host State. This is distinguished from the underlying investment or transaction itself.¹⁴⁴

Many terms are used to refer to a certain kind of capital: “Short-term” or “speculative” capital. Although there are technical differences, the point is the same: short-term capital flows or speculative capital is mainly attracted by the difference in interest rate and seeks a short-term profit.¹⁴⁵ On the other hand, long term capital is associated with what is known as “productive capital” that is invested in the long term, typically more than a year, in a project that aims at producing profit through producing or adding value to assets and selling them for profit.

For the purpose of defining capital, the IMF Articles distinguishes between funds arising from current transactions and funds arising from capital transactions. The IMF Articles states:

Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation:

- (1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
- (2) payments due as interest on loans and as net income from other investments;
- (3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and
- (4) moderate remittances for family living expenses.¹⁴⁶

The IMF Articles thus defines current transfers in the negative; funds that are not capital transactions. It gives an example of the current transfers. Two categories are considered current transfers, which are economically considered capital transfers. These are categories number 2 and 3 above.¹⁴⁷ On the other hand, the IMF Article does not define capital transactions because

¹⁴³ Cf. Juillard, *supra* n.5., at 451.

¹⁴⁴ Cf. *Id.* at 452 (Sabine Schlemmer-Schulte & Ko-Yung Tung eds., Kluwer Law International, 2001) (.

¹⁴⁵ Stephany Griffith-Jones, *Global Capital Flows: Should They Be Regulated?*, at 5 (Macmillan Press LTD, 1998).

¹⁴⁶ *Articles of Agreement of the International Monetary Fund*, art. XXX(d).

¹⁴⁷ Cynthia Crawford Lichtenstein, *International Jurisdiction over International Capital Flows and the Role of the IMF: Plus Ça Change . . .*, in *International Monetary Law: Issues for the New Millennium*, at 66 (Mario Giovanoli ed., OUP, 2000).

there is no need for the approval of the IMF to control capital movements. Meanwhile, payments for current transactions and other measures need the IMF approval.¹⁴⁸

Another related term is the “transfer of capital.” In economics, it refers to “transfers of ownership of fixed assets; transfers of funds linked to, or conditional upon, acquisition or disposal of fixed assets; or cancellation, without any counterparts being received in return, of liabilities by creditors.”¹⁴⁹ This component of capital, funds, is the subject of this study.

Equally relevant is the term “capital account convertibility,” which can be defined as permitting a resident to purchase foreign assets, to receive foreign exchange for selling domestic asset to non-resident, and for non-resident to sell domestic assets and repatriate the returns through providing foreign exchange conversion in all cases.¹⁵⁰ In other words, it is the unrestricted ability to convert domestic currency into foreign currency for the purpose of undertaking capital transactions.¹⁵¹ Capital account convertibility involves getting rid of direct prohibitions and quantitative controls that ban capital transactions completely.¹⁵² In contrast to capital account convertibility, keeping the convertibility of current transactions is a basic objective of the IMF and is a condition for staying as a member country of the IMF.¹⁵³

Under BITs, capital transfer and convertibility includes all funds relating to investment. This includes funds used to make or expand an investment, funds that result from investment like profits or as a result of liquidation, sale or compensation for the expropriation of the investment.

The definition of investment is paramount to the identification of the funds covered. Under the literal interpretation, any funds used to purchase or dispose of an asset would be covered by the BITs provision. This would virtually any transfer relating to any economic transaction, which would include long term capital, short term/speculative capital, and funds related to current and

¹⁴⁸ Joseph Gold, *International Capital Movement under the Law of the International Monetary Fund*, at 5 (IMF, 1977).

¹⁴⁹ OECD, *Glossary Of Statistical Terms*, at 53 (OECD, 2007).

¹⁵⁰ Richard N. Cooper, *Should Capital Controls Be Banished*, *Brookings Papers on Economic Activity* vol 1999 No.1, at 90 (1999).

¹⁵¹ Jonathan R. Macey & Enrico Colombatto, *Public Choice Theory and the Transition Market Economy in Eastern Europe: Currency Convertibility and Exchange Rates*, 28 *Cornell Int'l L.J.* 387, at 394 (1995).

¹⁵² Barry Eichengreen, *IMF Economic Forum: Capital Account Liberalization: What's the Best Stance*, (October 2, 1998, IMF Washington, D.C.), available at <http://www.imf.org/external/np/tr/1998/tr981002a.htm>.

¹⁵³ Cooper, *supra* n. 150, at 89.

capital transactions. On the other hand, under the contextual interpretation, funds have to be related to an asset that has the characteristics of investment to be covered by BITs.

Therefore, the interpretation of investment affects directly the scope of capital funds subject to the transfer obligations under BITs—the literal interpretation subjects all kind of funds relating to virtually any transaction that has economic value to the transfer obligation under BITs, while the contextual obligations would limit this obligation to capital arising from transactions that have the characteristics of investment.

iv. Summary

BITs' definition of the term investment-- BITs' subject of protection-- is broad since it refers to any kind of asset. Under the literal interpretation, investment means that any kind of asset or transaction that has economic value which is followed by most tribunals such as *Mytilineos*. The term's interpretation broadens the ambit of BITs to cover any regulation of property or funds owned by foreigners in the host State.

Under the contextual interpretation, only assets that have the characteristics of investment would qualify as investment under BITs. This is a better approach as it reasonably limits the ambit of BITs to investment and not all kinds of transactions and property rights. This approach is followed by minority of tribunals such as *Romak*. Yet this is consistent with BITs objective to protect and promote investment and not property. It also permits states to distinguish between different kinds of economic transactions and exclude transactions that do not qualify as investment.

III. Approaches to Admission of Investment under BITs

A. General

There is no right of establishment or admission under customary international law. It is rather based on some treaty obligations such as those included in BITs. Some BITs provide for NT or non-discrimination in the preadmission phase. A host State may admit the entry of foreign capital to establish or acquire investment in its territory. Many approaches in relation to the

admission of foreign investments and related capital have been taken by different BITs, as well as other treaties and codes. These approaches can be grouped into the following categories.

The first category retains the power of the host state to admit foreign investment in accordance with its respective laws, which may include imposing certain conditions or performance requirements for admission.¹⁵⁴ The second category grants most favoured nation treatment and/or national treatment on the admission of foreign investment, which is normally accompanied with a “negative list” of sectors or activities that are excluded from such treatment.¹⁵⁵ The Model BITs, and BITs generally, use one of these two approaches or a combination of them.

The third category, the “selective liberalization model” or “positive list”, liberalizes investment in certain sectors or industries, while retaining the discretionary powers for the rest of the sectors.¹⁵⁶ This is the case of GATS and OECD.¹⁵⁷ This may end up with a liberalization of almost all sectors, as in the case of the OECD Codes of Liberalisation of Capital Movements.¹⁵⁸

It is useful here to note the distinction between the right of admission and establishment. The right of admission is distinguished from the right of establishment. Admission refers to the right of an investor to enter the territory of the host State to do business.¹⁵⁹ The right to establishment refers to the right of an investor to conduct its business through certain form of establishment in the territory of the host State.¹⁶⁰ It follows that admission precedes establishment, and thus the right of establishment includes the right of admission.¹⁶¹

¹⁵⁴ UNCTAD, *Admission and Establishment*, UNCTAD Series on Issues in International Investment Agreements, at 4 (United Nations Publication, 2002); Pollan, *supra* n. 40, at 76; UNCTAD, *Flexibility for Development*, at 81-83.

¹⁵⁵ Pollan, *supra* n. 40, at 79; UNCTAD, *supra* n. 154, at 4-5.; Rudolf Dolzer & Schreuer, *supra* n.5, at 81.; UNCTAD, *supra* n. 154, at 87-92.

¹⁵⁶ UNCTAD, *supra* n. 154, at 4; Dolzer & Schreuer, *supra* n.5, at 81.; UNCTAD, *supra* n. 154, at 83-86.

¹⁵⁷ UNCTAD, *supra* n. 154, at 20; Gus Van Harten, *INVESTMENT TREATY ARBITRATION AND PUBLIC LAW*, at 75 (Oxford, 2007).

¹⁵⁸ See *OECD Code of Liberalisation of Capital Movements*, reprinted in OECD, *OECD Code of Liberalisation of Capital Movements*, Annex A.

¹⁵⁹ UNCTAD, *supra* n. 154.; UNCTAD, *Key Terms and Concepts in IIAs: A Glossary*, UNCTAD Series on Issues in International Investment Agreements, at 3 (United Nations Publication, 2004); Ignacio Gómez-Palacio & Peter Muchlinski, *Admission and Establishment*, in *The Oxford Handbook of International Investment Law*, at 230 (eds. Peter Muchlinski *et al.*, 2008).

¹⁶⁰ Juillard, *supra* n.5, at 450.; UNCTAD, *supra* n. 154, at 12.; Palacio & Muchlinski, *supra* n. 159, at 230.

¹⁶¹ *Cf.* UNCTAD, *supra* n. 154, at 12 (stating that “the right to establishment entails not only a right to carry out business transactions in the host country but also the right to set up a permanent business presence there.”).

A short term investment that only requires capital need only the right to admission and the right to establishment would not be necessary.¹⁶² On the other hand, a direct investment that requires control over the investment and physical presence in the host State would require the right of establishment in order to realize.¹⁶³ The right to admission or establishment included in some BITs like the US BITs would depend on whether the activity is covered in the definition of investment.

B. Host State Discretion to Regulate Admission

The right to admission may be qualified in BITs by the host State's right to regulate, through its laws and regulations, the admission of foreign investment.¹⁶⁴ Most BITs follow this approach, sometimes referred to as an "investment control model," where the host state retains its discretion to admit foreign investment according to its laws.¹⁶⁵ The requirement to follow host state law in relation to admission is typically not qualified in this category of treaty.¹⁶⁶

This means that foreign investment must follow the rules of the host State law regarding admission and establishment at the time of making its investment.¹⁶⁷ If it does not, it will not be considered admitted "in accordance with the laws of the host State," and will not be protected by the BIT. Some commentators and tribunals have even suggested that this requirement is implicit even if not explicitly stated in the relevant BIT.¹⁶⁸ Sacerdoti notes:

¹⁶² UNCTAD, *supra* n. 154, at 12.; Palacio & Muchlinski, *supra* n. 159, at 232.; Andrew Newcombe & L. Paradell, *Law and Practice of Investment Treaties*, at 132 (Kluwer Law International, 2009).

¹⁶³ UNCTAD, *supra* n. 154, at 12.; Palacio & Muchlinski, *supra* n. 159, at 232.; Newcombe & Paradell, *supra* n. 162, at 132.

¹⁶⁴ Newcombe & Paradell, *supra* n. 162, at 125-126. See, e.g., *Treaty Between the Federal Republic of Germany and the Republic of Kenya Concerning the Encouragement and Reciprocal Protection of Investment*, Signed May 3, 1996, art. 2(1); *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Angola for the Promotion and Protection of Investments*, Signed on July 4 2000, art. 2 (1).

¹⁶⁵ Anna Joubin-Bret, *Admission and Establishment in the Context of Investment Protection*, in STANDARDS OF INVESTMENT PROTECTION, at 10-11 (August Reinisch ed., OUP, 2008); UNCTAD, *supra* n. 154, at 16.; UNCTAD, *supra* n. 154, at 81.; Giorgio Sacerdoti, *The Admission and Treatment of Foreign Investment under Recent Bilateral and Regional Treaties*, 1 *JWI* 105, at 108 (2000).

¹⁶⁶ Ibrahim F.I. Shihata, *Recent Trends to Entry of Foreign Direct Investment*, 9 *ICSID Review-FILJ* 47, at 55 (1994) ("[S]ince the reference in these BITs clauses to domestic legislation is itself unqualified, it must be understood as referring to such legislation as it exists from time to time.").

¹⁶⁷ *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines*, ICSID Case No. ARB/03/25, Award, para. 343-345 (Aug. 16, 2007) (referring to "in accordance to law" provision as a *renvoi* to host State law that determines the legality of the investment) [hereinafter *Fraport Award*].; Shihata, *supra* n. 166, at 55.

¹⁶⁸ See *Phoenix Ltd. v The Czech Republic*, ICSID Case No. ARB/06/5 (Award), para. 101 (Apr. 15, 2009)[hereinafter *Phoenix Award*] ("[T]he conformity of the establishment of the investment with the national laws

Whenever foreign investment operations are admitted under general legislation, as is currently the case in most countries and in respect to most sectors, the expression “in accordance with its laws” is almost redundant. It requires that prescribed procedures be respected which is obvious-and authorizes the denying of the treaty benefits to illegal operations.¹⁶⁹

It also follows that the State may change the rules of admission without affecting already admitted investment. Consistent with this, Shihata notes:

It is therefore clear that in this largest group of BITs the obligation to admit investments is subject to whatever restrictions on such admission that may exist in the law of the host State at the time of the conclusion of the BIT and subsequently. Moreover, the treaties place no limitations on the nature or extent of the restrictions that may be introduced by the State.¹⁷⁰

Drafting may differ from one BIT to another in this category, but they generally do not grant unrestricted rights of establishment or admission to foreign investment.¹⁷¹ A state party to BITs under this approach is not obliged to amend its laws regarding admission to guarantee NT or MFN to investors from the other party.¹⁷² It also has the discretion to amend its laws regarding admission after the entry into force of such BIT.¹⁷³ Yet some BITs include broad admission clauses that generally refer to host state’s laws without detail, while other BITs include more detailed provisions. The latter type is preferred because they prevent the breadth of the provisions from resulting in ambiguity and incoherence that defy the purpose of these kinds of admission clauses.

i. Broad Admission Clauses

Most European BITs belong to this first category which retains host State discretion (sovereign autonomy) in relation to the admission of foreign investment. The German and UK Model BITs, for example, belong to this category. The UK Model BIT states: “Each Contracting Party shall

is implicit even when not expressly stated in the relevant BIT.”). *See also, Plama Consortium Ltd. v. Republic of Bulgaria*, ICSID Case No. ARB/03/24 (Award), para. 138 (Aug. 27 2008) [hereinafter *Plama Award*].

¹⁶⁹ Sacerdoti, *supra* n. 165, at 109.

¹⁷⁰ Shihata, *supra* n. 166 at 55.

¹⁷¹ Pollan, *supra* n. 40, at 76.

¹⁷² Dolzer & Schreuer, *supra* n.5, at 81.

¹⁷³ *Id.*; Bret, *supra* n. 165, at 12.

encourage and create favourable conditions for nationals or companies of the other Contracting Party to invest capital in its territory, and, subject to its right to exercise powers conferred by its laws, shall admit such capital.”¹⁷⁴

The UK Model BIT thus subjects the admission of foreign investment and related capital to the host state’s laws. In doing so, the UK Model refers to the admission of capital related to investment. It does not explicitly separate inward investment from related inward capital; and while it defines investment, it does not define capital. Two obligations on the host State are apparent from the above provision. First, there is the obligation to encourage and create an environment that is friendly to investment from the other party. Second, there is the obligation to admit such investment, but with the qualification that this is subject to the State’s discretionary powers conferred by its domestic laws.

No right to admission exists under this provision, since it subjects admission to host State discretion.¹⁷⁵ It also does not grant a right to national treatment or most favoured nation treatment at the admission stage. Foreign investment must thus comply with host State laws regarding admission. Pollan agrees that under this approach “[a] right to admission does not exist.”¹⁷⁶ Shihata notes that “while admission provisions of this type of BIT[s] may establish a presumption in favor of admission, they effect no fundamental change on admission over what would have been the case had the BIT not been concluded.”¹⁷⁷

Of course, this approach subjects admission to the host State’s domestic laws, which may themselves restrict the host state discretion in relation to admission.¹⁷⁸ Newcombe and Paradell note that a violation of a BIT “might occur if the host state's refusal [to admit foreign investment] is in breach of local law because it would have failed to admit the investment in accordance with its own laws.”¹⁷⁹ This constitutes a *renvoi* to the host State laws.¹⁸⁰

¹⁷⁴ *UK Model BIT*, art. 2 (1). See also *UK-Egypt BIT*, art. 2 (1); *UK-Moldova BIT*, art 2 (1); *UK-Ecuador BIT*, art. 2(1); *UK-Salvador BIT*, art. 2 (1).

¹⁷⁵ Dolzer & Schreuer, *supra* n.5, at 81. Cf. Pollan, *supra* n. 40, at 76.

¹⁷⁶ Pollan, *supra* n. 40, at 76.

¹⁷⁷ Shihata, *supra* n. 166, at 55.

¹⁷⁸ Cf. Sacerdoti, *supra* n. 165, at 108-109.

¹⁷⁹ Newcombe & Paradell, *supra* n. 162, at 135.

¹⁸⁰ Cf. *Fraport Award*, paras. 343-345.

Sacerdoti notes, citing to a BIT's provision that requires admission in accordance to host State laws:

The current formula does have definite legal implications, both as to procedure (due process) and the substance, in that it subjects the making of an investment only to the legal rules in force at that time. *A denial of admission, or its subjection to requirements not in conformity with the law would therefore be a violation of the treaty, if not towards the investor, surely in respect of its national State.*¹⁸¹

Thus, the “in accordance with the law” provision appears to impose a restriction on the host State government that in admitting foreign investment it must comply with its own laws at the time of admission. The application of relevant national law effectively becomes an international law obligation. Although investor-state arbitration may not be available in some cases to the investor for purposes of enforcement of this obligation, the investor's home State may be able to invoke its own rights under the treaty.¹⁸²

Similar to the UK Model BIT, the German Model BIT provides: “Each Contracting Party shall in its territory promote as far as possible investments by nationals or companies of the other Contracting Party and admit such investments in accordance with its legislation. It shall in any case accord such investments fair and equitable treatment.”¹⁸³

Additionally, the Protocol to the German Model BIT states: “Investment made, in accordance with the legislation of either Contracting Party, within the area of application of the law of that

¹⁸¹ Sacerdoti, *supra* n. 165, at 108-109 (2000) (emphasis added).

¹⁸² *Id.* at 108 (“[M]ost BITs, including recent ones . . . though stating an ‘open-door’ policy to foreign investment on a bilateral basis, do not grant to the investors of the other party an enforceable right to be admitted.”).

¹⁸³ *German-Model BIT*, Article 2 (1), reprinted in Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, (Kluwer Law International, 1995). *See also, Agreement between the Federal Republic of Germany and the Republic of the Philippines for the Promotion and Reciprocal Protection of Investments*, signed Apr. 18, 1997, art. 2(1) (entered into force Feb. 1, 2000) (“Each Contracting State shall promote as far as possible investments in its territory by investors of the other Contracting State and admit such investments in accordance with its Constitution, laws and regulations as referred to in Article 1 paragraph 1. Such investments shall be accorded fair and equitable treatment.”); *Germany-Sri Lanka BIT*, art. 2(1) (“Each Contracting State shall in its territory promote as far as possible investments by nationals or companies of the other Contracting State and admit such investments in accordance with its legislation. It shall in any case accord such investments fair and equitable treatment.”).

Contracting Party by nationals or companies of the other Contracting Party shall enjoy the full protection of the Treaty.”¹⁸⁴

The German Model BIT thus subjects admission of foreign investment to the laws of the host State. It, accordingly, does not grant a right of most favoured nation or national treatment to foreign investors at the admission stage. The promotion of investment obligation is less stringent than that of the UK Model BIT. This is evidenced by using the words “as far as possible” in the German Model BIT, which connotes an obligation to exert effort, not to achieve a particular result.

That said, the comment made above in relation to the UK Model BIT, regarding the prohibition of conditions of admission that violates the host State laws, applies equally here. A host State may not impose a condition that violates its laws to admit a foreign investment under this provision.

In addition, the Model German BIT, as other German BITs, refers to fair and equitable treatment in the admission provision.¹⁸⁵ The reference can be read to require granting fair and equitable treatment to investment after admission. However, requiring fair and equitable treatment in the same provision relating to admission could be read to require granting this treatment in the process of admission as well as in the post admission phase.¹⁸⁶ The use of the same term “such investments” for the subject of admission and the subject of the obligation to accord fair and

¹⁸⁴ Ad art. 2 (a).

¹⁸⁵ See for e.g. *Agreement between the Federal Republic of Germany and the People’s Republic of Bangladesh Concerning the Promotion and Reciprocal Protection of Investments*, signed on May 8, 1981, art. 1 (entered into force Sept. 14, 1986) (“Each Contracting Party shall in its territory promote as far as possible the investment of capital by nationals or companies of the other Contracting Party and admit such investments in accordance with its legislation. *It shall in any case accord such investments fair and equitable treatment.*”) (emphasis added); .

¹⁸⁶ Cf. Newcombe & Paradell, *supra* n. 162, at 135 (“Some [BITs] combine the reference to the requirement of admitting investments in conformity with local laws with the reference to the granting of ‘fair and equitable treatment’ to such investments.”).

equitable treatment suggests that the subject of treatment is the same, i.e. investment before admission. This means that under the Model German BIT the decision to admit foreign investment is also subject to the obligation to accord fair and equitable treatment. This restricts further the discretion of the host State to admit foreign investment.

Yet it is equally plausible that the reference to “such investment” is to the investment after admission. This would accord with the purpose of this admission provision to subject the admission to host State laws and as such is the preferred interpretation that conforms with language, context and intention of the parties to this type of clause. This kind of broad obligations leads to ambiguity and may result in unpredictable results.

ii. Narrow Admission Clauses

Some BITs that grant the host state discretion are drafted more narrowly. They specify the rights of the state to regulate admission of investment in a clearer way than the previous type.

For example, some UK BITs do not contain the same obligation to “admit” in accordance with the host state’s laws. The UK- Philippine BIT states:

Each Contracting Party shall encourage and create favourable conditions for investments, consistent with its national objectives, by companies or nationals of the other Contracting Party, subject to the laws and regulations of Party in whose territory the investment is made, including rules on registration and valuation of such investments, if any.¹⁸⁷

This provision does not explicitly provide for a right to admission in accordance with the law, only to “encourage[ing] and creat[ing] favourable” atmosphere for foreign investment. This

¹⁸⁷ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of the Philippines for the Promotion and Protection of Investments*, signed Dec. 3, 1980, art. III(1) (entered into force Jan. 2, 1981) [hereinafter *UK-Philippines BIT*].

approach is preferred since it clearly does not provide for a right to admission, which allows the host state to regulate admission.

Other UK BITs limit the scope of the covered investment to that which is specifically authorized by the host state. The UK-Singapore BIT, for example, states, “this Agreement shall only extend to, investments, whether made before or after the coming into force of this Agreement, which are specifically approved in writing by the Contracting Party in whose territory the investments have been made or will be made.”¹⁸⁸

A more detailed reference to parties’ laws exists in the UK-Indonesia BIT, which limits its application to investment that is admitted in accordance with a specific Indonesian law as amended from time to time.¹⁸⁹ It also envisages the possibility that the United Kingdom may issue a law that regulates admission of foreign investment and provides that Indonesian investments will be covered by the BIT only if they follow such law. It states:

This Agreement shall only apply to investments by nationals companies of the United Kingdom in the territory of the Republic Indonesia which have been granted admission in accordance with the Foreign Capital Investment Law No. 1 of 1967 or any law amending or replacing it.

In the event of the law of the United Kingdom making provisions regarding the admission of foreign investment, investments by nationals or companies of the Republic of Indonesia in the territory of the United Kingdom made after the coming into force of such provisions shall only enjoy protection under this Agreement if they have been admitted in accordance with such provisions.¹⁹⁰

Another mechanism used by UK BITs is to impose a registration requirement in order for the investment to be covered by the BIT, if the host State law requires such registration. The Philippine-UK BIT imposes the registration requirement as a BIT requirement only if the State law so requires. It states:

¹⁸⁸ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Singapore for the Promotion and Protection of Investments*, signed July 22, 1975, art. 12 (entered into force July 22, 1975).

¹⁸⁹ *Agreement between the Government of the United Kingdom of Great Britain And Northern Ireland and the Government of the Republic of Indonesia for the Promotion and Protection of Investment*, signed Apr. 27, 1976, art. 2(1) (entered into force Mar. 24, 1977) [hereinafter *UK-Indonesia BIT*].

¹⁹⁰ *Id.* art. 2(1)-(2).

This Agreement shall apply only to investments brought into, derived from or directly connected with investments brought into the territory of one Contracting Party by nationals or companies of the other Contracting Party which are qualified for registration and are duly registered by the appropriate government agency of the receiving Contracting Party, if so required by its laws.¹⁹¹

This provision refers to the host State laws regarding registration. It confirms that investments that are not registered according to the host State law will not be covered by the BIT. Of course, if the host State law does not require registration, investment will be covered without the need to register.

While this requirement does not appear to add a new requirement to BITs that require that admission of investment must be in accordance with host State law, because if the registration requirement is mandated by the host State law the investment must be registered to be in accordance with the host State law, as will be seen below, some case law requires the existence of this provision to find a violation of the requirement that investment must be made in accordance with host State law. Accordingly, this kind of detailed provisions are preferred over the broad admission provision that only requires admission accordingly to the laws of the host state. It is notable that these explicit and detailed references to registration and host State authorization exist in early UK BITs made during the 1970's. This was a time in which the UK applied capital controls to protect its market.

Also, some German BITs regulate admission in a more narrow and detailed manner. Article 2 of the Germany- India BIT, for example, states:

(1) Each Contracting Party shall encourage and create favourable conditions for investors of the other Contracting Party and also admit investments in its territory in accordance with its law and policy.

(2) Each Contracting Party shall accord to investments as well as to investors in respect of such investments at all times fair and equitable treatment and full protection and security in its territory.¹⁹²

This provision is different from the German Model BIT and other German BITs in two main ways. First, the admission of investment is not only in accordance to the host State law but also subject to its policy. This accords a wide discretion to the host State as it does not restrict its discretion to only its laws, but also to its policy. Second, the obligation to accord fair and equitable treatment appears to apply only to investments after admission. This is evident from the reference to investments, which is defined in the BIT to mean “every kind of asset *invested* in accordance with the national laws of the Contracting Party where the *investment is made*,”¹⁹³ and from the words “in its territory,” which indicate that the investment is already admitted in the host State.

Similarly, the China-Germany BIT does not provide for fair and equitable treatment at the admission phase. Article 2(1) regarding admission does not refer to fair and equitable treatment.

¹⁹¹ *UK-Philippines BIT*, art. II(1).

¹⁹² *India-German BIT*, art. 2 (1)-(2).

¹⁹³ *Id.* art. 1 (b).

Article 3(1) accords fair and equitable treatment to investment “in the territory” of the host State. These provisions respectively state:

Each Contracting Party shall encourage investors of the other Contracting Party to make investments in its territory and admit such investments in accordance with its laws and regulations.

...

Investments of investors of each Contracting Party shall at all times be accorded fair and equitable treatment in the territory of the other Contracting Party.¹⁹⁴

These two examples are preferred over the German Model BIT provisions because they are clear in what they cover and they accord the host state more discretion to admit investment.

iii. States Mechanisms to Regulate the Admission of Investment

There are different tools and approaches that a host State may adopt to exercise its powers to admit foreign investment. These vary from the most radical method, which is the complete prohibition of inward capital investment in all sectors, to a partial prohibition that applies only in specific sectors.¹⁹⁵ The host State may also screen foreign investment and require a prior approval, licence or registration for all foreign investment or for certain sectors or activities.¹⁹⁶

In general, the main control exerted by a host State, other than general or partial exclusion, is through screening, requiring written approval, or registration. The structure of screening systems is generally similar. The host State requires the potential investor to obtain first an authorization from a national authority in order to invest.¹⁹⁷ The host State reviews the foreign investment proposal and applies certain criteria provided in its laws depending on its policy objectives to grant this authorization.¹⁹⁸

¹⁹⁴ *Id.* art. 2(1), 3(1).

¹⁹⁵ See UNCTAD & World Bank, *Liberalizing International Transactions in Services: A Hand Book*, at 64-65 (United Nations, 1994); Peter T. Muchlinski, *Multinational Enterprise and the Law*, at 180-181 (OUP, 2007); Newcombe & Paradell, *supra* n. 162, at 133-134.

¹⁹⁶ Newcombe & Paradell, *supra* n. 162, at 133-134.; Shihata, *supra* n. 166, at 50. For more details, see discussion of capital controls Chapter II.

¹⁹⁷ UNCTAD, *Trends in International Investment Agreements: An Overview*, in UNCTAD Series on Issues in International Investment Agreements, UNCTAD/ITE/IIT/13, at 63 (1999); Muchlinski, *supra* n. 195, at 202.

¹⁹⁸ UNCTAD, *supra* n. 197, at 63; Muchlinski, *supra* n. 195, at 202-203.

To grant the authorization, a host State might require certain conditions, typically, in relation to the percentage of national ownership and the type of the investment.¹⁹⁹ Factors like employing local workers and exporting products are taken into consideration in deciding to grant an authorization.²⁰⁰ Some countries give a temporary authorization pending the completion of all requirements such as feasibility studies²⁰¹ and security checks.

Such conditions are a manifestation of the host country prerogative to admit foreign investment in the way it sees it achieves its economic and social development goals.²⁰² Conditions relating to national security still apply almost universally.²⁰³ These control tools appear to be sanctioned by BITs that follow the host State discretionary power approach, if the host State laws provide for them. Yet the theoretical foundation of this approach—foreign investment compliance with host State laws—is qualified by some case law, discussed below, which only requires compliance with fundamental principles of host State law to comply with BIT, except if the BIT explicitly requires that a certain requirement under host State law must be followed.

iv. Case Law on Admission Clauses

Case law that deals with the right to admission under BITs is sparse. This is probably because before admission an investor does not have an investment in the territory of the host State, which is generally the jurisdictional basis for protection under BITs. In addition, given the discretionary powers of State to admit the investment, the likelihood of a claimant prevailing in such a case are not high. The available remedies are also limited—conceivably, a tribunal might order specific performance requiring a host State to admit investment, or more likely, it may compensate the investor for its loss. The possibility of such remedies may not be enough to persuade an investor to file a costly arbitration. First, by the time the arbitration is settled, it

¹⁹⁹ UNCTAD, *supra* n. 197, at 63.; Palacio & Muchlinski, *supra* n. 159, at 238.

²⁰⁰ Palacio & Muchlinski, *supra* n. 159, at 228.; UNCTAD, *supra* n. 197, at 63.

²⁰¹ Jeswald W. Salacuse, *Host Country Regulation of Joint Ventures and Foreign Investment Codes*, in *JOINT VENTURING ABROAD: A CASE STUDY*, at 125 (ed., David N. Goldsweig, ABA, 1985).

²⁰² Pollan, *supra* n. 40, at 215.

²⁰³ UNCTAD, *supra* n. 197, at 63. See *U.S. Model BIT 1992*, art. X(1) (“This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.”); .*Cf.* *German Model BIT*, ad art. 3(a) (“Measures that have to be taken for reasons of public security and order, public health or morality shall not be deemed ‘treatment less favourable’ within the meaning of Article 3.”)

might be too late for the investment to be successful. Second, it is hard to quantify losses for an investment that was not made in the first place, and a tribunal might only award a prevailing claimant its pre-investment expenses and nominal damages.

There are cases, however, where the claimant's investment was already admitted into the host State, but the host State maintained that such admission was in violation of its laws. The inclusion of the requirement that investment must be "in accordance to the host State law" in the definition of the investment in a BIT or in the admission clause means that an investment made in violation of the host State law will not qualify as an investment under the BIT or will be denied the protection of the BIT. This principle has been applied by several tribunals. Some even ventured to state that, even if the IIA does not include such provision, it will be deemed implied.²⁰⁴

Yet some commentators and awards limit such requirement to compliance with "fundamental principles of the host State's law" or to investment that is illegal *per se*.²⁰⁵ McLachlan, Shore & Weiniger note that:

In many investment treaties the definition of 'investment' includes a requirement that the categories of assets admitted as 'investments' must be made 'in accordance with the laws and regulations of the said party'. The plain meaning of this phrase is that investments which would be illegal upon the territory of the host State are disqualified from the protection of the BIT. Attempts by respondent States to broaden the matters encompassed by this phrase have failed.²⁰⁶

Some awards maintain that in order for the host State law requirement of prior approval or registration of foreign investment to apply under a BIT, the relevant BIT must have specific and clear requirements of registration or approval. Otherwise, an investment which does not comply with a host State law requirement of registration or specific approval will still qualify as a protected investment under the BIT.

²⁰⁴ See *Plama Award*, para. 138; *Phoenix Award*, para. 101.

²⁰⁵ See, e.g., *Salini I Jurisdiction*, para. 46.; *Desert Lines Projects LLC v. Yemen*, ICSID Case No. ARB/05/17 (Award), para 104 (Feb. 6, 2008) [hereinafter *Desert Award*]; *Rumeli Telekom A.S. and Telsim Mobil Telekomikasyon Hizmetleri A.S. v. Republic of Kazakhstan*, ICSID Case No. ARB/05/16 (Award), para. 319 (July 29, 2008) [hereinafter *Rumeli Award*].

²⁰⁶ Campbell McLachlan et al., *International Investment Arbitration: Substantive Principles*, at 181 (OUP, 2008).

For example, in *Metalpar*, a claim brought under the Chile-Argentina BIT, the claimants violated the host State company law that requires registration.²⁰⁷ Article I (1) of the BIT had an “in accordance with the law” requirement in the definition of the investment. In addition, Article II (1) of the BIT, provides that admission shall be in accordance with the host State law. The tribunal noted that while Metalpar S.A. was registered before the dispute arose, the other claimant, Buen Aire S.A., was registered after the request of arbitration was made.²⁰⁸

The tribunal turned to the consequences of the untimely registration of Buen Aire S.A. It noted that the host law provides sanctions for the non-registration for the Claimants, which vary from rejecting its registration to imposing fines on the company and its managers.²⁰⁹ It refused to deny the claimant’s claims on this basis, reasoning that this would be disproportionate.²¹⁰ It added that it would be illogical to impose this penalty on the investment, while the host State law provides for different penalties.²¹¹

This reasoning conflates two separate matters: the application of host State law as the choice of law under the BIT on the subject of legality or validity of the admission of investment, and the application of the sanction under the host State law. The tribunal was not called upon to apply the host State law sanction, which it did not, nor to weigh the effect of different penalties under the BIT and host State law. Rather, the tribunal was called upon to determine under the BIT whether the investment was made in accordance with host State law. If it was not, then the correct finding would be that the investment has been illegally admitted and the Tribunal should then look to the BIT to ascertain the consequences of such illegal admission. The tribunal is not vested with the power to ignore an explicit provision of the BIT because it finds it inappropriate or illogical. This is akin to deciding *ex aequo et bono*, an approach which is not open to the tribunal in the absence of an express provision to the contrary.

That is not to say, however, that in all cases the tribunal is obliged to deny all protection of the BIT in such circumstances. It might still find that applying the BIT or its choice of law would

²⁰⁷ *Metalpar S.A. and Buen Aire S.A. v. Argentine Republic*, ICSID Case No. ARB/03/5 (Decision on Jurisdiction) (Apr. 27, 2006) [hereinafter *Metalpar Jurisdiction*]

²⁰⁸ *Id.* para. 82.

²⁰⁹ *Id.* paras. 83-84.

²¹⁰ *Id.* para. 84.

²¹¹ *Id.*

result in a different remedy for this illegality. But by ignoring the BIT's explicit requirement, the *Metalpar* tribunal ignored the BIT's guarantee that foreign investment in the host State would comply with the host State's laws. In other words, the treaty provision to this effect was rendered ineffective by the tribunal.

In another case, an ICSID tribunal refused to deny protection to an investment that allegedly did not comply with certain procedural requirements. In *Tokios*, under the Lithuania-Ukraine BIT, an "in accordance to the law and regulations" of the host State requirement for the admission of the investment was at issue.²¹² The host State contended that the claimant's investments were not made in accordance with its law. The alleged violations included procedural errors in the registration of the investment assets, including the "absence of signature or notarization."²¹³ The tribunal agreed with the *Salini I* award that the purpose of this requirement is to ensure that the protected investment is not "illegal."²¹⁴ The tribunal interpreted the requirement in light of the purpose and object of the BIT, which is "to provide broad protection for investors and their investments."²¹⁵ It noted that the investment, as admitted by the respondent, was not "illegal *per se*."²¹⁶

Since all the assets at issue were registered by the host State, the tribunal found that this registration confirmed that the investment was made in accordance with the host State laws. It did not find it necessary to examine the administrative procedure under the host State law. It explained that even if the respondent's allegations were true, "exclud[ing] an investment on the basis of such minor errors would be inconsistent with the object and purpose of the [BIT]."²¹⁷

The *Tokios* reasoning, unlike that in *Metalpar*, does not ignore the BIT's explicit legality requirement. The *Tokios* tribunal found that the investment was made in accordance with the host State's laws as evidenced by the host State's registration of the investment, and that the alleged procedural errors did not qualify as a violation of the host State's laws.

²¹² *Tokios Tokeles v. Ukraine*, ICSID Case No. ARB/02/18 (Decision on Jurisdiction), (Apr. 29, 2004) [hereinafter *Tokios Jurisdiction*].

²¹³ *Id.* para. 83.

²¹⁴ *Id.* para. 84.

²¹⁵ *Id.* para. 85.

²¹⁶ *Id.* para. 86.

²¹⁷ *Id.*

As for the requirement of investment registration under host State law some tribunals have found that violating this requirement will only violate the legality requirement under a BIT if the BIT specifically so provides. For example, in *Mytilineos*, the UNCITRAL tribunal distinguished BITs that specifically require that investment obtain prior approval or registration and BITs that have the general “in accordance with host State law” requirement.²¹⁸ In that case, the BIT included only a general “in accordance with host law” requirement. The tribunal stated:

It is important, however, that the specific approval requirements . . . are different from the broader “in accordance with legislation” standard found in many other BITs including the one applicable to the present dispute. The present BIT does not require any approval on the part of host States. Thus, the two above-cited cases [requiring specific approval or registration under BITs that require the same] must be distinguished and cannot be relied upon by Respondent to demand registration or approval in order for the Claimant’s investment to be protected under the BIT.²¹⁹

The tribunal found that this requirement only applies to ensure that the investment is valid and not *per se* illegal.²²⁰ This reasoning is problematic, which arises from the breadth of the admission provision. It imposes an unwarranted restriction on the legality requirement, and effectively denies effect to the host State’s laws requiring prior registration of investment. States entering into these BITs have reserved their right to regulate admission according to their laws, which includes requiring registration of investments. That State parties should explicitly include a registration requirement in the BIT’s admission clause if they want this requirement to be recognized under the BIT is not reasonable. There is no peculiarity to registration from other requirements that host States laws might mandate. Further, State parties cannot be expected to explicitly provide for every possible type of requirement they may impose under their laws in any certain time and explicitly include it in order for it to be recognized. The explicit reference to their laws should suffice.

Violations that are considered illegal *per se* include fraud and misrepresentation. Applying the *per se* illegality requirement, an ICSID tribunal in *Inceysa* declined jurisdiction under an “in accordance with law” requirement in the Spain-El Salvador BIT. This was on the basis of its

²¹⁸ *Mytilineos Jurisdiction*, para. 146.

²¹⁹ *Id.*

²²⁰ *Id.* paras. 148, 152.

finding that the foreign investor was awarded a concession through fraudulent means.²²¹ The claimant had obtained the concession by defrauding the public bidding process, including by submitting false financial documentation, deliberately misrepresenting its experience and concealing its relationship with another bidder.²²² The tribunal after reviewing the *travaux* and the language of the BIT found that the “in accordance with the law” requirement in the admission provision of the BIT meant that an investment made in violation of the host State law would not be a protected investment covered by the BIT. It stated:

[B]y interpreting in good faith Article III of the Agreement, and by attributing to each of its words the meaning and scope the parties wanted to give them, and according to the will of the contracting States manifested in the *travaux préparatoires*, it is clear that the only correct interpretation of said article must be in the sense that any investment made against the laws of El Salvador is outside the protection of the Agreement and, therefore, from the competence of this Arbitral Tribunal.²²³

The tribunal found that “because Inceysa’s investment was made in a manner that was clearly illegal, it [wa]s not included within the scope of consent expressed by Spain and the Republic of El Salvador in the BIT”.²²⁴

As can be seen from the foregoing, while most BITs require that investment is made or admitted “in accordance with host State laws,” this requirement has been interpreted restrictively by arbitral tribunals. An investment will only violate this obligation if it was illegal. The illegality threshold is high. It appears that only a breach of “fundamental legal principles of the host country” will be held to meet this standard.²²⁵

Having said that, when the relevant BIT explicitly requires compliance with certain legal requirement in the national law or the registration or approval of the foreign investment by the host State, some tribunals apply this requirement. For instance, in *Yaung Chi Oo*, a dispute under the 1987 ASEAN Agreement, the foreign investment was admitted before the Agreement

²²¹ *Inceysa Vallisoletana S.L. v. Republic of El Salvador*, ICSID Case No. ARB/03/26, Award dated Aug. 2, 2006 [hereinafter *Inceysa Award*].

²²² *Id.* paras 53-61.

²²³ *Id.* para 203.

²²⁴ *Id.* para 257.

²²⁵ *Rumeli Award*, para. 319.

was in force in the host State.²²⁶ Article II(1) of the ASEAN Agreement explicitly limits its application to investments “which are specifically approved in writing and registered by the host country and upon such conditions as it deems fit for the purposes of this Agreement.”²²⁷ Article II(3) of the ASEAN Agreement provides that the Agreement applies to existing investment in the host State at the time of its entry into force provided that the investment is, for the purpose of the ASEAN Agreement, similarly approved in writing and registered.²²⁸ When the investment was made it was approved and registered as required by the host State law before the ASEAN Agreement entered into force. However, it did not seek specific approval and registration after its entry into force nor did the host State grant any such approval after the Agreement’s entry into force.²²⁹ The tribunal noted that such approval and registration would suffice for the purpose of Article II(3) of the ASEAN Agreement in case of an investment that was approved and registered after the Agreement entered into force.²³⁰ However, the tribunal found that the explicit requirement of Article II(3) “requires an express subsequent act amounting at least to a written approval and eventually to registration of the investment,”²³¹ The original approval and registration before the entry in to force of the ASEAN Agreement did not meet this requirement.²³² The tribunal concluded that the investment was not covered by Article II(3) and accordingly not protected by the ASEAN Agreement.²³³

Similarly, in *Philippe Gruslin*, a dispute under the Inter-Governmental Agreement between the Belgo-Luxembourg Economic Union and Malaysia (IGA), the tribunal similarly denied jurisdiction over a foreign investment that was not specifically approved as required by the IGA.²³⁴ The IGA requires that the invested assets in Malaysia be “in a project classified as an ‘approved project’ by the appropriate Ministry in Malaysia, in accordance with the legislation and the administrative practice, based thereon”.²³⁵ The claimant invested in securities listed on

²²⁶ *Yaung Chi Oo Trading Pte Ltd. v. Government of the Union of Myanmar*, Award, 42 ILM 540, para. 56 (Mar. 31, 2003) [hereinafter *Yaung Award*]

²²⁷ *Id.* para. 22.

²²⁸ *Id.*

²²⁹ *Id.* para. 62.

²³⁰ *Id.* para. 59.

²³¹ *Id.* para. 60.

²³² *Id.*

²³³ *Id.* para. 63.

²³⁴ *Philippe Gruslin v. Malaysia*, Award, para. 9.2 (Nov. 27, 2000) (quoting Article I(3) of the Inter-Governmental Agreement between the Belgo-Luxembourg Economic Union and Malaysia (IGA)) [hereinafter *Philippe Award*].

²³⁵ *Id.*

the Kuala Lumpur Stock Exchange (KLSE) through another entity.²³⁶ The tribunal found that such investment must satisfy the “approved project” requirement of the IGA.²³⁷ The claimant argued that the term “project” means activity, and that his ownership of stocks in the corporation is an investment in its activity.²³⁸ The claimant further argued that the approval requirement is satisfied, since the Malaysian Capital Issues Committee (CIC) approves the listing of any shares on the KLSE.²³⁹ Such approval should satisfy the “approved project” requirement.²⁴⁰ The tribunal rejected the claimant’s argument because the subject matter of the CIC approval is different from that of the approval required by the IGA. It reasoned:

Approval by the CIC may satisfy a governmental requirement that the business of a corporation be approved by a governmental agency. But this is not the content or subject matter of the “approved project” requirements of proviso (i) [of the IGA]. What is required is something constituting regulatory approval of a “project”, as such, and not merely the approval at some time of the general business activities of a corporation.²⁴¹

In this regard, the tribunal agreed with the respondent that “mere investments in shares in the stock market, which can be traded by anyone, and are not connected to the development of an approved project, are not protected” by the IGA.²⁴² The tribunal concluded that the claimant’s investment did not qualify as a protected investment under the IGA because it is not an “approved project” within the meaning of this term in the IGA.²⁴³

In the same vein, in *Fraport*, the investment was made in violation of the host State laws. The BIT contained “in accordance with the host State laws” requirement in the definition of investment and in the admission provision. In addition there was a specific reference to the constitutional requirements that the foreign investment violated in the Protocol to the BIT and the instrument of ratification. The tribunal stated:

²³⁶ *Id.* para. 8.1.

²³⁷ *Id.* para. 24.

²³⁸ *Id.* para. 25.1.

²³⁹ *Id.*

²⁴⁰ *Id.* para. 25.5.

²⁴¹ *Id.*

²⁴² *Id.* (quoting respondent’s argument with approval).

²⁴³ *Id.* para. 25.7.

The fact that there are three explicit references in the total of 16 provisions in the Treaty and Protocol plus an additional reference in the Instrument of Ratification, which selected only four items in the treaty deemed so important to the Philippines as to require additional recitation, indicates the significance of this condition. The parties had in mind explicit constitutional limitations in the Philippines. Article 2 of the Protocol as well as the Instrument of Ratification make that clear beyond peradventure of doubt.

The tribunal found that the investment was made intentionally in violation of the host State laws and the specific constitutional requirement. Such violations were sanctioned by the BIT, which refers to the host State laws. It stated:

The BIT is, to be sure, an international instrument, but its Articles 1 and 2 and ad Article 2 of the Protocol effect a *renvoi* to national law, a mechanism which is hardly unusual in treaties and, indeed, occurs in the Washington Convention. *A failure to comply with the national law to which a treaty refers will have an international legal effect.*²⁴⁴

The tribunal accordingly found that the investment did not qualify for the protection of the BIT.

Yet in another case where certification was explicitly required in the BIT and registration was required by host State law, the tribunal did not find this requirement compulsory. In *Desert Line*, a dispute under the Yemen-Oman BIT, Yemen argued that the claimant was not issued an investment certificate as required by the BIT and failed to register its investment in accordance with the Yemen Investment Law (YIL).²⁴⁵ Article 1(1) of the BIT states:

The term “Investment” shall mean every kind of assets owned and invested by an investor of one Contracting Party, in the territory of the other Contracting Party, and that is accepted, by the host Party, as an investment according to its laws and regulations, and for which an investment certificate is issued.²⁴⁶

The ICSID tribunal described the respondent’s objection as “unpersuasive” and “unattractive.”²⁴⁷ It based its analysis on the preamble of the BIT that describes the objectives of the BIT stating “that offering mutual promotion and protection of such investments, on the basis of investment laws and regulations in force in both countries and on the basis of this Agreement, will

²⁴⁴ *Fraport Award*, para. (Aug. 16, 2007) (emphasis added). For more analysis of this case, see chapter I on the definition of investment.

²⁴⁵ *Desert Award*, para. 104.

²⁴⁶ *Id.* para. 92 (quoting the Yemen-Oman BIT translation).

²⁴⁷ *Id.* para. 99.

contribute in stimulating investment ventures which will foster the prosperity of both Contracting Parties.” The tribunal interpreted the reference to “mutual promotion and protection” of investment in relation to investment laws of the host State to mean that these laws may only encourage investment and cannot limit or restrict such investment. It stated:

The “mutual promotion and protection” is envisaged as effected “on the basis of” laws, regulations, and the BIT itself. It is thus not described as *restricted* by the laws, the regulations or the BIT, but rather the contrary - as *founded* on those normative sources. They are a support, not an impediment.²⁴⁸

The tribunal rejected the respondent’s argument that the claimant must show it followed “some mechanism of acceptance” for its investment to be in accordance with the host State laws.²⁴⁹ It reasoned that the “in accordance to its laws and regulations” requirement would have explicitly referred to the YIL if the parties intended that the YIL requirements apply on the investment.²⁵⁰ In addition, the respondent did not prove to the tribunal that the YIL requires a specific form of acceptance.²⁵¹ The tribunal referred to other awards for the proposition that the “in accordance with the laws” requirement is intended “to ensure the legality of the investment by excluding investments made in breach of fundamental principles of the host State’s law, e.g. by fraudulent misrepresentations or the dissimulation of true ownership.”²⁵² Since no such illegality was established, the tribunal concluded that the claimant’s investment was not in violation of the host State laws.²⁵³ In addition the tribunal found that because of the evidence proving that the claimant was dealing with high level officials in Yemen regarding its investment, including the President the “acceptance” requirement was also satisfied.²⁵⁴

As for the “investment certificate” requirement, the issue for the tribunal was whether this was a “mere formalism” or a “material objective.”²⁵⁵ The tribunal chose the former, reasoning that the insistence on such formality is not in “the real interest” of the State parties to the BIT, and

²⁴⁸ *Id.* para. 101 (emphasis in original).

²⁴⁹ *Id.* para. 102.

²⁵⁰ *Id.* 103.

²⁵¹ *Id.*

²⁵² *Id.* para. 104.

²⁵³ *Id.* para. 105.

²⁵⁴ *Id.*

²⁵⁵ *Id.* para. 106.

contrary to the objective of the BIT to protect foreign investment.²⁵⁶ Such formality cannot be upheld except if there is “an explicit and compelling demonstration to the contrary”.²⁵⁷ It stated:

A purely formal requirement would by definition advance no real interest of either signatory State; to the contrary, it would constitute an artificial trap depriving investors of the very protection the BIT was intended to provide. Such an idea must give way - in the absence of an explicit and compelling demonstration to the contrary - when there is, as we shall see, an obvious substantive justification for the requirement under general international law, which forms the context in which the BIT is called upon to operate.²⁵⁸

The tribunal further found that, unlike the term “accepted”, the term “investment certificate” is not qualified by the “in accordance with the laws” requirement.²⁵⁹ It follows that the “investment certificate” requirement should be interpreted “in a general sense, in light of the objectives of the BIT.”²⁶⁰ The tribunal distinguished between BITs that do not require an “*ex ante* identification of investors” subject to the BIT and BITs that require such identification and specific approval of investment to be covered by the BIT.²⁶¹ Admittedly, the Yemen-Oman BIT belongs to the later category that requires specific approval. However, the tribunal found that there was no proof that the BIT State parties intended to have a “specific or indispensable formality.”²⁶² The tribunal rejected the argument that the term “certificate” has a “plain and ordinary meaning” that can be interpreted according to the Vienna Convention on the Law of Treaties.²⁶³

In order for the formality to be mandatory, in the tribunal’s view, more specific guidance as to the type of required document and the issuing authority must be indicated in the BIT. It stated:

[I]f an imperative formality were intended to be required, it would have been appropriate, if not indispensable, to identify the type of document required in each of the two countries and to identify the issuing department, or at least direct the attention of readers of the Treaty - prospective investors - to the

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ *Id.*

²⁵⁹ *Id.* para. 107.

²⁶⁰ *Id.*

²⁶¹ *Id.* para. 108.

²⁶² *Id.* para. 109.

²⁶³ *Id.*

proposition that the precise nature of the required certificates is to be determined by “specific regulations in force from time to time.”²⁶⁴

If no specific reference is made, the requirement would be considered a mere formality that only requires substantive acceptance from the host State. The tribunal referred to the ASEAN Agreement limiting its scope to investment “registered by the host country,” and other BITs, including UK-Indonesia BIT discussed above, for examples of specific references that satisfy this criterion.²⁶⁵ It concluded that since the BIT requirement lacked this kind of specificity, it only meant that the required certificate refers to “the substantive *certification* that the investment has indeed been *accepted* for the purposes of Article 1(1).”²⁶⁶ The tribunal found that such acceptance existed in this case given the evidence that showed that the claimants have been dealing with the host State’s highest level officials regarding its investment.²⁶⁷

A major part of *Desert Line*’s reasoning is problematic in many respects. While the facts of the case supported the result reached by the tribunal, the extreme requirements it imposed were not necessary for its main finding: that the host State has indeed accepted the investor’s investment and was estopped from challenging it. For one, States cannot be reasonably expected to detail every document they require, each national law that applies, and each governmental department that issues registrations, in their BITs. Even if this were possible, it would freeze State’s ability to amend their laws or administrative structures, which is again unreasonable. Further, the reasoning assumes that the main legal framework for the admission of foreign investment which the foreign investor evaluates before making its investment is the BIT. This is a flawed assumption. The main legal framework that applies to foreign investment admission is the host State’s local laws. These are what a foreign investor must undertake its due diligence to comply with. This is what the BIT references in its admission clause.

²⁶⁴ *Id.*

²⁶⁵ *Id.* para. 110.

²⁶⁶ *Id.* para. 111 (emphasis in original).

²⁶⁷ *Id.* paras. 105, 118.

Yet some arbitral awards suggest that when it comes to whether an investment was made “in accordance with the host State law,” such requirement should be interpreted “in a more liberal way which is generous to the investor.”²⁶⁸

Summary of Case Law

The broad admission clauses in BITs have led to ambiguity and different interpretations in practice. It appears that there are three types of violations of the host state laws during the admission of investment that are identified in case law. First, illegality that makes the investment “illegal *per se*,” as described by the *Tokios* tribunal and applied by the tribunals in the *Inceysa* and *Fraport* cases. Second, illegality arising from a violation of “fundamental principles of the host State law” that constitutes a serious civil illegality, like that in *Plama*. Investments that were made while tainted with these two kinds of illegality are not protected under BITs. Accordingly, tribunals have found that investments that were made through bribery, fraudulent misrepresentation, or through an intentional conspiracy to invest in violation of constitutional and criminal prohibitions are not protected by BITs.

Illegal actions under these first two categories may overlap. The same transaction may be illegal *per se* and violate fundamental principles of host State law. Indeed, illegal transactions that belong to the first category will almost always be covered by the second category.

Third, illegality arising from violations of host State laws and regulations that does not fall in the above two categories were not considered by some tribunals to be in violation of the “in accordance with host State laws” requirement. This has included failures to register the foreign investment as required by the host State law and minor administrative violations. Investments made in violation of such rules have been considered made “in accordance with the laws of the host State,” and such investments benefit from the protection of the BIT. Yet, if the relevant BIT specifically requires registration or abiding by a specific requirement of a certain law of the host State at the time of the initiation of the investment, an investment that violates such specific requirement will not be considered validly made under the BIT.

²⁶⁸ *Fraport Award*, para. 396; *Desert Award*, paras. 116-117 (quoting *Fraport* with agreement and introducing a new criterion for resolving the question of the absence of the required formal approval of the host State. The criterion is whether such investment would likely have received the formal approval had it applied for it.).

As noted above, this last category is problematic. It poses a question of whether the host State indeed retained discretionary power to admit investment under the “in accordance with the host State laws” requirement. It suggests that if a foreign investor does not commit a crime by bribing or violating a fundamental legal rule like fraudulent misrepresentation, its transactions will be considered investment even if they are not in fact in conformity with legal rules in the host State. Only if the BIT itself requires registration or refers explicitly to a registration requirement under host State law will a violation of such requirement be considered a violation of the BIT such that the BIT protections do not apply. Of course, if a “in accordance with the host State laws” requirement will not be given effect unless specific legal requirements are specified in the BIT, the host State’s discretion to regulate admission is no more than theoretical.

A principal mechanism that a host State can deploy to regulate the admission of investment is screening or requiring registration of such investment. If a host State requires that any foreign investment be registered or licensed in its territory, either generally or in specific sectors or activities, and a foreign investor undertakes the investment nevertheless without such registration or license, it may still be considered to have made investment ‘in accordance with the law’ according to the case law discussed above. Consequently, it would enjoy the rights afforded by the BIT including the right to transfer capital relating to its investment.

In addition, this interpretation conflates the national legal regime for admission of investment and the international legal regime for its protection. The host State law is the proper law governing the admission of investment, as is confirmed by the explicit reference in the BIT. Accordingly, an investor is obliged to examine the host State law, not the BIT, before making its investment. This makes the *Desert Lines* tribunal’s requirement that the BIT include a detailed explanation of the admission procedures of each State party difficult to justify.

Consistent with this reasoning, a recent award departed from the *Desert Lines* approach. The issue in this recent case was not whether the investment was registered but whether the subject of investment was licensed as required by the host State’s law. It found that investment made in violation of host State law would be considered illegal and denied BIT’s protection even when the illegality was unknown to the foreign investor. In *Alasdair*, foreign investors made deposits with the Villalobos brothers, two Costa Rican nationals, in Costa Rica in return for a high

interest rate.²⁶⁹ The Villalobos brothers' solicitation of funds was in violation of Organic Law of the Central Bank, which prohibits financial intermediation without authorization.²⁷⁰ The dispute was filed under the Canada-Costa Rica BIT, which requires investment to be in accordance with the host State law. The ICSID tribunal found that this requirement was "objective and categorical," and the foreign investor must comply with it "regardless of his or her knowledge of the law or his or her intention to follow the law."²⁷¹

As the investors had made deposits with an unauthorized financial intermediary, their investment was not in accordance with the host State's law.²⁷² The tribunal emphasized that investors must undertake their due diligence before investing, and that ignorance of the law is not an excuse. It stated:

[P]rudent investment practice requires that any investor exercise due diligence before committing funds to any particular investment proposal. An important element of such due diligence is for investors to assure themselves that their investments comply with the law. Such due diligence obligation is neither overly onerous nor unreasonable. Based on the evidence presented to the Tribunal, it is clear that the Claimants did not exercise the kind of due diligence that reasonable investors would have undertaken to assure themselves that their deposits with the Villalobos scheme were in accordance with the laws of Costa Rica.²⁷³

The tribunals accordingly dismissed all the claimants' claims as they did not qualify as investment under the BIT.

For the reasons explained above, this result is to be preferred. If the host State laws and regulations are published, or otherwise obtainable by undertaking due diligence, and the investor fails to comply with them, such investment should not be considered valid under the provisions

²⁶⁹ *Alasdair Ross Anderson and others v. Republic of Costa Rica*, ICSID Case No. ARB(AF)/07/3 (Award), para. 18 (May 19 2010) [hereinafter *Alasdair Award*].

²⁷⁰ *Id.* para. 54.

²⁷¹ *Id.* para. 52.

²⁷² *Id.* para. 55 (footnote omitted) ("The entire transaction between the Villalobos brothers and each Claimant was illegal because it violated the Organic Law of the Central Bank. If the transaction by which the Villalobos acquired the deposit was illegal, it follows that the acquisition by each Claimant of the asset resulting from that transaction was also not in accordance with the law of Costa Rica. Although the Claimants may not have committed a crime by entering into a transaction with the Villalobos, the fact that they gained ownership of the asset in violation of the Organic Law of the Central Bank means that their ownership was not in accordance with the laws of Costa Rica and that therefore each of their deposits and resulting relationships with Villalobos did not constitute an "investment" under the BIT.").

²⁷³ *Id.* para. 58.

of a BIT that have been discussed above. However, if the host State's law is not clear, or available through reasonable due diligence, or if the proper authority in the host State government is estopped from raising such violation because it has "knowingly overlooked them and endorsed an investment which was not in compliance with its law," it would be appropriate to find that the foreign investment has complied with the BIT and host State law in making its investment.²⁷⁴

The above also shows the problem of broad obligations and clauses that lead to different interpretations and ambiguity in practice. This restricts the host state right to admit investment and accordingly its right to regulate capital under BITs. Narrower clauses or clauses that specifically provides for the host state discretion to admit foreign investment is thus preferred.

C. Most Favoured Nation Treatment, National Treatment and Prohibition of Performance Requirements

i. General

Some BITs extend NT and/or MFN treatment to the parties' foreign investors. Granting NT and MFN to foreign investment in both pre-entry and post-entry phases is viewed as an important tool to avoid distorting competition and to ensure an efficient economy. As discussed, the argument runs that, due to its progressive integration, non-discrimination policy leads to an efficient global economy.²⁷⁵

NT with regard to the right of establishment obliges the host country to allow foreign investors to carry out business in the host country like nationals and under the same conditions that apply to nationals in establishing or acquiring investment.²⁷⁶ Foreign investments from the other party may not be discriminated against on the basis of their nationality. This means that foreign investors may not be required to do what is not required from their national competitors in order

²⁷⁴ *Fraport Award*, paras. 346, 396; *Desert Lines*, para. 120 (agreeing with *Fraport* that the government should be estopped from raising the violation of its national law if it intentionally ignored the violation of its law, and asserting that such result is applicable *a fortiori* when the violation relates to a mere formality.)

²⁷⁵ See Chapter II; see also UNCTAD, *National Treatment*, in UNCTAD Series on Issues in International Investment Agreements, UN Doc. UNCTAD/ITE/IIT/11 (Vol. IV), at 3 (1999).

²⁷⁶ Juillard, *supra* n.5, at 451.; Michael R. Reading, *Note: The Bilateral Investment Treaty in ASEAN: A Comparative Analysis*, 42 Duke L.J. 679, at 699 (1992).

for their investment to enter into the host State.²⁷⁷ This includes not imposing minimum national ownership or shareholding on foreign investment.²⁷⁸

To extend MFN to admission and establishment means that the foreign investment from state parties to the BIT may not be discriminated against vis-a-vis other foreign investments. If third party foreign investors are accorded national treatment or right to free admission in the State of one party, the other State party investments are entitled to the same treatment. MFN treatment may thus grant a foreign investor better treatment than a national, if a third party investor receives such better treatment.²⁷⁹

ii. Broad Obligation

The US Model BITs extend national treatment and most favoured nation treatment to the right of establishment. Earlier US model BITs and the most recent model of 2004 have different wordings in the relevant parts, but they all grant national treatment and most favoured nation treatment to foreign investors at the pre-entry phase. The 1992 Model US BIT states:

Each Party shall permit and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies of any third country, whichever is the most favorable, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty.²⁸⁰

The 2004 Model US BIT 2004 states:

²⁷⁷ See Newcombe & Paradell, *supra* n. 162, at 150.; Reading, *supra* n. 276, at 699.

²⁷⁸ Jean Raby, *The Investment Provisions of the Canada-United States Free Trade Agreement: A Canadian Perspective*, 84 Am. J. Int'l L. 394, 410 (1990) (referring to the explicit provision in the Free Trade Agreement between Canada and the USA of December 22, 1987, art. 1602 (2)). For more details on MFN and NT, *see* Chapter V.

²⁷⁹ UNCTAD, *supra* n. 275, at 11.

²⁸⁰ *US Model BIT 1992*, art. IV 240-253. *See also US Model BIT 1994*, art. 2(1) (“With respect of establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of covered investment, each party shall accord treatment no less favorable than that it accords, in like situations, to investments in its territory of its own nationals or companies (hereinafter ‘national treatment’) or to investments in its territory of nationals or companies of a third country (hereinafter ‘most favored nation treatment’), whichever is most favorable (hereinafter ‘national and most favored nation treatment.’)”); *Treaty Between the Government of the United States of America and the Government of the Republic of Azerbaijan Concerning the Encouragement and Reciprocal Protection of Investment*, signed Aug. 1, 1997, art. II (1) (entered into force Aug. 2, 2001) (containing a similar provision); *U.S.-Honduras BIT*, art. II(1) (containing a similar provision).

Article 3: National Treatment

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

...

Article 4: Most-Favored-Nation Treatment

1. Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.
2. Each Party shall accord to covered investments treatment no less favorable than that it accords, in like circumstances, to investments in its territory of investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.²⁸¹

The above provisions are broad and grant rights to investment in the pre-establishment phase. As such, they represent “the pre-entry model” of admission in BITs.²⁸² US BITs, thus, bestow on the foreign investor a right to receive national treatment and most favoured nation treatment, whichever is more favourable, in the pre-entry phase.²⁸³ The 1992 Model and BITs following this model use the term “permit” and accord foreign investment national treatment or MFN

²⁸¹ *US Model BIT 2004*. See also *Treaty between the Government of the United States of America and the Government of the Republic of Rwanda Concerning the Encouragement and Reciprocal Protection of Investment*, signed February 19, 2008, art. 3-4 (containing similar provision); *Treaty Between the United States of America and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment*, signed November 4, 2005, art. 3-4 (entered into force November 1, 2006) (containing similar provision).

²⁸² See Newcombe & Paradell, *supra* n. 162, at 137-139. The same approach is followed by NAFTA, which grants national treatment to the parties’ foreign investors and investment in the pre –entry phase. It provides that:

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. NAFTA, art. 1102.

²⁸³ Kenneth J. Vandeveld, *UNITED STATES INVESTMENT TREATIES: POLICY AND PRACTICE*, at 75 (Kluwer Law and Taxation Publishers, 1992) (U.S. “BITs require the *better* of MFN or national treatment with respect to the right of establishment . . .”) (emphasis in original); Jeffrey Lang, *The International Regulation of Foreign Direct Investment: Obstacles and Evolution*, 31 *Cornell Int’l L.J.* 455, 457 (1998).

treatment in this phase.²⁸⁴ This is broad and appears to cover admission and establishment, since the word “permit” is not qualified.

Moreover, NT and MFN are also expressed to cover “associated activities”. As this term is defined under the US Model BIT 1992, it grants broad coverage over many activities that include establishing and operating companies and other entities, and entering into contracts and acquiring different kinds of property.²⁸⁵ Granting national treatment to these activities restricts further the host state’s ability to restrict the underlying investment activity.

The US 1994 Model and 2004 Model use the terms “establishment,” “acquisition” and “expansion”. Juillard apparently refers to the establishment right when he notes that “national treatment, as far as it refers to the pre-establishment phase, means that foreigners may engage in the same economic activities under the same conditions as nationals – *provided, however, such economic activities will be conducted through a permanent establishment.*”²⁸⁶

²⁸⁴ Cf. Newcombe & Paradell, *supra* n. 162, at 137. See for e.g., *US -Ecuador BIT*, art. II(1) (“Each Party shall permit and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favorable, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Protocol to this Treaty.”); *Treaty Between United States of America and the Republic of Kyrgyzstan Concerning the Encouragement and Reciprocal Protection of Investment*, signed Jan. 19, 1993; art. II (1), (entered into Force Jan. 12, 1994) (“Each Party shall permit and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favorable, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty.”); *Treaty between the Government of the United States of America and the Government of Romania Concerning the Reciprocal Encouragement and Protection of Investment*, signed May 28, 1992, art. II(1) (entered into force Jan. 15, 1994) (“Each Party shall permit and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favorable, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty.”); *Treaty Between the United States of America and the Republic of Turkey concerning the Reciprocal Encouragement and Protection of Investments*, signed December 3, 1985; art. II(1) (entered into force May 18, 1990) (“Each Party shall permit in its territory investments, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investments of nationals or companies of any third country, and within the framework of its laws and regulations, no less favorable than that accorded in like situations to investments of its own nationals and companies.”); *Treaty between the United States of America and the Republic of Tunisia Concerning the Reciprocal Encouragement and Protection of Investment*, signed May 15, 1990, art. II(1) (entered into force Feb. 7, 1993) (“Each Party shall permit in its territory investments, and activities associated therewith, by nationals and companies of the other Party on a basis no less favorable than that accorded in like situations to investments of nationals or companies of any other country and, within the framework of its existing laws and regulations, no less favorable than that accorded in like situations to investments of its own nationals and companies.”).

²⁸⁵ *US Model BIT 1992*, art. 1(e).

²⁸⁶ Juillard, *supra* n.5, at 451.

This interpretation appears to be applicable to BITs that grant NT with regard only to the right of establishment. However, the US BITs include language that is broader than the right of establishment. This language accords national treatment in “permit[ting]” or for “establishment,” “acquisition” and “expansion” of investment.²⁸⁷ No explicit requirement that the establishment be permanent exists.

US Model BITs and US BITs, thus, prohibit discrimination based on nationality in the admission and establishment foreign investment, save in respect of the exceptions that are provided for in the BIT. This restricts the discretionary power of host states to prevent or limit admission of foreign investment. Only if the host state restricts nationals and other foreign investors from certain sectors or activities would it be able to regulate the entry of foreign investment or condition such entry in these sectors or activities.

This includes screening on ground of nationality.²⁸⁸ Accordingly, under US BITs, a host State cannot impose a screening procedure or conditions for foreign investment from the other party without applying the same to its nationals and other foreign investments.

It is important to note that NT and MFN treatment obligations are restricted to treatment accorded to national and other foreign investment in “like situations” or “like circumstances.” There is no available BIT case law applying national treatment and MFN in the admission phase, although some cases are available regarding the application of national treatment on already admitted investment, which can shed light on how would national treatment be applied to admission. The question is what would be the comparable situations or circumstances that can be used to compare between the foreign investment and national investment at the entry phase. This is generally a difficult question that has to be left for the facts of each case.²⁸⁹

²⁸⁷ Shihata, *supra* n. 166, at 56 (“In U.S. BITs, . . . the national and MFN standards are made applicable to the ‘establishment’ or ‘acquisition’ of investments, or in other words to their admission”); Vandeveld, *supra* n. 35 at 237 (“[T]he right to ‘establish’ or ‘acquire’ investment . . . should not be regarded as mutually exclusive. In fact, U.S. BIT negotiators tended to use the terms interchangeable, along with the term to ‘make’ an investment.”).

²⁸⁸ See Department of State, *Letter of Submittal: U.S.-Honduras BIT*, at VII-VIII (Article II(1) of the BIT “ensure[s] the better of national or MFN treatment in both the entry and post-entry phases of investment. It thus prohibits, outside of exceptions listed in the Annex, “screening” on the basis of nationality during the investment process, as well as nationality-based post-establishment measures.”); Department of State, *Letter of Submittal: U.S.-Azerbaijan BIT*, (Washington, September 8, 2000); Victor Mosoti, *Bilateral Investment Treaties and the Possibility of a Multilateral Framework on Investment at the WTO: Are Poor Economies Caught in Between?*, 26 NW. J. INT’L L. & BUS. 95, at 121 (2005).

²⁸⁹ UNCTAD, *supra* n. 275, at 33-34.

However, it can be assumed that “like circumstances” exist in relation to conditions imposed on nationals and other foreign investment in the same business sector who compete with the foreign investor, since the purpose of the national treatment is to prevent discrimination based on nationality.²⁹⁰ Some tribunals have narrowed the extent of comparison to “identical” national investors if these exist. Thus, in *Methanex*, the tribunal rejected a comparison between the claimant, which produces methanol, with national investors that produced ethanol, because there were national investments that produced methanol like the claimant.²⁹¹ The tribunal reasoned that “[i]t would be a forced application of Article 1102 if a tribunal were to ignore the identical comparator and to try to lever in an, at best, approximate (and arguably inappropriate) comparator.”²⁹²

However, in *Occidental*, a dispute under the US-Ecuador BIT, the tribunal was confronted with the scope of the “in like situations” qualifier of national treatment.²⁹³ The claimant, which was in the oil exploitation and exportation business in Ecuador, claimed that it was entitled to a refund of Value Added Tax (VAT) because it exported the produced oil, as mandated by national law.²⁹⁴ It contended that Ecuador violated national treatment and MFN treatment because other producers who export their other goods (flowers, mining and seafood products) received VAT refunds.²⁹⁵

Ecuador argued that the comparison should be with producers from the same sector, i.e., oil producers.²⁹⁶ It maintained that other national oil producers had also been denied VAT refunds and that no foreign producer of oil received a VAT refund.²⁹⁷

²⁹⁰ See *Pope & Talbot, Inc. v. Canada*, NAFTA Ch. 11 (Award on the Merits, Phase Two), para. 78 (Apr. 10, 2001) (“[T]he treatment accorded a foreign owned investment protected by Article 1102(2) [regarding national treatment] should be compared with that accorded domestic investments in the same business or economic sector.”).

²⁹¹ *Methanex v. United States*, UNCITRAL (Final Award), para. 17 (Aug. 3, 2005) (“[I]t would be as perverse to ignore identical comparators if they were available and to use comparators that were less ‘like’, as it would be perverse to refuse to find and to apply less ‘like’ comparators when no identical comparators existed. The difficulty which Methanex encounters in this regard is that there are comparators which are identical to it.”).

²⁹² *Id.* para. 19.

²⁹³ *Occidental Exploration and Production Company v. Ecuador*, LCIA Case No UN 3467 (Award) , IIC 202 (2004), (July 1, 2004) [hereinafter *Occidental Award*]

²⁹⁴ *Id.* para. 30.

²⁹⁵ *Id.* para. 168.

²⁹⁶ *Id.* para. 171.

²⁹⁷ *Id.* paras. 171-172.

The tribunal rejected Ecuador's narrow interpretation, which was based on WTO law. It found that the purpose of the national treatment in the BIT and WTO agreements were different. While the WTO agreement's purpose was to avoid discrimination between imported products and national products, the BIT's purpose was to avoid discrimination between different exporters. It stated:

[T]he purpose of national treatment in this dispute is the opposite of that under the GATT/WTO, namely it is to avoid exporters being placed at a disadvantage in foreign markets because of the indirect taxes paid in the country of origin, while in GATT/WTO the purpose is to avoid imported products being affected by a distortion of competition with similar domestic products because of taxes and other regulations in the country of destination.

In the first situation, no exporter ought to be put in a disadvantageous position as compared to other exporters, while in the second situation the comparison needs to be made with the treatment of the "like" product and not generally. In any event, the reference to "in like situations" used in the Treaty seems to be different from that to "like products" in the GATT/WTO. The "situation" can relate to all exporters that share such condition, while the "product" necessarily relates to competitive and substitutable products.²⁹⁸

The tribunal concluded that the claimant was not accorded national treatment because other national companies were entitled to tax refunds. This amounted to discrimination, notwithstanding that there was no intent to discriminate.²⁹⁹ The tribunal found Ecuador in breach of its obligation to accord national treatment.³⁰⁰

The result of the *Occidental* tribunal's rejection of the narrow interpretation of "like situations" is peculiar. In this case, the foreign investor would be entitled to better treatment than its national competitors, and also other third party state foreign competitors that do not have similar protection under their respective states' BITs. The tribunal's interpretation of "like situation" that is inclusive of all exporters, if applied on entry might lead to similar results, whereby different conditions applicable for certain industries but not to others would entitle a foreign investor to claim violation of national treatment. In light of this, the interpretation rendered by the *Methanex* tribunal is more convincing.

This is a result of the breadth of the NT provision that refers to the broad criterion of "in like situations" or "in like circumstances". This allowed the tribunal to reach a broad interpretation

²⁹⁸ *Id.* para. 175-176.

²⁹⁹ *Id.* para. 177.

³⁰⁰ *Id.* para. 179.

that restricts the host state power to distinguish between different investors in different industries or sectors according for any rational reason.

This result would have been more reasonable if the dispute was under a BIT that provided for the best national treatment available. For example, the Czech-US BIT defines national treatment as the best treatment accorded to nationals. It states “‘national treatment means treatment that is at least as favourable as the most favourable treatment accorded by a Party to companies or nationals of third Parties in like circumstances.’”³⁰¹ However, national treatment is still qualified by “like circumstances,” which suggests that such treatment is confined to comparable national investments, mainly identical competitors.³⁰² Vandevelde notes:

The BITs provide little guidance concerning the meaning of the phrase “in like situations.” In general, however, one purpose of the national and MFN treatment provisions is to prevent the host state from providing a competitive advantage to some investments based on their nationality. Thus, the fact that investments are in competition with each other militates in favor of considering them to be “in like situations,” though it is not conclusive.³⁰³

Some US BITs use the term “nondiscriminatory” to reach the same result. For example, the Bulgaria-US BIT states: “Each Party shall permit and treat investment, and activities associated therewith, on a *nondiscriminatory basis*, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty.”³⁰⁴ It defines the term “nondiscriminatory” treatment as “treatment that is at least as favorable as the better of national treatment or most-favored-nation treatment.”³⁰⁵ It accordingly accords both national treatment and MFN.

Even if no definition of “discriminatory” is provided in the BIT, it has been interpreted to include national treatment. For instance in *Noble Ventures*, a claim under the US-Romania BIT, the ICSID tribunal interpreted discriminatory measure to mean “that a certain measure was

³⁰¹ *Treaty Between the U.S. and the Czech and Slovak Federal Republic Concerning the Reciprocal Encouragement and Protection Of Investment*, signed Oct. 22, 1991, art. I(1)(g) (entered into Force Dec. 19, 1992).

³⁰² Vandevelde, *supra* n. 35, at 240.

³⁰³ *Id.*

³⁰⁴ *US-Bulgaria BIT*, art. II (1) (emphasis added).

³⁰⁵ *Id.* art. I(1)(F).

directed specifically against a certain investor by reason of his, her or its nationality.”³⁰⁶ The other comparable categories of nationals or third party investors in like situations must be accorded more favourable treatment, which may include not having been subjected to similar measures.³⁰⁷

iii. Immediacy and Negative List

The NT and MFN apply immediately under US BITs. There is no gradual application for the applying the admission obligations. Notably, US Model BITs and US BITs preclude the application of NT and MFN treatment to certain sectors and matters that are specified in an annex.³⁰⁸ The US Model BIT 1992 requires that existing exceptions in the sectors and matters specified in the annex to be notified to the other party together with any future exceptions that must be limited “to a minimum.”³⁰⁹ Any future exceptions may not apply to existing investments.³¹⁰

No similar notification requirements exist in the US Model 1994. The US Model 1994 does not prevent future exceptions from applying to existing investment. It only prevents the future exceptions from requiring “the divestment, in whole or in part, of covered investments existing at the time the exception becomes effective.”³¹¹

The US Model 2004 contains a more detailed regulation of the exceptions.³¹² Three annexes exist: one for all existing non-conforming measures in general (Annex I); one for all excepted

³⁰⁶ *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11 (Award), para. 180 (Oct. 12, 2005) [hereinafter *Noble Award*].

³⁰⁷ *Id.* Cf. *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil Genin v. Republic of Estonia*, ICSID Case No. ARB/99/2 (Award), para. 368 (June 25, 2001) (“Article II(3)(b) of the [U.S.-Estonia] BIT further requires that the signatory governments not impair investment by acting in an arbitrary or discriminatory way. In this regard, the Tribunal notes that international law generally requires that a state should refrain from “discriminatory” treatment of aliens and alien property. *Customary international law does not, however, require that a state treat all aliens (and alien property) equally, or that it treat aliens as favourably as nationals. Indeed, ‘even unjustifiable differentiation may not be actionable.’*”) (emphasis added).

³⁰⁸ See for e.g., *U.S. Model BIT 1992*, art. II(1); *U.S. Model BIT 1994*, art. 2 (2) (a); *U.S. Model BIT 2004*, art. 14.

³⁰⁹ See for e.g., *U.S. Model BIT 1992*, art. II(1).

³¹⁰ See for e.g., *Id.*

³¹¹ *U.S. Model BIT 1994*, art. 2 (2) (a).

³¹² *U.S. Model BIT 2004*, art. 14. It states:

1. Articles 3 [National Treatment], 4 [Most-Favored-Nation Treatment], 8 [Performance Requirements], and 9 [Senior Management and Boards of Directors] do not apply to:

(a) any existing non-conforming measure that is maintained by a Party at:

(i) the central level of government, as set out by that Party in its Schedule to Annex I or Annex III,

non-conforming measures in the financial sector (Annex III); and one for all excepted sectors and activities (Annex II).³¹³ The first two (Annexes I and III) specify the existing measures that do not conform with national treatment and MFN treatment. A party may amend the existing non-conforming measures to make them more in conformity with the national treatment or MFN. It may not however amend them otherwise. The third annex (Annex II) that contains the sectors and matters excepted from the NT and MFN can be amended without such qualification, except that an existing investor may not be forced to sell its investment because of its nationality. As Shihata notes, “US BITs thus achieve a ‘freezing’ or stabilization of the areas in which each State can apply restrictions to investors from the other State.”³¹⁴

The liberalization of investment in US BITs conforms to the US national interest as defined by US foreign policy: it grants US investors access to foreign countries. BITs are considered an instrument to enforce such policy, which conforms to the ideology behind the US BITs programme to allow investment and capital flows associated thereto to move according to market rules only, without government interference.³¹⁵ This approach, which was also followed by Canada and Japan, highlights the change in the role of BITs from protecting foreign investment to being an instrument to liberalise the movement of foreign investment and capital.³¹⁶ Some European BITs have also started to follow suit. An example is the Italian Model BIT.³¹⁷

The US Model BITs thus require the immediate application NT and MFN on the admission of investment except for certain sectors that are included in a list. The immediacy of the NT and

(ii) a regional level of government, as set out by that Party in its Schedule to Annex I or Annex III, or
(iii) a local level of government;

(b) the continuation or prompt renewal of any non-conforming measure referred to in subparagraph (a); or
(c) an amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment, with Article 3 [National Treatment], 4 [Most-Favored-Nation Treatment], 8 [Performance Requirements], or 9 [Senior Management and Boards of Directors].

2. Articles 3 [National Treatment], 4 [Most-Favored-Nation Treatment], 8 [Performance Requirements], and 9 [Senior Management and Boards of Directors] do not apply to any measure that a Party adopts or maintains with respect to sectors, subsectors, or activities, as set out in its Schedule to Annex II.

3. Neither Party may, under any measure adopted after the date of entry into force of this Treaty and covered by its Schedule to Annex II, require an investor of the other Party, by reason of its nationality, to sell or otherwise dispose of an investment existing at the time the measure becomes effective.

³¹³ Vandeveld, *supra* n. 35, at 253-254.

³¹⁴ Shihata, *supra* n. 166, at 59.

³¹⁵ Kenneth J. Vandeveld, *Of Politics and Markets: The Shifting Ideology of the BITs*, 11 Int'l Tax & Bus. Law. 159, at 162 (1993); Herbert Golsong, *Introductory Note Argentina-United States: Treaty Concerning the Reciprocal Encouragement and Protection of Investment*, 31 I.L.M. 124, (1992).

³¹⁶ Luke Eric Peterson, *Bilateral Investment Treaties and Development Policy-Making*, at 32 (International Institute for Sustainable Development, 2004).

³¹⁷ Pollan, *supra* n. 40, at 78.

MFN application to admission of investment combine with a negative list approach is flawed. This approach entails an immediate lifting of all restrictions on the admission of foreign investment including screening and requiring registration. This does not allow developing countries to regulate the admission of different investments according to their needs and to prevent short-term investment and certain kinds of investors that can threaten the stability of the economy. The inclusion of a negative list is not sufficient for covering different kinds of short-term investments and does not apply to the kind of investors. It does not also accommodate developing countries incapability to identify the sectors that might be threatening to their economy.

IV. Conclusion

This chapter has discussed the breadth of the term investment and the admission of investment provisions under BITs. The broad meaning given to investment leads to ambiguity and incoherence in practice, and unduly broadens the ambit of capital entitled to transfers, transactions subject to admission and investor-state arbitration.

While the contextual interpretation of the term investment—which requires certain characteristics in an asset to qualify as investment—is more close to the object and purpose of BITs, it is not shared by most tribunals and commentators. Many follow the literal interpretation—which do not adopt any limitation on the term investment under BITs. They consider that each asset or contract that has an economic value and each item included in the non-exhaustive list is separately considered investment under BITs.

However, some recent practice of certain States, including the US, has clarified that an asset must have certain characteristics to be considered investment. This practice is still at its inception and mostly followed by developed States which had been subject to investor-state arbitration. It is still early to see whether this practice will have any effect on BITs jurisprudence in general, or would be followed by other states.

The importance of the definition of investment under BITs is more than jurisdictional. Substantively, BITs regulation of the right of admission of investment and transfer of the proceeds are widened or limited by the investment definition. A foreigner's right to own property

might be protected under a BIT that gives a NT to admission or establishment of investment, since mere fact of owning an asset would qualify as investment under the literal interpretation trend. Generally, any right in the preadmission or pre-establishment stages is tied to the relevant BIT and to whether its definition of investment covers that activity.³¹⁸

Similarly, under the literal interpretation trend, the proceeds of a sale of any asset or a contract would be considered investment proceeds subject to the transfer obligations under BITs. Funds arising out of any transaction would thus be guaranteed transferability in and out of the host state.

The breadth of the investment definition is problematic because it extends the scope of BITs' protection and its guarantee of capital transferability in a manner that unnecessarily covers assets and property that are not rightly characterized as investment and accordingly extends the transferability of capital beyond what is necessary to protect and promote investment.

It is true that some tribunals and recent State practice of certain countries, like the US, have clarified this definition by limiting it to assets that have the characteristics of investment. Yet the majority of BITs are still missing this express limitation on the term. Similarly, most awards do not limit the term investment under BITs to assets that have the characteristics of investment. Instead, they consider any asset that has economic value is considered an investment.

In addition, most BIT admission provisions are broadly drafted and allow the admission of investment according to the host State's laws and regulations. These broad provisions have led to interpretations that find that foreign investors' violation of the registration requirement in the host state laws and regulation does not constitute violation of the BIT admission provision. The breadth of these admission provisions and their interpretation can result in the host State losing its discretion to require registration of investment and accordingly, its discretionary power to admit investment. Further, the admission of investment under US BITs is subject to national and most favoured nation treatment. This further restricts the State's discretionary powers to control admission of capital through restricting the underlying investment.

³¹⁸ Palacio & Muchlinski, *supra* n. 159, at 231.

First, some BITs' treatment of the subject of regulation of admission of investment and some arbitral decisions lead to restricting this discretion. There are two main approaches under BITs for the treatment of admission of foreign investment: (i) host State discretion approach; and (ii) non-discrimination approach. The former provides for the admission of investment in accordance with the host State laws. This in theory permits the host State to regulate the admission of investment under its laws. Accordingly, it was found that a violation of the host State law that requires authorization for making certain investment would be in violation of the BIT's legality requirement even if the foreign investor did not know of the violation because it has a duty to undertake a due diligence and know the law.

However, many arbitral awards have found that this is a legality requirement: only if the investment is illegal *per se* or violates a fundamental principle of host State law would it be in violation of this requirement.³¹⁹ Tribunals found, accordingly, that violation of host State's laws requiring prior registration was not in violation of the legality requirement under BITs except if the relevant BIT specifically provide that certain procedure should be followed. In addition, some tribunals indicated that a liberal interpretation of this requirement in favour of foreign investors is generally warranted.

Second, under the non-discrimination approach, the host state must grant national treatment and MFN to the foreign investor: the same treatment to foreign investment in the admission phase that it grants to its nationals and other foreigners except in the sectors or activities included in the negative list annexed to the relevant BIT. This limits the host state power to distinguish between different kinds of investment and investors due to the broad application of NT and MFN. It also requires the immediate application of these obligations, which is an approach that does not accommodate the need of developing states.

³¹⁹ See, e.g., *Rumeli Award*, para. 319 (acknowledging that the investment must be made in accordance with host State law to be protected by the BIT, but limits this rule to violations of certain legal rules of the host State: "fundamental legal principles.") It reasoned that "in order to receive the protection of a bilateral investment treaty, the disputed investments have to be in conformity with the host State laws and regulations. On the other hand, . . . investments in the host State will only be excluded from the protection of the treaty if they have been made in breach of fundamental legal principles of the host country." *Id.* It gave examples of such fundamental legal principle, like fraudulent investment in violation of the principle of good faith; "the principle of *nemo auditor propriam turpitudinem allegans* or international public policy." *Id.* para. 323.

The combination of the broad definition of investment and broad and immediate admission provisions in BITs restrict unduly the ability of states to regulate the admission of investment and to distinguish between different kinds of investment.

Chapter Four: BITs Direct Treatment of Capital Movement

I. Introduction

Customary international law is silent on the issue of the foreign investor right to transfer funds, and does not impose an obligation on the host country to allow the movement of funds. This right includes the right to regulate inward and outward capital, which is a part of a State's "monetary sovereignty."¹ Methods of regulation of capital movement through capital controls have already been discussed.²

This right to regulate capital movements is confirmed by the Articles of Agreement of the International Monetary Fund. They provide that, "Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments . . ."³

BITs, in turn, fill this void by directly treating the ability of foreign investors to import and repatriate funds related to their investments. By and large, BITs oblige the host State to permit the repatriation of funds arising from investment. While most BITs regulate transfer of capital, not all of them explicitly regulate inward transfers.

Some provide only for the repatriation of capital, that is, outward transfers. Some BITs just provide for the free transfer of capital related to investment without qualification, and some explicitly provide for the transfer of both capital inflows and outflows. In these last two categories, capital inflows related to investment must be permitted. No discretion is left to the host state. Another category leaves discretion to admit capital and subject it to the laws of the

¹ Charles Proctor, *Mann on the Legal Aspect of Money*, at 500-501 (OUP, 6th ed., 2005); see also Ibrahim F.I. Shihata, *Recent Trends to Entry of Foreign Direct Investment*, 9 ICSID Review-FILJ 47, at 47 (1994); Giorgio Sacerdoti, *The Admission and Treatment of Foreign Investment under Recent Bilateral and Regional Treaties*, 1 JWI 105, at 105 (2000); Ian Brownlie, *Principles of Public International Law*, at 520 (OUP, 2008).

² See Chapter II.

³ *Articles of Agreement of the International Monetary Fund*, signed July 22, 1944, art. VI Sec. 3 (entered into force Dec. 27, 1945) [hereinafter *IMF Articles*]. See also Proctor, *supra* n. 1, at 559 ("[I]f the members of the [IMF] grant to each other the right 'to regulate international capital movements', then it is possible to suggest that such a right is recognized by customary international law.") (footnote omitted); Rudolf Dolzer & Christoph Schreuer, *Principles of International Investment Law*, at 192 (OUP, 2008).

host State. Some categories allow for exceptions in case of financial crises or balance of payment problems. Where there is no exception to deal with financial crises or balance of payment problems, this problematic lack of discretion is exacerbated.

BITs, in general, oblige the host State to allow certain capital transfers relating to investment. In this respect, BITs are used as a vehicle to liberalize foreign investment-related capital flows between its parties.⁴ The obligation to permit transfers may differ from one BIT to another in terms of its nature and content. It typically requires lifting capital controls over capital outflows related to foreign investment, and prevents the host State from using capital controls in relation to the transfer of capital related to these investments, which may -- as previously discussed -- be necessary to preserve the financial stability of the host State.⁵

It is true that “[t]he growth of international investment depends on capital accounts that are at least partly open.”⁶ Yet the available evidence suggests that not all capital flows are beneficial for the host State economy and that complete liberalization may be a prime cause of financial crises.

This chapter analyses the nature of the BITs obligation to permit the transfer of funds and capital resulting from foreign investment, and the effect of this obligation in conjunction with other BITs obligations and standards on the regulatory power of the State to regulate capital transfer and use capital controls. It evaluates whether BITs regulation balances between the investor’s need to transfer funds and the host state need to regulate capital. It identifies the themes where BITs regulation has been absolute, broad and immediate and the effect of that. In doing so, it uses the Model BITs for illustration. It starts by analyzing BITs different approaches in directly regulating capital outflows and inflows.

⁴ Timothy A. Canova, *Banking and Financial Reform at the Crossroads of the Neoliberal Contagion*, 7 U.S.-Mex. L.J. 85, at 107 (1999).

⁵ Kenneth J. Vandavelde, *Of Politics and Markets: The Shifting Ideology of the BITs*, 11 Int’l Tax & Bus. Law. 159, at 167 (1993); Canova, *supra* n. 4, at 92, 107.

⁶ Michael Waibel, *BIT by BIT: The Silent Liberalization of the Capital Account*, in *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer*, at 498 (eds. Christina Binder et al, OUP, 2009).

II. Treatment of Capital Outflows

A. General

The repatriation of capital resulting from foreign investment is an important component in any BIT, and is a main concern for the host state, the home State, and foreign investors. The host State typically desires to keep the foreign capital and prefers if the capital proceeds were to be reinvested. The host state may also be concerned with the possibility of sudden substantial capital outflows that may upset—among other things—its economic stability and balance of payment in addition to burdening its foreign currency reserves.⁷ In addition, the state parties should be cognizant of the effect of obligations they undertake in this respect on their regulatory powers over capital movement and foreign exchange.

On the other hand, the foreign investor and the home State will be keen to assure that repatriation of the original capital and its proceeds are permitted, preferably without restrictions or with minimal ones. Most importantly, the foreign investor might be required to pay loans or other financial obligations it incurred to make its investment, and the ability to transfer these amounts when they are due is crucial.

Yet the regulation of outward capital under the Model BIT does not generally establish a balance between these interests. Rather, all the Model BITs require the transfer of funds related to investment as an absolute and broad obligation without providing for exceptions or distinguishing between different kinds of capital. It is also immediate in nature. The drafting and the scope differ nonetheless.

The UK Model BIT states:

Each Contracting Party shall in respect of investments guarantee to national or companies of the other Contracting Party the unrestricted transfer of their investments and returns. Transfers shall be effected without delay in the convertible currency in which the capital was originally invested or in any other convertible currency agreed by the investor and the Contracting Party concerned. Unless otherwise agreed by the investor transfers shall be made at the rate of exchange applicable on the date of transfer pursuant to the exchange regulations in force.⁸

⁷ See Chapter II; UNCTAD, *Transfer of Funds*, in UNCTAD Series on Issues in International Investment Agreements, UN Doc. UNCTA/ITE/IIT/20, at 7 (2000) [hereinafter UNCTAD, *Transfer of Funds*].

⁸ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of ... for the Promotion and Protection of Investments*, art. 6, reprinted in Rudolf Dolzer &

The German Model BIT states:

Each Contracting Party shall guarantee to nationals or companies of the other Contracting Party the free transfer of payments in connection with an investment, in particular

- (a) of the principal and additional amounts to maintain or increase the investment;
- (b) of the returns;
- (c) in repayment of loans;
- (d) of the proceeds from the liquidation or the sale of the whole or any part of the investment;
- (e) of the compensation provided for in Article 4.

...

- (1) Transfers . . . shall be made without delay at the applicable rate of exchange.
- (2) This rate of exchange shall correspond to the cross rate obtained from those rates which would be applied by the International Monetary Fund on the date of payment for conversions of the currencies concerned into Special Drawing Rights.⁹

The US Model BIT 1992 states:

- 1. Each Party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory. Such transfers include: (a) returns; (b) compensation pursuant to Article III; (c) payments arising out of an investment dispute; (d) payments made under a contract, including amortization of principal and accrued interest payments made pursuant to a loan agreement; (e) proceeds from the sale or liquidation of all or any part of an investment; and (f) additional contributions to capital for the maintenance or development of an investment.
- 2. Transfers shall be made in a freely usable currency at the prevailing market rate of exchange on the date of transfer with respect to spot transactions in the currency to be transferred.
- 3. Notwithstanding the provisions of paragraphs 1 and 2, either Party may maintain laws and regulations (a) requiring reports of currency transfer; and (b) imposing income taxes by such means as a withholding tax applicable to dividends or other transfers. Furthermore, either Party may protect the rights of creditors, or ensure the satisfaction of judgments in adjudicatory proceedings, through the equitable, non-discriminatory and good faith application of its law.¹⁰

Margrete Stevens, *Bilateral Investment Treaties*, 228-239 (Kluwer Law International, 1995) [hereinafter *UK Model BIT*]. See also, *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Albania for the Promotion and Protection of Investments*, signed on March 30, 1994, art. 6 (entered into force on August 30 1995) [hereinafter *UK-Albania BIT*]; *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Argentina for the Promotion and Protection of Investments*, signed on December 11, 1990, art. 6 (1)&(2) [hereinafter *UK-Argentina BIT*]; *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of China for the Promotion and Reciprocal Protection of Investments*, signed on May 15, 1986, art. 6 (1) (May 15, 1986) [hereinafter *UK-China BIT*].

⁹ *Model Treaty between the Federal Republic of Germany and ... Concerning the Encouragement and Reciprocal Protection of Investments*, arts 5, 7 (February, 1991), reprinted in Rudolf Dolzer & Margrete Stevens, *BILATERAL INVESTMENT TREATIES*, 187-199 (Kluwer Law International, 1995) [hereinafter *German Model BIT*].

¹⁰ *Treaty Between the United States of America and ... Concerning the Encouragement and Reciprocal Protection of Investment*, art. IV (February 1992), reprinted in Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, 240-253 (Kluwer Law International, 1995) [hereinafter *US Model BIT 1992*]. See for e.g., *Treaty between United States of America and the Argentine Republic Concerning the Reciprocal Encouragement*

From the above, it follows that the Model BITs provide for the right to transfer under five themes. The first theme is the nature of such right. The second theme is the categories of payments entitled to such right. The third theme relates to the currency of transfer. The fourth theme deals with the exchange rate that applies to the transfer. The fifth theme deals with the timing that the host state must permit the transfer.¹¹

B. The Absolute Nature of the Obligation to Permit Outward Transfer

Under the Model BITs -- unlike the national treatment, which is relative in nature -- this obligation grants an absolute, and, in case such right is not enjoyed by national investors, a “preferential treatment” to foreign investors.¹²

The German Model BIT provides for the liberalization of transfers in absolute terms, using the term “free transfer”.¹³ In the same vein, the UK Model BIT prohibits the host state from imposing restrictions on the outflows of funds that originate from foreign investors’ “investments” and “returns” thereof, using the term “unrestricted transfer”.¹⁴ However, the UK in some BITs uses the term “free transfer”.¹⁵ The use of the two terms does not appear to mean different results. It is probably correct that in most cases, interpreting the two terms will lead to the same result of allowing capital payments related to investment to be repatriated.

Similarly, the US BITs provide for the freedom to repatriate the investment proceeds and capital. The US Model BITs do not allow for limitation on the free outflow transfer of capital related to

and Protection of Investment, signed Nov. 14, 1991; art. V(1) (entered into Force Oct. 20, 1994) [hereinafter *US-Argentine BIT*].

¹¹ Cf. Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 Harv. Int'l L.J. 67, at 85 (2005).

¹² UNCTAD, *supra* n. 7, at 29.

¹³ *German Model BIT*, art. 5

¹⁴ *UK Model BIT*, art. 6. See for e.g. *UK-Albania BIT*, art 6; *UK-Argentina BIT*, art. 6 (1)&(2); *UK-China BIT*, art. 6 (1).

¹⁵ See, e.g., *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's of Bangladesh for the Promotion and Protection of Investments*, signed June 19, 1980, art. 6 (entered into force June 19, 1980).

investment, except for stipulated exceptions.¹⁶ This makes the nature of the obligation absolute as well.

It is safe, accordingly, to conclude that the obligation to permit outflows in the Model BITs is absolute. It does not seem to allow for any exception other than those stipulated therein.

C. Broad Meaning and Scope of Transfer Provisions

Generally, the obligation to permit the transfer of capital outflows related to investment entails the right of an investor to acquire and repatriate amounts arising out of the investment, and to convert these amounts before repatriation.¹⁷ In *Biwater*, under UK-Tanzania BIT, the tribunal stated that the transfer clause “guarantees that if investors have funds, they will be able to transfer them.”¹⁸ It further stated that “[t]he free transfer principle is aimed at measures that would restrict the possibility to transfer, such as currency control restrictions or other measures taken by the host State which effectively imprison the investors’ funds, typically in the host State of the investment.”¹⁹

Similarly, in *Continental*, under US-Argentina BIT, the tribunal stated that “the U.S. BITs ‘prohibit virtually all restrictions,’ thus limiting the Parties’ prerogatives under customary international law to impose currency exchange restrictions.”²⁰

A similar result was reached by the European Court of Justice (ECJ) in several cases filed by the European Commission, asserting the incompatibility of certain BITs transfer provisions with the Treaty Establishing the European Community (EC).²¹ Some of these transfer provisions are

¹⁶ *US Model BIT 1992*, art. IV; see also *2004 Model BIT: Treaty Between the Government of The United States of America and the Government of [Country] concerning the encouragement and Reciprocal Protection of Investment*, art. 7, available at http://www.ustr.gov/assets/Trade_Sectors/Investment/Model_BIT/asset_upload_file847_6897.pdf [hereinafter *US Model BIT 2004*].

¹⁷ UNCTAD, *supra* n. 7, at 6; Joachim Karl, *The Promotion and Protection of German Foreign Investment Abroad*, 11 ICSID Rev.—FILJ 1, at 17 (1996) (referring to art. 5 of the German Model BIT).

¹⁸ *Biwater v. United Republic of Tanzania*, ICSID CASE NO. ARB/05/22 (Award), para. 735 (July 24, 2008) [hereinafter *Biwater Award*].

¹⁹ *Id.* para. 735.

²⁰ *Continental Casualty Company v. Argentina*, ICSID Case No. ARB/03/9 (Award), para. 240 (Sept. 5, 2008) [hereinafter *Continental Award*].

²¹ See *Commission of the European Communities v. Austria*, Case C-205/06 (Grand Chamber Judgement), (Mar. 3, 2009) [hereinafter *Commission v. Austria*]; *Commission of the European Communities v. Sweden*, Case C-249/06 (Grand Chamber Judgement), (Mar. 3, 2009) [hereinafter *Commission v. Sweden*]; *Commission of the European*

similar to that of the Model BITs.²² While the EC mandates the free movement of capital between EC members and between EC members and third countries,²³ it also obliges EC countries to restrict capital transfers in certain cases upon a decision by the European Council.²⁴ The ECJ found the transfer provisions in certain BITs concluded by Austria, Sweden and Finland incompatible with EC because they do not permit restrictions on capital flows.²⁵

This obligation thus eliminates the host country's power to restrict certain transfer of funds relating to investment. But what is the scope of this obligation? What funds and transfers are subject to this obligation?

Generally, the scope of the obligation to permit transfers may differ with regard to the subject of the transfer obligation as well as the time of making the investment that is entitled to the right to transfer. The wordings in the Model BITs differ in this concern, although final result may not always be different.

For the subject of transfer, the German Model BIT obliges the host state to ensure that any payment related to an investment shall be freely transferred.²⁶ While investment is broadly defined, the subject payments are not defined, but a non-exhaustive list is given, which includes returns, loans' payment, amounts arising from liquidation and any sale of investment, and compensation for expropriation.²⁷

But what type of outflow transfers are subject to this obligation? It is not any transfer in connection to investment, but rather a transfer that constitutes "a payment." The difference is if an outflow transfer is just made for the purpose of changing the place of the funds, instead of

Communities v. *Finland*, Case C-118/07 (Second Chamber Judgement), (Nov. 19, 2009) [hereinafter *Commission v. Finland*].

²² See, e.g., for a provision that is similar to the German Model BIT, *Agreement Between the Republic of Austria and the Republic of Cape Verde on the Encouragement and Protection of Investments*, signed Sept. 3, 1991, art. 5 (entered into force Apr. 1, 1993) ("Each Contracting Party shall guarantee to investors of the other Contracting Party the free transfer, without undue delay and in the convertible currency in which the investment is made or another currency agreed on between the investor and the competent authorities of the other Contracting Party, of payments in connection with an investment . . .").

²³ EC, art. 56.

²⁴ *Id.* arts. 57(2), 59, 60(1).

²⁵ See *Commission v. Austria*; *Commission v. Sweden*; *Commission v. Finland*.

²⁶ *German Model BIT*, art. 5; see for e.g. *Treaty between the Kingdom of Thailand and the Federal Republic of Germany concerning the Encouragement and Reciprocal Protection of Investments*, signed June 24, 2002, art. 5 (1) [hereinafter *Thailand-German.BIT*]

²⁷ *German Model BIT*, art. 5 (a)-(e).

payment to shareholders or to a lender for example, in which the former would not be subject to the transfer provision.

While the German Model BIT liberalizes “all payments in connection with an investment,” the UK Model BIT bans any restriction on the transfer of investment and returns.²⁸ The subject of the transfer obligation in the UK Model BIT is thus investment and return, and not any transfer relating to investment. The UK Model BIT does not provide a non-exhaustive list of the transfers subject to the transfer provision. Yet, both investment and return are defined in the UK Model BIT, and non-exhaustive lists are provided on what these two terms include.

As for the US Model BIT, it provides for the obligation of the host country to allow all transfers related to an investment both inflows and outflows, offering a non-exhaustive list.²⁹ This obligation is broadest between the Model BITs since it does not limit the transferability of funds to certain category or transaction.

Model BITs transfer provisions refer to non-exhaustive lists to illustrate the transfers subject to the transfer provision. Just like the investment definition, the scope of the transfer obligation in the Model BITs is broad and includes funds arising from foreign direct investment, indirect investment, and other transactions. These categories include investment and liquidation proceeds, returns, and loan payments among others.

While the definition of investment, which is broad in the Model BITs, has been discussed,³⁰ one category of capital outflows that the Model BITs specifically guarantees is “returns”. BITs by and large liberalize outflows that consist of “returns” and define this term.³¹ While the definition differs from one BIT to another,³² the Model BITs' definition of returns is very similar.

²⁸ *UK Model BIT*, art. 6; *see also*, *UK-Albania BIT*, art. 6; *UK-Argentina BIT*, art. 6 (1)&(2); *UK-China BIT*, art. 6 (1).

²⁹ *US Model BIT 1992*, art. IV(1) (“Each Party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory.”); *see also*, *US Argentine BIT*, art. V (1) (same).

³⁰ *See* Chapter III.

³¹ Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, at 91 (Kluwer Law International, 1995); UNCTAD, *supra* n. 7, at 30.

³² Dolzer & Stevens, *supra* n. 31, at 91.

In the UK Model BIT, “returns” is defined to include any sum of money arising from an investment.³³ A non-exhaustive list is provided, which “includes profit, interest, capital gains, dividends, royalties and fees.”³⁴ Similarly, the German Model BIT defines returns as any sum generated from an investment, which includes “profit, dividends, interest, royalties, or fees.”³⁵ The Model US BIT defines returns as any sums arising from or related to investment.³⁶ It provides a non-exhaustive list of what is considered “returns.”³⁷ Accordingly, the common feature in the Model BITs is their broad definition of returns to include all amounts that arise from investment. It should follow that for the UK and US Model BITs, any amount arising from investment or even related to it in the US Model BIT would be subject to the transfer position without any other qualification as to the type of the transfer or its purpose. For the German Model BIT, the funds must arise from an investment and must also qualify as a payment. Yet this broad interpretation of the US Model BIT was rejected by an arbitral tribunal under the US-Argentina BIT, discussed below.

Another category that the Model BITs liberalize is loan repayment. Likewise, different BITs adopt various definitions for this category.³⁸ The German Model BIT mandates the liberalization of transfers “in repayment of loans”.³⁹ The UK Model BIT includes in its definition of investment “claims to money”.⁴⁰ In addition, some UK BITs provide explicitly for the transferability of loan payments.⁴¹ The US Model BITs provides for the free transfer of “payment made pursuant to a loan agreement.”⁴² This category is important to guarantee that foreign investors can meet their obligations under their loan agreement, and thus are able to raise funds for their investment in the host State.

³³ *UK Model BIT*, art. 1 (b).

³⁴ *Id.*

³⁵ *German Model BIT*, art. 1(2).

³⁶ See *US Model BIT 1992*, art. I (1)(d); see also, *Treaty between the United States of America and the Arab Republic of Egypt Concerning the Reciprocal Encouragement and Protection of Investment*, signed March 11, 1986 (modified), art. I (1)(f) (entered into force June 27, 1992) [hereinafter *US-Egypt BIT*] (defining returns as “ an amount derived from or associated with an investment”).

³⁷ See *US Model BIT 1992*, art. I (1) (d); *US-Egypt BIT*, art. I (1) (f).

³⁸ Dolzer & Stevens, *supra* n. 31, at 92.

³⁹ *German Model BIT*, art. 5 (c).

⁴⁰ *UK Model BIT*, art. 1 (a) (iii).

⁴¹ *UK-China BIT*, art. 6 (1) (providing for the free transfer of “investments and returns and any payments made pursuant to a loan agreement in connection with any investment.”).

⁴² *US Model BIT 1992*, art. IV (1) (d); *US Model BIT 2004*, art. 7 (1)(d).

BITs also usually provide for the free transfer of the proceeds of liquidation. Some BITs and the German and US Model BITs provide explicitly for the free transfer of both partial and total liquidation.⁴³ Others BITs do not provide for such distinction and simply provide for the free transfer of the proceeds of liquidation or investment.⁴⁴

Some BITs provide for the free transfer of the royalties and other licensing fees paid for intellectual property rights, such as copy right, trademarks, and know how.⁴⁵ The Model BITs include the royalties in their definition of returns.⁴⁶ The US Model BIT 2004 explicitly mandates the liberalization of the transfers of “royalty payments”.⁴⁷

The Model BITs, also, provide for the freedom of the transfer of the funds that arise from paying a compensation for the expropriation of investment.⁴⁸

In addition, the Model BITs stipulate that the investment will still be covered by the protection of the BITs, even if its form changes.⁴⁹ Accordingly, the scope of the transfer provision will include also the amounts arising from the change in the form of investment, since it will be considered “investment” covered by the freedom of transfer provision.

In many BITs concluded by the Model BITs countries, however, the drafting and the scope of the transfer provision are different than what is provided in the Model BITs. In addition, the scope of allowed transfers changes from one BIT to another for the same country.

For example, the Egypt-UK BIT provides for the freedom of transfer with regard only to “returns.”⁵⁰ “Returns” is defined as the sums that arise from an investment.⁵¹ The same does not apply to the investment capital. The Egypt-UK BIT provides that with regard to “transfer of

⁴³*German Model BIT*, 5 (d); *US Model BIT 1992*, art. IV (1) (e).

⁴⁴*UK Model BIT*, art. 6.

⁴⁵ Dolzer & Stevens, *supra* n. 31, at 93

⁴⁶ *German Model BIT*, art. 1 (2); *UK Model BIT*, art. 1 (b); *US Model BIT 1992*, art. I (1) (d).

⁴⁷ *US Model BIT 2004*, art. 7(1) (c).

⁴⁸ *German Model BIT*, art. 5 (1); *UK Model BIT*, art. 5 (1); *US Model BIT 1992*, art. IV (1) (b).

⁴⁹ *German Model BIT*, art. 1; *UK Model BIT*, art. 1; *US Model BIT 1992*, art. I (3). *US Model BIT 2004*, however, does not provide for this rule.

⁵⁰ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investment*, signed June 11, 1975, art. 6 (1) (entered into force February 24, 1976) [hereinafter *UK-Egypt BIT*].

⁵¹ *Id.* art. 1 (b).

capital this shall be effected in accordance with the relevant laws of the two Contracting Parties.”⁵²

This means that, under the Egypt-UK BIT, the transfer of the original capital after liquidation or sale of assets should be allowed, subject to conditions imposed by laws of the host country. These conditions may include capital controls that temporarily restrict capital transfers or that may impose certain limits on the amounts that can be transferred within a certain period of time. Accordingly, capital transfer may be restricted in terms of quantity or time or otherwise by virtue of applicable laws without abolishing totally the right to transfer. The Egypt-US BIT and the Egypt- Canada BIT, on the other hand, provide for the freedom of transfer of amounts arising from the liquidation of investment without similar qualifications.⁵³ This permits a UK investor in Egypt from benefiting from MFN and requiring the same treatment granted under these BITs.

While the US Model BIT has the broadest transfer provision, since it liberalizes all transfers related to investment without limiting the subject or the type of transfer, case law has imposed limitation to the subject of the transfer provision. In *Continental*, the tribunal found that this provision in US BITs is not limitless.⁵⁴ In that case, the investor was not able to transfer funds from an account in Argentina to another account outside Argentina because, as a result of the Argentinean economic crisis in 2001, Argentina banned bank withdrawals and transfer of funds.⁵⁵

The issue was framed by the tribunal as whether the desired transfer qualified as a “transfer[] related to an investment” under the US-Argentina BIT.⁵⁶ The tribunal identified the purpose of the transfer provision to allow foreign investors to repatriate the income from investment and the investment value and capital gains at liquidation.⁵⁷ It then referred to this purpose and the non-exhaustive list for interpreting what transfers are considered “related to investment,” and, accordingly, subject to the free transfer provision. It interpreted the transfers subject the free transfer provision, calling them “protected transfers,” stating:

⁵² *Id.* art. 6 (2).

⁵³ *US-Egypt BIT*, art. V (1) (f); *Agreement Between the Government of Canada and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investment*, signed November 13, 1996, art. IX (1) (b).

⁵⁴ *Continental Award*, para. 239 (“[T]he Treaty terms show that such freedom is not without limit.”).

⁵⁵ *Id.* para. 237.

⁵⁶ *Id.*

⁵⁷ *Id.* para. 239.

Protected transfers are those essential for, or typical to the making, controlling, maintenance, disposition of investments, especially in the form of companies; or in the form of debt, service and investment contracts, including the making, performance and enforcement of contracts; the acquisition, use, protection and disposition of property of all kinds, including intellectual and industrial property rights; and the borrowing of funds, to name the kind of investments and associated activities mentioned in Art. I of the BIT more relevant to this issue.⁵⁸

The tribunal then found that the transfer at issue did not qualify as a “protected transfer” because “[i]t was merely a change of type, location and currency of part of an investor’s existing investment,” and the funds were not “proceeds of liquidation,” but were only transferred to protect them from devaluation.⁵⁹

While noting the legitimate character and purpose of the transfer as a business decision, the tribunal emphasized that the transfer was not required to pay an obligation or to transfer the ownership of the funds at issue, which makes it not “related to an investment.”⁶⁰

Continental’s interpretation is curious in many respects: first, it maintains that not all transfer of funds by the foreign investment for business purposes would be subject to the freedom of transfers provision; second, it confines the subject of the transfer provisions to those that are made for making, managing (including payment of loans and other payment obligations), paying foreign investors and liquidating the investment; third, it specifically excludes transfers made to protect investment from devaluation and, by analogy, other short-term investment for the purpose of benefiting from interest rate differences in other countries without changing ownership of the funds.

This appears at odds with the seemingly limitless terms of the transfer provision in the U.S.-Argentina BIT, which permits any transfer related to investment without confining this to the liquidation of investment, or to payment of obligation, profits or capital gains. This interpretation would be more appropriate to the transfer provision in the German Model BIT, which uses the term “payment” to qualify the subject of the transfer obligation. This problem

⁵⁸ *Id.* para. 240.

⁵⁹ *Id.* para. 241.

⁶⁰ *Id.* para. 242.

arises from the breadth of the transfer provisions that leads to ambiguity and unpredictable results, which does not always benefit the foreign investor.

In conclusion, transfer provisions in the Model BITs are drafted differently, but they all are absolute in nature and have a broad scope that covers any funds relating to investment. Yet, while the subject of the transfer provisions is broad, it might be subject to the limitation that the transfers are made to pay the shareholders or other stakeholders of the investment, and not only made to protect the funds from devaluation.

D. Time of Transfer

The time of transfer is an important issue. Hardship might arise to foreign investors if they cannot make the transfer in a timely fashion. On the other hand, immediate transfer of capital may also burden the host state if substantial transfers are required to be allowed during economic turmoil, which can exacerbate the situation.

Terms like “without delay” and “without undue delay” are usually used in BITs to characterize the timing obligation regarding the execution of the transfer incumbent upon the host state.⁶¹ It is also common to provide that procedures for the transfer shall be “carried out expeditiously.”⁶² The Model BITs provide that the transfer must be made “without delay.”⁶³

The obligation to permit transfers “without delay” does not set a specific time and does not mean immediate permission.⁶⁴ It means that a reasonable time is allowed to satisfy formal requirements as defined in German BITs.⁶⁵ It is a relative criterion, which may entail different time limits dependant on the circumstances. Such circumstances include the amount of transfer and the general economic circumstances of the host state.

In some cases, the US BITs included a definition for the term “without delay”. The US-Turkey BIT defines the term “without delay” to mean allowing the transfer “as rapidly as possible in

⁶¹ Dolzer & Stevens, *supra* n. 31 , at 95.

⁶² *Id.*

⁶³ *German Model BIT*, Article 7 (1); *UK Model BIT*, art. 6; *US Model BIT 1992*, art. IV.

⁶⁴ Kenneth J. Vandavelde, *United States Investment Treaties: Policy and Practice*, at 141 (Kluwer Law and Taxation Publishers, 1992).

⁶⁵ Dolzer & Stevens, *supra* n. 31, at 95; Vandavelde, *supra* n. 64, at 141. *See also German Model BIT*, Ad art. 7; *Thailand-German.BIT*, art. 5 (2).

accordance with the normal commercial transaction procedures”.⁶⁶ It further adds a time limit of two months from the application date.⁶⁷

Similarly, the German BITs specify a maximum amount of time for the transfer to be made, usually not exceeding two months from the application for the transfer.⁶⁸ Other model BITs refer to the time customarily needed for such financial transactions to be effected.⁶⁹

The timing factor can be relevant with regard to certain formal requirements or capital controls in the nature of requiring authorization to transfer capital. In the latter case, under the UK and the US model BITs, there is no specific time limit, but rather a general requirement that this be allowed “without delay.” However, under the German model BIT, there is a time limit of two months.⁷⁰

E. Convertibility and Exchange Rate

The freedom of transfer obligation typically includes requiring the host country to allow the foreign investor to convert the national currency to a foreign currency.⁷¹ This raises questions of which type of currency the host country should provide, and at which exchange rate. The Model BITs differ in their methods of dealing with this issue.

The UK Model BIT provides that the repatriation of funds must be

“in the convertible currency in which the capital was originally invested or in any other convertible currency agreed by the investor and the Contracting Party concerned. Unless otherwise agreed by the investor transfers shall be made at the rate of exchange applicable on the date of transfer pursuant to the exchange regulations in force.”⁷²

⁶⁶ *US-Turkey BIT*, Protocol art. 2 (a).

⁶⁷ *Id.*

⁶⁸ Dolzer & Stevens, *supra* n. 31, at 95.

⁶⁹ See, e.g., *Draft Agreement between the Government of the Kingdom of Denmark and the Government of ... Concerning the Promotion and Reciprocal Protection of Investment*, Article 1 (6) (29 November 1991) reprinted in Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, 176-186 (Kluwer Law International, 1995) (providing that the requirement that the transfer must be made “without delay” shall be satisfied “if a transfer is made within such period as is normally required by international financial custom case and not later, in any case, than three months.”).

⁷⁰ *German Model BIT*, Protocol (5) Ad art. 7.

⁷¹ UNCTAD, *supra* n. 7, at 6.

⁷² *UK Model BIT*, art. 6.

The UK Model BIT, thus, mandates that the transfer be in “the convertible currency” that the funds used in the investment were originally denominated, or any other “convertible currency” agreed upon between the foreign investor and the host country.⁷³ The applicable exchange rate is decided according to the host country's exchange regulations in effect.⁷⁴

Many questions can arise out of this provision. The original investment may have been introduced in the national currency. In this case, the provision does not suggest an answer. The “other convertible currency” alternative requires the agreement of both the foreign investor and the host country, which may not be available. In this case, the host country should not be obliged to agree on certain “convertible currency”, since the original investment was in the national currency. The consideration behind the obligation assumes that the foreign investor brought “convertible currency” into the host country and should therefore be allowed to transfer its profits back in this currency or in another convertible currency. However, when the original investment was made in the national currency, the solution would appear to allow conversion into a convertible currency agreed to between the host country and the investor if the parties agree. If not, an investor may be able to invoke MFN or national treatment if another foreign investor or national is entitled to better treatment.

In the absence of agreement or better treatment, the question would be whether a foreign investor, under this Model BIT, is entitled to convert the national currency into convertible currency. It would appear that the right to repatriate funds relating to investment and returns includes the right to convert the national currency to another currency, and thus, the investor would be entitled to convert the national currency for the purpose of repatriation. On the other hand, while repatriation is allowed, the foreign investor in this case would not be entitled to any more right of conversion than it had under customary international law.

Another scenario is if the original currency of investment ceases to be “convertible”. The UK Model BIT does not seem to require that the original currency stay convertible. The host country will thus satisfy its obligation if it permits the exchange with the original currency.

⁷³ *Id.*

⁷⁴ *Id.*

While the German Model BIT does not provide for the type of currency that should be provided for the transfer, it provides that the exchange rate shall be the one used by the IMF “on the date of payment for conversions of the currencies concerned into Special Drawing Rights.”⁷⁵

In this respect, the German BITs do not have a standard rule. Some German BITs follow the German Model BIT, like the German-Bolivia BIT.⁷⁶ Other German BITs have different rules on the type of currency and exchange rate. The German-India BIT, for example, provides that the transfer must be in a “convertible currency.”⁷⁷ It also provides that the exchange rate for the transfer shall be “the prevailing market rate of change” at the time of transfer, and if such exchange rate does not exist, the applicable exchange rate used by the IMF in relation to the SDR will be applied.⁷⁸

On the other hand, the Thailand-Germany BIT provides that the host country shall allow the free transfer of funds related to investment in “freely usable currencies.”⁷⁹ It provides that the market rate of exchange on the transfer day shall apply to transfers related to investment.⁸⁰ In case there is no foreign exchange market, the rates used by the IMF to convert currencies to Special Drawing Rights (SDRs) shall apply.⁸¹

The Korea-German BIT provides for different options for the applicable exchange rate.⁸² It provides that the applicable rate is the one “effective for current transactions” at the date of the transfer.⁸³ It refers to the previous regime of par value to decide the exchange rate.⁸⁴ However, it foresees the change of the system and provides for another criterion to decide the applicable exchange rate, which is the current official exchange rate effective in the host country between

⁷⁵ *German Model BIT*, art. 7.

⁷⁶ *Treaty between the Federal Republic of Germany and the Republic of Bolivia Concerning the Promotion and Mutual Protection of Investment*, signed March 23, 1987, art. 7 (2) (entered into force November 9, 1990) [hereinafter *German-Bolivia.BIT*]

⁷⁷ *Agreement between the Federal Republic of Germany and the Republic of India for the Promotion and Protection of Investments*, signed on July 10, 1995, art. 7 (3) [hereinafter *German-India.BIT*].

⁷⁸ *Id.*

⁷⁹ *Thailand-German.BIT*, art. 5 (1).

⁸⁰ *Id.* art. 5 (2).

⁸¹ *Id.* art. 5 (3).

⁸² *Treaty between the Republic of Korea and the Federal Republic of Germany Concerning the Promotion and Reciprocal Protection of Investments*, signed February 4, 1964, art. 6 (entered into force January 15, 1967) [hereinafter *Korea-German BIT*]

⁸³ *Id.* art. 6 (1).

⁸⁴ *Id.* art. 6 (2).

its currency and the US dollar, or any other “freely convertible currency or to gold”.⁸⁵ In case such official rate does not exist, the competent authority in the host country shall decide one, provided it “is fair and equitable.”⁸⁶ There is no criteria given to what could be “fair and equitable.”

As for the US Model BIT, it uses the term “freely usable currency” for the currency to be provided for transfers.⁸⁷ The US BITs typically follow suit and provide for the right of the investor to exchange local currency for foreign, albeit sometimes using slightly different terms and styles of drafting.⁸⁸

What is considered “freely usable” or “convertible currency” is not always defined in BITs. The Model BITs do not provide a definition except for the 2004 US Model BIT. One suggested definition for the terms “freely usable currency” and “freely convertible currency” is “a currency that may be freely exchanged for other currencies in the principal foreign exchange markets.”⁸⁹ This definition is apparently referring to the IMF Articles of Agreement that defines “a freely usable currency” as “a member’s currency that the Fund determines (i) is, in fact, widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets.”⁹⁰

Some BITs refer explicitly to the IMF definition. The US-Cameroon BIT, for example, provides that the “transfers shall be at the prevailing rate of exchange generally used by the IMF.”⁹¹ In the same vein, the US Model BIT 2004 defines “freely usable currency” as the “‘freely usable currency’ as determined by the International Monetary Fund under its Articles of Agreement.”⁹²

⁸⁵ *Id.* art. 6 (3).

⁸⁶ *Korea-German BIT*, art. 6.

⁸⁷ *See US Model BIT 1992*, art. IV (2); *see also US Model BIT 2004*, art. 7 (2).

⁸⁸ *See, e.g., US-Albania BIT*, art V (2) (“Each party shall permit transfers to be made in a freely transferable currency at the rate of exchange prevailing on the date of transfer.”); *US-Argentine BIT*, art. V(2) (“Transfers shall be made in a freely usable currency at the prevailing market exchange on the date of transfer with respect to spot transactions in the currency to be transferred.”).

⁸⁹ Vandeveld, *supra* n. 64, at 142.

⁹⁰ *IMF Articles*, art. XXX(f).

⁹¹ *Treaty Between the United States of America and the Republic of Cameroon Concerning the Reciprocal Encouragement and Protection of Investment*, signed February 26, 1986, art. V (2). In other BITs made by Cameroon there were no mention to the exchange rate. *See for, e.g., Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United Republic of Cameroon for the Promotion and Protection of Investments*, signed June 4, 1982 (entered into force June 7 1985).

⁹² *US Model BIT 2004*, art 1.

Although it is asserted that these terms are used interchangeably, they could be interpreted differently. By and large, there is no consensus on the conditions that should be satisfied for a currency to be deemed a “convertible currency.”⁹³ A freely usable currency as defined by the IMF Articles and determined by the IMF may not be formally convertible or free from exchange regulations.⁹⁴ This means that such currency may not satisfy the relevant BIT obligation.

In sum, while the Model BITs specify the exchange rate and currency, they are inconsistent, broad and may lead to ambiguous situations.

F. Economic Difficulties Exception

BITs, by and large, allow some restrictions on free transfer of capital outflows related to investment.⁹⁵ There are two main categories of restrictions. The first category of these restrictions does not constitute real exceptions to the freedom of transfer, but rather an application of other laws that do not intend to restrict capital movement. This includes formalities, restrictions related to tax withholding and enforcing laws, and court judgements. The German and the US Model BITs provide for some of these restrictions. The UK Model BIT, on the other hand, does not explicitly provide for any exception.

The German Model BIT permits “transfer formalities”, which may not delay the transfer for more than two months.⁹⁶ There are no other exceptions in the German Model BIT regarding repatriation of funds. The US Model BITs also provide for this kind of exception.⁹⁷ The US Model BIT 1992 and US BITs, generally, permit three kinds of these restrictions. The first kind is the requirement of reporting foreign currency transfers.⁹⁸ This requirement may cause some delay to allow for administrative processing, but it does not normally impose a high burden on

⁹³ Richard W. Edwards, *International Monetary Collaboration*, at 380 (Transnational Publishers, Inc., 1985).

⁹⁴ *Cf. Id.* at 198.

⁹⁵ Teresa McGhie, *Bilateral and Multilateral Investment Treaties*, in *Legal Aspects of Foreign Direct Investment*, at 118 (Daniel D. Bradlow & Alfred Escher eds., 1999).

⁹⁶ *German Model BIT*, protocol (5) Ad. art. 7; see also for e.g. *German-India.BIT*, art. 7 (4); *Korea-German BIT*, protocol ad. art. 6 (1).

⁹⁷ *US Model BIT 1992*, art. IV (3); *US Model BIT 2004*, art. 7 (4).

⁹⁸ *US Model BIT 1992*, art. IV (3) (a); McGhie, *supra* n. 95, at 118; see for e.g., *Treaty Between the United States of America and the Republic of Armenia Concerning the Encouragement and Reciprocal Protection of Investment*, signed September 23, 1992; art. IV (3)(a) (entered into Force March 29, 1996) [hereinafter *US-Armenia BIT*].

investors.⁹⁹ Some US BITs refer to formalities in general, but these formalities may not encroach on the right to transfer.¹⁰⁰

The second kind relates to the power of the state to withhold income tax that applies “to dividend or other transfers”.¹⁰¹ This is important to ensure the payment of due taxes on the foreign investor activities in the host state. The third kind relates to the enforcement of court decisions and protection of creditors’ rights.¹⁰² The US Model 2004 provides for a similar, albeit more detailed, exception.¹⁰³ As mentioned, some US BITs approve formalities that do not encroach on the right to transfer.¹⁰⁴

The second category of restrictions constitutes a real exception to the free transfer of capital related to investment. This is the exception that allows a country facing economic difficulties to temporarily restrict the transfers.

Provisions regarding the liberalization of capital transfers pose many difficult practical problems, in addition to the legal ones. The exception is usually triggered by financial and economic hardships faced by the host state. Many developing countries suffer from balance of payments problems, which may not permit them to satisfy the obligation of allowing substantial amounts of convertible foreign currency to be exchanged.¹⁰⁵ Developing countries enter into BITs to promote foreign investment and foreign capital. Repatriation of initial capital and substantial amount of proceeds leads to the opposite result.¹⁰⁶

⁹⁹ McGhie , *supra* n. 95, at 118.

¹⁰⁰ *Cf. Treaty between the Government of the United States of America and the Government of the Republic of Albania Concerning the Encouragement and Reciprocal Protection of Investment*, signed on January 11, 1995, art. XIV (2) [hereinafter *US-Albania BIT*] stating “provided that such formalities shall not impair the substance of any of the rights set forth in this Treaty.”

¹⁰¹ *US Model BIT 1992*, art. IV (3) (b); McGhie , *supra* n. 95, at 118; see for e.g., *US-Armenia BIT*, art. IV (3)(b).

¹⁰² McGhie , *supra* n. 95, at 118; see for e.g., *US-Armenia BIT*, art. IV (3)(b).

¹⁰³ *US Model BIT 2004*, art. 7 (4) (allowing the restriction of transfer according to the host state law with relation to “(a) bankruptcy, insolvency, or the protection of the rights of creditors; (b) issuing, trading, or dealing in securities, futures, options, or derivatives; (c) criminal or penal offenses; (d) financial reporting or record keeping of transfers when necessary to assist law enforcement or financial regulatory authorities; or (e) ensuring compliance with orders or judgements in judicial or administrative proceedings.”).

¹⁰⁴ *Cf. US-Albania BIT*, art. XIV (2).

¹⁰⁵ Vandeveldel, *supra* n. 64, at 143.

¹⁰⁶ *Id.*

Some BITs maintain the balance between investors' right to repatriate capital and the need of the host state to limit outflows in case of economic crises.¹⁰⁷ This is why in some BITs, an exception is made on the principle of free transfer of capital relating to investment. In exceptional economic and financial circumstances, the host state may exercise its powers as conferred by its national laws to regulate the outward capital related to investment protected by a BIT.¹⁰⁸

Many German, UK, and US BITs follow the Model BITs, and do not include any explicit exception to the freedom of transfer.¹⁰⁹ Yet some BITs entered into by the Model BITs countries provide for such exceptions. These exceptions differ, however, from one BIT to another in terms of their nature and scope.

The Philippines-UK BIT, for example, allows the host country to apply necessary measures to protect the "integrity and independence of its currency, its external financial position and balance of payments" in accordance with the IMF Articles.¹¹⁰ It thus gives a broad discretion to the host country to restrict transfers in case of wide range of economic difficulties. Similarly, the Panama-UK BIT entitles the host country to take measures that restricts transfer as an exception to the right to repatriate funds related to investment "in exceptional balance of payments difficulties and for a limited period".¹¹¹ Likewise, the measures that the host country can take are not defined. The only conditions are that the measures are temporary. Both BITs provide that the host country must use its powers "equitably and in good faith".¹¹² This gives the host country facing such difficulties a wide discretion to temporarily restrict capital outflows.

¹⁰⁷ M. Sornarajah, *The International Law on Foreign Investment*, at 266 (Cambridge University Press, 2004).

¹⁰⁸ Bernard Kishoiyian, *The Utility of Bilateral Investment Treaties in the Formulation of Customary International Law*, Nw. J. Int'l L. & Bus. 327, at 353 (1994); See for e.g., *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of the Philippines for the Promotion and Protection of Investments*, signed December 3, 1980, art. VII (1) (entered into force on January 2, 1981) [hereinafter *UK-Pilippines BIT*].

¹⁰⁹ See for e.g., *German-Bolivia.BIT*; *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of India for the Promotion and Protection of Investments*, signed March 14, 1994 (entered into force January 6, 1995); *US-Armenia BIT*.

¹¹⁰ *UK-Pilippines BIT*, art. VII (1).

¹¹¹ *Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Panama for the Promotion and Protection of Investments*, signed October 7, 1983, art. 6 (entered into force June 3, 1987) [hereinafter *UK-Panama.BIT*].

¹¹² *UK-Pilippines BIT*, art. VII; *UK-Panama.BIT*, art. 6.

These measures are broader than those granted under other UK BITs, like the UK-China BIT, which contains a similar, although narrower, exception.¹¹³ For one, it restricts the scope of the powers granted to the host country since they cannot be used to restrict investment proceeds which consist of “profits, interest, dividends, royalties or fees”.¹¹⁴ In addition, for all other transfers related to investment, twenty percent must be allowed yearly.¹¹⁵ This type of exception is reasonable since it allows the investor to meet its obligations, distribute profits, and transfer a percentage of its investment capital while also allowing the host country to deal with economic crisis.

In the same vein, some US BITs acknowledge the fact that the host country may not be able to permit foreign currency exchange in case of financial crises.¹¹⁶ The US-Turkey BIT, for example, allows Turkey to postpone the transfers arising from liquidation or sale of the investment in case of “exceptional financial or economic circumstances relating to foreign exchange”.¹¹⁷ Turkey has to abide by any contractual obligation with the foreign investor. The postponement measure may only be maintained for the time “necessary to restore its reserves of foreign exchange to a minimally acceptable level”, and with a time limit of three years from the time of the transfer application.¹¹⁸ In addition, the BIT provides that such measures must be conforming to Article II of the BIT.¹¹⁹ This refers to the MFN and national treatment and contract sanctity principles, among others. This means that MFN and national treatment obligations explicitly apply to the delay measures.¹²⁰ Accordingly, if another foreign investor benefits from a BIT that does not provide for such exception or for a differently drafted exception, this exception may not apply.

To sum, while many BITs do not include economic difficulties exceptions, some do. They are inconsistent and they may be subject to MFN, which could negate their availability.

¹¹³ *UK-China BIT*, art. 6 (2).

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ Vandevelde, *supra* n. 64, at 143.

¹¹⁷ *Treaty between the United States of America and the Republic of Turkey Concerning the Reciprocal Encouragement and Protection of Investments*, signed December 3, 1985, Protocol art. 2 (b) (entered into Force May 18, 1990) [hereinafter *US-Turkey BIT*].

¹¹⁸ *Id.* Protocol art. 2 (b)(ii).

¹¹⁹ *Id.*

¹²⁰ Kenneth J. Vandevelde, *The Bilateral Investment Treaty Program of the United States*, 21 *Cornell Int'l LJ* 201, at 255 Fn. 371 (1988).

III Approaches to Admission of Capital Inflows

Once the investment is admitted, it will need funds to conduct its business in the host State and may need funds at a later point to maintain or expand it.¹²¹ Different BITs have different rules on the transfer of funds. One main distinction is between those that regulate transfer of funds into and out of the host State and those that regulate the transfer of funds only out of the host State.¹²² The latter type is discussed elsewhere.¹²³

The regulation of inward capital in the Model BITs is not uniform, but there exists main two approaches: (1) host State discretion and (2) free transfer of inward capital.

A. Host State Discretion

The UK Model BIT does not treat inward capital related to investment separately from the investment.¹²⁴ It leaves admission for both investment and capital to the host State laws and regulation. It provides that “[e]ach Contracting Party shall encourage and create favourable conditions for nationals or companies of the other Contracting Party to invest capital in its territory, and, subject to its right to exercise powers conferred by its laws, shall admit such capital.”¹²⁵ It does not impose any condition on such power under the host State’s laws. Accordingly, it does not directly restrict the host State right to regulate inward capital under its laws.

Yet if the same interpretation on admission of investment discussed above taken by some tribunals applies to capital inflows, this would restrict this discretion to restrict capital inflows relating to those inflows which are illegal *per se* or which violate fundamental principles of host State law. Following this interpretation, a host State may not impose direct capital controls that ban capital inflows related to certain type of investment, except if the underlying investment is illegal *per se* or in violation of host State fundamental principles.

¹²¹ Andrew Newcombe & L. Paradell, *Law and Practice of Investment Treaties*, at 406 (Kluwer Law International, 2009).

¹²² Waibel, *supra* n. 6, at 511-512.

¹²³ See Chapter V.

¹²⁴ See *UK Model BIT*, art. 2(1).

¹²⁵ *Id.*

A host State may still, however, impose indirect capital controls, such as taxation on certain types of transfers or URR, as long as they do not discriminate on the basis of nationality or arbitrarily, as will be discussed further below in relation to the indirect regulation of capital inflows.

On the other hand, another interpretation that accords to the Model BIT's plain meaning would permit the host State to impose restrictions on capital inflows under its laws and regulations. In addition, this would apply to any further capital inflows other than those required to establish the investment—the host State could impose restrictions on further contributions to the capital. Accordingly, under this interpretation, a host State could impose both direct and indirect capital controls.

It should be noted that not all UK BITs follow this model. The UK-Philippine BIT, for example, states:

Each Contracting Party shall in respect of investments permit nationals or companies of the other Contracting Party the free transfer of their capital and of the earnings from it, subject to the right of the former Contracting Party to impose equitably and in good faith such measures as may be necessary to safeguard the integrity and independence of its currency, its external financial position and balance of payments, consistent with its rights and obligations as a member of the International Monetary Fund.¹²⁶

This provision is not clear on the scope of free transfers of funds relating to capital. There is no general limitation on the admission of capital that keeps it within the exclusive ambit of the host State's laws. Yet, it qualifies the freedom of transfer of capital, including capital inflows, with the host State's right to impose capital controls to protect its currency, financial position and balance of payments in accordance with the IMF Articles and in good faith. This right is explicitly provided for. It appears to cover both inward and outward capital from the host State. This would be different from the UK Model BIT and other UK BITs, which, as explained above, do not have a separate treatment of inward capital. Notably, this BIT was made in the early 1980s, at a time when many developed countries imposed or retained the right to impose capital controls.

¹²⁶ *UK-Pilippines BIT*, art. VII(1).

B. Liberalization of Capital Inflows

The German Model BIT and US Model BITs offer a broader transfer clause in terms of scope, which is only limited with the qualification that such transfers are “in connection with an investment” or “related to an investment.” As Waibel notes, “[g]iven the broad definition of investment in modern BITs, this limitation has limited practical significance.”¹²⁷

The German Model BIT provides that “[e]ach Contracting Party shall guarantee to nationals or companies of the other Contracting Party the free transfer of payments in connection with an investment, in particular (a) of the principal and additional amounts to maintain or increase the investment”¹²⁸

The German Model BIT, thus, requires the host state to allow the transfer of the capital required to make the initial investment.¹²⁹ This provision not only mandates the capital transfer for the initial investment, it also grants the right to transfer additional capital for the purpose of maintaining or expanding the investment. The host state may not restrict such transfers.

Accordingly, the German Model BIT obliges the host state to allow the free transfer of both the initial capital and any amounts to be used to maintain or expand the investment. This obligation, that covers both the initial capital and any other amount used to maintain or expand the

¹²⁷ Waibel, *supra* n. 6, at 511-512.

¹²⁸ *German Model BIT*, art. 5. *See also, Agreement between the Federal Republic of Germany and the People’s Republic of Bangladesh Concerning the Promotion and Reciprocal Protection of Investments*, signed on May 8, 1981, art. 4 (entered into force Sept. 14, 1986) (“Either Contracting Party shall in respect of investments guarantee to nationals or companies of the other Contracting Party the free transfer of the capital, of the returns from it and, in the event of liquidation, of the proceeds from such liquidation.”); *Treaty Concerning the Promotion and Reciprocal Protection of Capital Investment Between the Federal Republic of Germany and Benin*, signed June 29, 1978, art. 4 (entered into force July 18, 1985) (“Either Contracting Party shall in respect of investments guarantee to nationals or companies of the other Contracting Party free transfer of the capital, of the returns therefrom and, in the event of liquidation, of the proceeds from such liquidation.”); *Treaty between the Federal Republic of Germany and the Democratic Socialist Republic of Sri Lanka Concerning the Promotion and Reciprocal Protection of Investment*, signed Feb. 7, 2000, art. 5 (Jan. 14, 2004) (“Each Contracting State shall guarantee to nationals or companies of the other Contracting State the free transfer of payments in connection with an investment, in particular (a) the principal and additional amounts to maintain or increase the investment”); *Treaty Between the Kingdom of Lesotho and the Federal Republic of Germany Concerning the Encouragement and Reciprocal Protection of Investments*, signed Nov. 11, 1982, art. 5 (entered into force Aug. 17, 1985) (“Each Contracting Party shall guarantee to nationals or companies of the other Contracting Party the free transfer of payments in connexion with an investment, in particular (a) of the capital and additional amounts to maintain or increase the investment”).

¹²⁹ *Cf. Newcombe & Paradell, supra* n. 121, at 407 (commenting on a similar provision in Czechoslovakia-Netherlands BIT noting that “transfer provisions may be more open-ended, arguably applying to transfer into and out of both the home and host state.”).

investment, restricts the host State power to regulate inward capital flows in terms of timing, rate and quantity. Article 7 of the German Model BIT emphasizes that such transfers are to “be made without delay” at the rate “applied by the International Monetary Fund on the date of payment for conversions of the currencies concerned into Special Drawing Rights.”¹³⁰ The transfer shall be made “without delay” if it is completed within the time needed to complete the transfer formalities, which time may not exceed two month from the time of the transfer request submission.¹³¹ There is no quantitative limitation in the Model German BIT on the amount of capital that can be transferred into the host State. The obligation to permit capital appears to limit the host State’s ability to impose quantitative restrictions over capital inflows.

However, this does not mean that an investment can bring any amount of capital into the host State. This is limited to an amount “in connection to” to its admitted investment. This would be restricted by the good faith doctrine under international law to the amount of capital proportionate to the needed capital for the admitted investment. While a host State may not impose quantitative capital controls that limit the amount of capital that is required for the initial investment and its expansion under this provision, it may restrict the amount that is not necessary for activities related to the investment. Of course, a host State cannot impose exchange restrictions or capital controls that vary the exchange rate from that provided for in the German Model BIT: the IMF rate.

Along with the German Model BIT, the US Model BITs explicitly cover transfers related to investment both into and out of the host State. US Model BITs follow this with an illustrative list. US Model BITs and BITs include different provisions in relation to inward capital. Some refer to “contributions to capital,” while others refer to “additional contributions to capital” as covered under the transfers provision. The 1992 US Model BIT has a broad transfer provision that liberalizes the transfer of capital relating to investment into the host State, but it does not explicitly include the initial capital. It does, however, include capital needed to maintain or develop an investment.¹³²

¹³⁰ *German Model BIT*, art. 7.

¹³¹ *Id.*

¹³² *US Model BIT 1992*, art IV. See also, *Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment*, signed Aug 27, 1993, art. IV (1) (entered into force May 11, 1997)(“Each Party shall permit all transfers related to an investment to be made freely and

On the other hand other US BITs provide explicitly that “contributions to capital” are covered under the transfer provision.¹³³ Similarly, the US Model BIT 2004 states: “Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory. Such transfers include: (a) contributions to capital . . . ”¹³⁴

The use of the words “contributions to capital” in these two US Model BITs does not distinguish between an initial contribution to capital and additional contributions. Vandeveld notes on the differences between these formulations that “[t]he word ‘additional’ was deleted because it was implied. The phrase ‘for the maintenance or development of an investment’ was deleted because it was unnecessary and potentially confusing, *given that the provision applies to all transfers relating to an investment.*”¹³⁵

without delay into and out of its territory, Such transfers include: (a) returns; (b) compensation pursuant to Article III; (c) payments arising out of an investment dispute; (d) payments made under a contract, including amortization of principal and accrued interest payments made pursuant to a loan agreement; (a) proceeds from the sale or liquidation of all or any part of an investment; and (f) additional contributions to capital for the maintenance or development of an investment.”); *US-Argentine BIT*; art. V(1) (“Each Party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory. Such transfers include: (a) returns; (b) compensation pursuant to Article IV; (c) payments arising out of an investment dispute; (d) payments made under a contract, including amortization of principal and accrued interest payments made pursuant to a loan agreement directly related to an investment; (e) proceeds from the sale or liquidation of all or any part of an investment; and (f) additional contributions to capital for the maintenance or development of an investment.”); *Treaty between the United States of America and the Kingdom of Morocco Concerning the Encouragement and Reciprocal Protection of Investments*, signed July 22, 1985, art. IV(1) (entered into force May 29, 1991) (“Each Party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory. Such transfers include: (a) returns; (b) compensation pursuant to Article III; (c) payments arising out of an investment dispute; (d) payments made under a contract, including amortization of principal and accrued interest payments made pursuant to a loan agreement; (e) proceeds from the sale or liquidation of all or any part of an investment; and (f) additional contributions to capital for the maintenance or development of an investment.”).

¹³³ See *Treaty between the Government of the United States Of America and the Government of the State of Bahrain Concerning the Encouragement and Reciprocal Protection of Investment*, signed Sept. 29 (1999), art. 5 (1) (“Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory. Such transfers include, but are not limited to: (a) contributions to capital”);

¹³⁴ *US Model BIT 2004*, art. 7. See also, *Treaty Between the United States of America and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment*, signed November 4, 2005, art. 7 (entered into force November 1, 2006) (“Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory. Such transfers include: (a) contributions to capital”).

¹³⁵ Kenneth J. Vandeveld, *U.S. International Investment Agreements*, at 532 (OUP, 2009).

Some US BITs, such as the US-Albania BIT, explicitly make reference to initial capital in the transfer provision.¹³⁶ But the US Model BITs and most US BITs do not make such explicit reference. However, this does not seem to exclude initial capital from the scope of the provision, given the broad scope of the transfer provision that includes all investment-related transfers.¹³⁷

US BITs, thus, oblige host States to admit inward transfers made upon the admission of investment under the obligation of the host state to admit “additional contributions for the maintenance or development of an investment” or “contributions to capital.”¹³⁸ This means that an already established investment has the ability to get inward capital transfer, which the government is obliged to permit. This obligation restricts the ability of the host State to impose capital controls on inflows. It also enables the investor to raise claims against the host state before an international arbitral tribunal if the host State refuses to admit such additional contributions.

Furthermore, like the German Model BIT, the US Model BITs refer to a certain exchange rate: market rate, which does not permit the host State to impose a different exchange rate for capital inflows.

It is important to note that not all US BITs have the same broad transfer provision. Some US BITs provide for the freedom of transfers only for an exhaustive list of items. For example, the US-Egypt BIT includes an exhaustive list. The relevant provision states:

Either Party shall in respect to investments by nationals or companies of the other Party grant to those nationals or companies the free transfer of-

- (a) returns;
- (b) royalties and other payments deriving from licenses, franchises and other similar grants or rights;
- (c) installments in repayment of loans;
- (d) amounts spent for the management of the investment in the territory of the other Party or a third country;
- (e) *additional funds necessary for the maintenance of the investment;*

¹³⁶ *US-Albania BIT*, art. V (“Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory such transfers include: a) *initial* and additional contributions to capital relating to the investment . . .”) (emphasis added).

¹³⁷ *Cf. Vandeveldelde, supra* n. 135, at 559 (noting that the words “initial and additional capital” in U.S.-Albania BIT that differ from the words “contribution to capital” in other U.S. BITs do not “affect[] the substance of the” obligation.”).

¹³⁸ Jeffrey Lang, *The International Regulation of Foreign Direct Investment: Obstacles and Evolution*, 31 *Cornell Int’l L.J.* 455, at 457 (1998).

- (f) the proceeds of partial or total sale or liquidation of the investment, including a liquidation effected as a result of any event mentioned in Article IV; and
- (g) compensation payments pursuant to Article III.¹³⁹

This BIT limits the free movement of inward transfers and derogates substantially from the US Model BITs transfer provision. First, the BIT provides an exhaustive list of capital that is subject to the obligation of free transfer. Of that only one category of capital inflows is subject to the obligation of free transfer: funds that are needed to maintain the investment. Funds needed to expand the investment are not included in this list, and accordingly the host State is not under obligation to permit their transfer. In other words, pursuant to this provision, the host State retains the discretion to impose capital control on capital inflows, except for capital needed to maintain investment.

Another US BIT includes an exhaustive list. The US-Tunisia BIT does not have an open-ended transfer clause. It provides for an exhaustive list of what is subject to the free transfer of funds. It states:

Each Party shall, with respect to investment by nationals or companies of the other Party, permit the free and prompt transfer, related to such investment, of: (a) returns; (b) compensation pursuant to Article III; (c) payments arising out of an investment dispute; (d) payments made under a contract, including amortization of principal and accrued interest payments made pursuant to a loan agreement; (e) proceeds from the sale or liquidation of all or any part of an investment; and (f) *additional contributions to capital for the maintenance or development of an investment*.¹⁴⁰

With regard to inward capital, the US-Tunisia BIT provides for the obligation to permit additional contribution needed to maintain and develop the investment. The scope of the inward transfer of funds is thus broader than the US-Egypt BIT because it obliges the host State to permit funds for the purpose of expanding the investment, unlike the US-Egypt BIT. In addition, some US BITs include exceptions to the transfer provision.

¹³⁹ *US-Egypt BIT*, art. V (emphasis added).

¹⁴⁰ *Treaty between the United States of America and the Republic of Tunisia Concerning the Reciprocal Encouragement and Protection of Investment*, signed May 15, 1990, art. IV(1) (entered into force Feb. 7, 1993) (emphasis added).

C. Conclusions as to Direct Treatment of Capital Inflows

It is evident from the foregoing discussion that the framework for transfer of capital inflows restricts considerably the discretionary power of the host State.

i. Foreign Investors have Broad Rights to Make Capital Transfers

It is important to recall what makes foreign investment different from national investment under many BITs. Foreign investors protected by BITs, unlike domestic investors, have the right to make inward capital transfers and to repatriate funds. The host state often has no right to restrict such transfers, even if domestic circumstances so require. National investors, by contrast, have no such rights to make inward or outward capital transfers.

As for capital inflows, some BITs, like the UK Model BIT, leave discretion to regulate capital inflows to the host State in accordance with its laws. This is the same position adopted in relation to the admission of investment. The problem with this is that it could be interpreted in the same way that some tribunals have interpreted the admission of investment provision: that it is intended to prevent capital transfers that are tainted with illegality but not all capital transfers that do not conform with host state laws and regulation. As discussed before, a different interpretation is to be preferred, one which retains the discretionary powers of the State over the capital inflows in accordance with its laws. It is submitted that this later interpretation is more in accordance with the meaning of the BIT's provision and the intention of the parties.

On the other hand, unlike in the UK Model BIT, there is no explicit qualification to the capital transfer rights under the German and US Model BITs. Neither includes reference to host State laws, nor to measures necessary to protect the host State economy or its balance of payments or to State party obligations under the IMF.

ii. The Problem of Unexpected Restrictions on Host State Discretion

This framework of admission of investment and capital under BITs is problematic. It restricts the discretion of the host State in ways that may not have been expected. The restriction arises from the combination of the broad meaning of investment under BITs, case law that interprets

the discretion of State to regulate admission narrowly (effectively abolishing its right to require prior registration or approval), and broad transfer provisions.

Investments, as defined in BITs and interpreted by arbitral tribunals, may not be authorized by the host State. Many activities that constitute foreign “investments” may not need a governmental authorization to be made. A purchase of stocks in a corporation, a deposit in a bank, or a turn key contract between a foreign contractor and a private party will be considered an investment, but may not require an authorization from the host State.

It is therefore possible to have an investment under the BIT that exists legally in the host State, notwithstanding that it was not authorized by the host State. In this case, such investment will be entitled to transfer capital into the host State under US and German Model BITs. More so, as demonstrated above, an investment may not be in compliance with host State law requiring registration or other requirements, but may still be considered valid under the BIT.

Some examples from case law show facts where the host State was not positively engaged in the approval of the investment or capital undertaking, but an investment was found to have been admitted nonetheless.¹⁴¹ In *Saluka*, the tribunal found that if the transaction (a purchase of shares agreement) between private parties that constituted an investment under the BIT was valid, the host State must admit the investment.¹⁴² It stated:

[I]t is necessarily implicit in Article 2 of the Treaty that an investment must have been made in accordance with the provisions of the host State’s laws. In relevant part, Article 2 stipulates that “[e]ach Contracting Party . . . shall admit such investments in accordance with its provisions of law”. Accordingly, and as both parties acknowledge, the obligation upon the host State to admit an investment by a foreign investor (i.e. in the present context, to allow the purchase of shares in a local company) only arises if the purchase is made in compliance with its laws.¹⁴³

In other words, if the investment transaction between private parties is legal *per se*, the host State is obliged to permit the investment under a BIT that only contains an “in accordance with the host State” admission clause. And because a transfer of capital to the host State is not required

¹⁴¹ See for e.g. *Fedax N.V. v. Venezuela*, ICSID case no. ARB/96/3 (Decision of the Tribunal on Objections to Jurisdiction), 37 ILM 1378, para. 41 (July 11, 1997).

¹⁴² *Saluka Investments BV (The Netherlands) v. The Czech Republic*, UNCITRAL (Partial Award), para. 204 (Mar. 17, 2006) [hereinafter *Saluka*].

¹⁴³ *Id.*

for there to be an investment, in some cases the host State was liable to pay for funds that never entered its territory.¹⁴⁴

In addition, while not explicitly addressing the admission of investment and capital or transfers, in *Sempra*, the tribunal was faced with a claim that included a substantial amount of money that was loaned from the foreign investor to Argentinean companies in which it indirectly held an interest to pay its due liability under bonds and notes it issued to finance its operations.¹⁴⁵ The issue was whether the investment included this amount, which was loaned after the alleged expropriatory measures were taken. Argentina argued that it should not compensate the investor for the loan in question as it “responded to financial decisions made by the Claimant that [we]re not to be attributed to anyone else, and for which the Government [wa]s not responsible.”¹⁴⁶

In applying the US-Argentina BIT, the tribunal found that subsequent capital contributions to an investment should not be treated in isolation since they were made because of the original investment.¹⁴⁷ The tribunal first considered “the context in which th[e] loan was made,” noting that when the Argentinean companies attempted to arrange financing to pay the notes that were due around the time of the alleged expropriatory measure, they were unable to obtain the required financing from the financial markets.¹⁴⁸ It concluded that “[s]uch loans were in fact part of the investment’s *continuing* financing arrangements, and were interposed at a moment when only the investor was available to make them.”¹⁴⁹ Accordingly, even though the claimant may have known of the expropriation or its impending nature at the time, the tribunal allowed it to claim compensation for the loan. The loan “was a normal business move by the investor in a situation where additional financing was necessary to keep a company out of default. To the extent that the loans were made in connection with a legitimate business purpose, as they in fact were, there is no reason to exclude them from the protected investment.”¹⁵⁰

¹⁴⁴ See *Ceskoslovenska Obchodni Banka v. The Slovak Republic*, ICSID Case No. ARB/97/4 (Decision of the Tribunal on Objections to Jurisdiction), paras. 78-79 (May 24, 1999).

¹⁴⁵ *Sempra Energy International v. Argentine Republic*, ICSID Arb/02/16 (Award), para. 211 (Sept. 28, 2007) [hereinafter *Sempra Award*].

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* (At the time, “financial markets were for all purposes closed to Argentine companies.”) *Id.* Para. 213.

¹⁴⁹ *Id.* para. 214 (emphasis added).

¹⁵⁰ *Id.* para. 215.

It follows from this reasoning that an investment in the territory of the host state is entitled to incur financial liabilities and import capital as part of its continuing business and financial arrangements, which will be considered protected investments under BITs even though the host state did not approve them.

While it is reasonable that if the host State authorizes the investment that it also admits the capital required for such investment,¹⁵¹ not all kinds of investment require prior authorization, and even if they do, some case law has made such requirements ineffective. The fact that an investment is authorized does not mean that the host State authorized capital inflows. Obligations such as national treatment in some BITs require a host State to admit investment as nationals, which means that its admission was not an acceptance of importing capital, but rather compliance with its BIT obligation.

Similarly, it could be argued that this obligation is reasonable in case of capital inflows needed for the maintenance of investment because maintenance may be necessary to the financial viability or competitiveness of investment. But it does not follow that all kinds of capital should be liberalized. While in the case of expanding an investment, it can be argued that this may be necessary for an existing investment to compete effectively,¹⁵² this is not the case in all expansions, which could be financed from capital within the host State.

iii. BITs Liberalization of Capital Inflows is Comparatively Extreme

One of the main problems in this legal framework is its method of capital liberalization: immediate and total liberalization of capital relating to investment. Compare this to what OECD countries have agreed to in the *OECD Codes of Liberalisation of Capital Movements*,¹⁵³ which deal with admission and establishment of investment.¹⁵⁴ The *OECD Code of Liberalisation of Capital Movement* (Code) is technically not an international treaty, but is a decision by the

¹⁵¹ See also *infra* discussion on fair and equitable treatment standard that includes good faith and complying with the basic expectation of the foreign investor.

¹⁵² See Lang, *supra* n. 138, at 456 (noting that this guarantees “a predictable environment guided by market forces.”).

¹⁵³ *OECD Code of Liberalisation of Capital Movements*, reprinted in OECD, *OECD Code of Liberalisation of Capital Movements*, (OECD, 2003) [hereinafter *OECD Code of Liberalisation of Capital Movements*].

¹⁵⁴ OECD, *OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations: User’s Guide 2007*, at 7 (OECD, 2007).

OECD Council that takes all its decisions by a unanimous vote of all member countries.¹⁵⁵ First, the Code, although binding on OECD member countries, depends on “a consultative process” and peer “persuasion” for monitoring and enforcement.¹⁵⁶

Second, as mentioned before, the Code has not restricted the country members’ ability to regulate the right of establishment until 1984.¹⁵⁷ Only after 1984 did the Code subject the discretion of the member countries in this regard to its rules.¹⁵⁸

Third, the Code depends on a positive list method: it liberalizes capital inflows through listing the covered capital transactions in an attachment to the Code. To be sure, the Code’s coverage is currently very broad and liberalizes both long term and short term capital flows between OECD member countries.¹⁵⁹ But this was done gradually and over a long period of time through certain capital transactions and not a general liberalization of every kind of capital.

Fourth, the Code permits its members to make reservations to liberalization,¹⁶⁰ but these reservations cannot be made to the non-discrimination principle. Finally, the Code allows member states to derogate therefrom if they are experiencing economic problems.¹⁶¹

To compare this method of liberalization taken by developed countries with BIT liberalization that in many cases does not even include exceptions for financial difficulties illustrates the problem. Although some variations exist in BITs, and some include exceptions or limit the type of capital entitled to free transfer, an application of other obligations such MFN, could abolish these exceptions.

IV. Conclusion

BITs direct treatment of capital related to investment is absolute, broad and immediate. While there are some variations between BITs and their scope, they generally allow the repatriation of original capital and other transfers related to investment. The scope of the obligation is broad

¹⁵⁵ *Id.* at 8.

¹⁵⁶ *Id.* at 7. It has, also, become a *sine qua non* for countries that wish to accede to OECD. *Id.* at 21.

¹⁵⁷ Franziska Tschofen, *II. Multilateral Approaches to the Treatment of Foreign Investment*, in Ibrahim F. I Shihata, *Legal Treatment of Foreign Investment: The World Bank Guidelines*, at 273 (Martinus Nijhoff Publishers, 1993).

¹⁵⁸ *Id.*

¹⁵⁹ See *OECD*, *supra* n. 154, at 9, Annex A.

¹⁶⁰ *OECD Code of Liberalisation of Capital Movements*, art. 2 (b).

¹⁶¹ *Id.* art. 7.

and covers most funds arising from the investment including its liquidation. It is also absolute and does not generally allow for exceptions. Exceptions, if any, are generally limited, inconsistent, and subject to MFN and NT. Time of transfer and exchange rate are specified. They accordingly lead to the abolition of all controls on the repatriation of capital and the duty to provide the necessary foreign exchange for transfer.

Not allowing for an exception on the freedom of outflows transfers in exceptional economic difficulties is problematic. Another problem is that in some BITs, that right is very restricted in scope and only covers certain types of outflows with quantity and time limits for the exception. Moreover, the exception may be subject to the MFN principle, whether explicitly or implicitly.

Accordingly, as a result, many developing countries will end up unable to utilize the exception they bargained for. This is because, as shown, they may have concluded other BITs that do not provide for the exception at all, or provide for an exception for different reasons, which make the exceptions mutually exclusive, i.e., denying effect to each other.

As for capital inflows regulation, there are two main approaches to the treatment of capital inflows. The first one grants the host State discretion to admit capital in accordance with its laws; and the second provides for the free transfer of capital inflows related to investment without restrictions. Under the first approach, some BITs, such as those following the UK Model BIT, combine the host State discretion to admit investment and capital according to host State law. It follows that the same interpretations given to the admission of investment under the host State discretion approach apply.

BITs under the second approach, such as those following the German and US Model BITs, provide for the free transfer of capital related to investment, which includes capital inflows. They provide for the rate of exchange and the time frame within which the transfer should be permitted.

Most importantly, there is no qualification or distinction between the types of capital related to investment subject to the transfer obligation, which could be long term or short term capital or even current transactions related funds because investment, as defined and interpreted by the majority of tribunals under BITs, includes any kind of asset or right that has economic value.

BITs, such as the ones following US Model BIT 2004, have restricted the investment definition, this is not the case in many BITs. In addition, host States may not impose capital controls or exchange restrictions, and there is no general exception for financial crises or balance of payment difficulties.

While there are different variations of the second approach directly treating capital inflows in different BITs—some provide for exceptions in case of financial crises or limit the types of capital subject to transfer—the application of other general standards under BITs restricts further these variations.

Chapter Five: Breadth of BITs Obligations and Incoherence of Investor-State Arbitration

I. Introduction

BITs, by and large, treat the issue of transfer of funds into and out of the host State. BITs' treatment to this subject includes direct treatment, which exists in the transfer of funds provisions and some times in the admission of capital provision. They also include indirect treatment, which manifests in other general obligations and standards.

Many BITs contain general obligations and standards that might result in restricting the host State's regulatory autonomy to regulate capital flows. These include the obligation to grant most favoured nation treatment (MFN) and fair and equitable treatment (FET). These obligations are drafted and interpreted broadly, which lead to ambiguity and incoherence in their application.

These results could have been mitigated if there is a dispute settlement mechanism that can unify the interpretation of these rules and create a coherent law that guides both the host state and the foreign investors. Yet the chosen method of dispute settlement, investor-state arbitration, does not achieve these targets, but rather contribute to the incoherence and inconsistency of the law.

This chapter analyzes these obligations that may affect the transfer of capital scope under BITs. It assesses how the breadth and absoluteness of these obligations can affect the treatment of capital movement under BITs, which constitutes the indirect treatment of capital under BITs. It also assesses the investor-state arbitration role in applying these obligations.

II. Most Favoured Nation Treatment Breadth

A. General

MFN means that the host State must treat the foreign investment or investor no less than the best treatment given to other foreign investors or investment from other countries.¹ This prohibits a host country from discriminating between different foreign investors on the basis of nationality.²

¹ UNCTAD, *Most-Favoured-Nation Treatment*, in UNCTAD Series on Issues in International Investment Agreements, UN Doc. UNCTAD/ITE/IIT/10 (Vol. III), at 3 (1999); Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties*, at 65 (Kluwer Law International, 1995).

² UNCTAD, *supra* n. 1, at 3.

MFN treatment is typically included in a clause between two states to treat each other's investors no less than each country treats third country investors.³

The International Law Commission's Final Draft Articles on Most Favored Nation Clauses defines MFN clause as "a treaty provision whereby a State undertakes an obligation towards another State to accord most-favoured-nation treatment in an agreed sphere of relations."⁴ This definition affirms that an MFN clause "always applies to a determined sphere of relations agreed upon by the parties to the treaty concerned."⁵

This agreed sphere of relations that limits the scope of the MFN clause is referred to as the *ejusdem generis* rule, which means that the scope of the MFN is restricted to the subject matter of the original BIT.⁶ The original treaty is the treaty containing the MFN clause that beneficiary home State is party and it is referred to as the base treaty. The favourable treatment given in the third-party agreement must be concerning a subject matter that is covered in the base agreement.⁷ This third-party treaty to which the investor seeking to apply the MFN clause is permitted to benefit from its favourable treatment determines "the extent of the favours" to which the investor may be entitled to.⁸

The MFN clause although included in bilateral agreements is considered a step towards multilateralism.⁹ "Indeed, that standard is at the heart of multilateralism. . . . [T]he MFN

³ ILC, *Most-Favoured-Nation Clause: Report of the Working Group*, UN Doc. A/CN.4/L.719, at 3 (20 July 2007) ("An MFN clause is a provision in a treaty under which a State agrees to accord to the other contracting partner treatment that is no less favourable than that which it accords to other or third States.").

⁴ International Law Commission Final Draft Articles on Most-Favoured Nation Clauses, art. 4, *reprinted in* 3 Sir Arthur Watts, *THE INTERNATIONAL LAW COMMISSION 1949-1998*, at 1793, 1803 (1999) [hereinafter *ILC Draft Articles*].

⁵ *Report of the Commission to the General Assembly on the Work of its Thirtieth Session*, 2 Y.B. Int'l L. Comm'n, Part 2, at 21, U.N. Doc. A/CNA/SER.A/II978/Add.1 (Part 2) (1978).

⁶ Rudolf Dolzer & Terry Myers, *After Tecmed: Most-Favored Nation Clauses in Investment Protection Agreements*, 19 ICSID Rev. FILJ 49, at 50 (2004); Stephen D. Sutton, *Emilio Augustin Maffezini v. Kingdom of Spain and the ICSID Secretary-General's Screening Power*, 21 *Arbitration International* 113, at 119 (2005); Dolzer & Stevens, *supra* n. 1, at 66; *ILC Draft Articles, supra* n. 4, art. 10, at 1821. *See also CMS Gas Transmission Company v. The Argentine Republic*, ICSID award no. ARB/01/8 (final award), para. 377 (May 12, 2005) [hereinafter *CMS Final Award*].

⁷ Dolzer & Myers, *supra* n. 6, at 50.

⁸ 3 *ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW*, at 471 (1997); ILC Draft Articles, *supra* n. 4, art. 8, at 1817-1820.

⁹ OECD, *Most-Favoured-Nation Treatment in International Investment Law*, Working Papers on International Investment Number 2004/2, at 2 (2004); Jürgen Kurtz, *The Delicate Extension of Most-Favoured-Nation Treatment to Foreign Investors: Maffezini v. Kingdom of Spain*, in *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law*, at 530 (Todd Weiler ed.,

standard seeks to prevent discrimination against investors from foreign countries on grounds of their nationality.”¹⁰

Yet the extent that the MFN clause can import obligations from other treaties has raised some controversy.¹¹ Although, the definition of the MFN rule and its scope of application may be straight forward to define in abstract, it can be difficult and problematic to draw the scope of its application in practice.¹² It is problematic to incorporate very different substantive obligations from other treaties.¹³ This distorts the contractual obligations balance of the original treaty.¹⁴ Nevertheless, this is the essence of the MFN treatment clause and this result is the purpose of its existence.¹⁵

Generally, this importation will depend on the exact words of the specific clause in the original BIT and the treaty that grants the favourable treatment.¹⁶ The differences in drafting of the MFN clauses in different BITs result in different scopes of application for the MFN.¹⁷

If the MFN clause in the base agreement explicitly includes admission in its scope, then the foreign investor will be entitled to the national treatment right included in the other BIT. An example of such clause is the one in the Japan-Bangladesh BIT.¹⁸ On the other hand, if the MFN

Cameron May Ltd, 2005); Giorgio Sacerdoti, *The Admission and Treatment of Foreign Investment under Recent Bilateral and Regional Treaties*, 1 *JWI* 105, at 107 (2000) (“[T]he play of the standard most-favoured-nation (MFN) clause included in BITs would immediately multilateralize any commitment which a developing party might have preferred to keep bilateral in order to secure through negotiations some specific reciprocal undertaking by the capital-exporting party in return.”).

¹⁰ UNCTAD, *supra* n. 1, at 3.

¹¹ See generally Gabriel Egli, *Don't Get Bit: Addressing ICSID's Inconsistent Application of Most-Favored-Nation Clause to Dispute Resolution Provisions*, 34 *Pepp. L. Rev.* 1045, at 1074 (2007); Okezie Chukwumerije, *Interpreting Most-Favored-Nation Clauses in Investment Treaty Arbitrations*, 8 *JWIT* 597 (2007); Dolzer & Myers, *supra* n. 6.

¹² Dolzer & Myers, *supra* n. 6, at 50.

¹³ UNCTAD, *supra* n. 1, at 10.

¹⁴ *Cf. id.*, at 9.

¹⁵ *Siemens A.G. v. The Argentine Republic*, ICSID award no. ARB/02/8 (Decision on Jurisdiction), para. 106 (Aug. 3, 2004) [hereinafter *Siemens Jurisdiction*]; *Vienna Convention on the Law of Treaties*, opened for signature May 23, 1969, 1155 UNTS 331, art. 32 (1) (entered into force Jan. 27, 1980) (“A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”).

¹⁶ *Cf. Siemens Jurisdiction*, para 109; Stephen Fietta, *Most Favoured Nation Treatment and Dispute Resolution Under Bilateral Investment Treaties: A Turning Point*, 8(4) *Int. A.L.R.* 131, at 131 (2005).

¹⁷ Fietta, *supra* n. 16, at 131.

¹⁸ *Agreement Between Japan and the People's Republic of Bangladesh Concerning the Promotion and Protection of Investment*, signed Nov. 10, 1998, art. 2(2) (“Investors of either Contracting Party shall within the territory of the other Contracting Party be accorded treatment no less favourable than that accorded to investors of any third country in respect of the matters relating to the admission, or investment.”).

clause explicitly excludes or limits the scope of this right, then the foreign investor will not be entitled to national treatment in the admission phase, or will be entitled to the extent of the limitation imposed in the base agreement. A BIT may limit the MFN clause scope with the condition that the extension is reciprocal. An example of such clause can be found in the Japan-Sri Lanka BIT.¹⁹

According to Pollan, “the MFN standard is generally, with the exception of the BITs drafted according to the US model, not applied during the pre-establishment period. European and other BITs seem to introduce the standard limited to the period after admission.”²⁰

Dolzer and Schreuer note that while this might be true regarding admission right, “[c]oncerning the right of establishment, it would seem that the principles of national treatment and of the most-favoured-nation rules, as contained in each treaty, will apply, regardless of the existence of a right to admission, as long as the investment has been properly made.”²¹ Sacerdoti suggests that it would be appropriate that the MFN treatment be extended to the right of admission.²²

B. Application

The Model German BIT provides for the national treatment and MFN for foreign investment, stating: “Neither Contracting Party shall subject *investments in its territory* owned or controlled by nationals or companies of the other Contracting Party to treatment less favourable than it accords to investments of its own nationals or companies or to investments of nationals or companies of any third State.”²³ It also provides for the MFN to be granted to investors “as regards their activity in connection with *investments in its territory*.”²⁴

¹⁹ *Agreement Between Japan and the Democratic Socialist Republic of Sri Lanka Concerning the Promotion and Protection of Investment*, signed Mar. 1, 1982, art. 2 (2)-(3) (“Nationals and companies of either Contracting Party shall within the territory of the other Contracting Party be accorded treatment no less favourable than that accorded to nationals and companies of any third country in regard to the matters relating to the admission of investment. Notwithstanding the provisions of paragraph 2 of the present Article, either Contracting Party may require that the treatment with respect to rights on immovable property shall be accorded on the basis of reciprocity.”).

²⁰ Thomas Pollan, *Legal Framework for the Admission of FDI*, at 80 (Eleven International Publishing, 2006).

²¹ Rudolf Dolzer & Christoph Schreuer, *Principles of International Investment Law*, at 82 (OUP, 2008).

²² Sacerdoti, *supra* n. 9, at 109.

²³ *Germany Model BIT*, art. 3 (1) (emphasis added).

²⁴ *Germany Model BIT*, art. 3 (2) (emphasis added).

It appears from this provision that only admitted investment is entitled to national treatment and MFN. The use of the words “investment in its territory” suggests that the national and MFN treatment only applies to already admitted or established investments.

This limits the scope of the national treatment and MFN provision in the German Model BIT to only admitted or established investment. Thus the national treatment and MFN treatment do not extend to the pre-investment phase. Since any investment that is not admitted cannot be in the territory of the host State, the national treatment and MFN clause cannot be applied to the conditions of admitting foreign investment. This conforms to article 1 of the German Model BIT that subjects the power of the host State over the admission of investment to the host State law.

However, once admitted, it might be argued that as to conditions of establishment, the national treatment may apply. This follows from the generality in the national treatment clause. But the MFN treatment appears to apply only to the “activities” of the foreign investor and not on the legal structure it uses for carrying out these activities.

Second, for the transfer of funds, both national treatment and MFN would apply to the right to transfer funds into the country, as it relates to the carrying out the activities of investment in the territory of the host State, which is covered by national treatment and MFN. In addition, national treatment and MFN will also apply to treatment relating to development and expansion of foreign investment and transfers required for such expansion.

Similar to the German Model BIT, the UK Model BIT provides most favoured treatment to investments. It states:

(1) Neither Contracting Party shall in its territory subject investments or returns of nationals or companies of the other Contracting Party to treatment less favourable than that which it accords to investments or returns of its own nationals or companies or to investments or returns of nationals or companies of any third State.

(2) Neither Contracting Party shall in its territory subject nationals or companies of the other Contracting Party, as regards their management, maintenance, use, enjoyment or disposal of their investments, to treatment less favourable than that which it accords to its own nationals or companies or to nationals or companies of any third States.²⁵

²⁵ *UK Model BIT*, art. 3 (1)-(2).

However, the UK Model BIT also excludes pre-investment and admission from the scope of the MFN clause. The use of the words “in its territory,” and requiring only MFN treatment for investors with regard “their management, maintenance, use, enjoyment or disposal of their investments” without referring to admission or establishment, indicates that admission and establishment are not included in scope of the MFN clause.²⁶

That said, provisions regarding transfers required to make the admitted investment would be covered by MFN treatment as it relates to “management, maintenance, use, [and] enjoyment” of investment. Accordingly, under the UK Model BIT, favourable treatment granted to other investments regarding capital inflows would apply to investors under it.

In this way, MFN and NT may change the substance of a transfer obligation under a BIT. A combination of different favourable treatments in different BITs concluded by the host State could lead to unrestricted transfer of capital inflows. For example, a State that concluded BITs following the UK Model BIT and German Model BIT on capital transfers would be required to extend the treatment of capital inflows under the favourable German Model BIT to investors subject to the UK Model BIT under MFN of the UK Model BIT.

In addition, exceptions to freedom of capital inflows transfers provided in different BITs by one host State may lead to them being mutually exclusive by virtue of MFN clause, leaving the host State without any discretionary power to regulate capital inflows even in financial emergencies.

The Model BITs contain most favoured nation (MFN) and national treatment (NT) clauses.²⁷

The Model German BIT provides for the NT and MFN for foreign investment.²⁸ It also provides for the MFN to be granted to investors “as regards their activity in connection with investments”.²⁹

²⁶ *UK Model BIT*, art. 3 (2).

²⁷ *Germany Model BIT*, art. 3 (1)-(2); *UK Model BIT*, art. 3; *U.S. Model BIT 1992*, art. II(1).

²⁸ *Germany Model BIT*, art. 3 (1) (“Neither Contracting Party shall subject investments in its territory owned or controlled by nationals or companies of the other Contracting Party to treatment less favourable than it accords to investments of its own nationals or companies or to investments of nationals or companies of any third State.”).

²⁹ *Germany Model BIT*, art. 3 (2).

The US Model BIT 1992 also extends the MFN treatment generally to investment.³⁰ The US Model BIT 2004 MFN clause extends its coverage to both investors and investments.³¹ However, it is suggested that the difference in drafting the clause by referring to investor or investment or both is just a difference in style, which is not intended to make a difference in the scope of the MFN treatment, which is broad and includes both pre-investment and post-investment under US BITs.³²

It follows from the above that the MFN clause in the Model BITs of the UK, US and Germany would apply to transfer provision. It would accordingly be possible to incorporate any better treatment accorded in other BITs and to avoid restrictions and qualifications to such right. Exceptions to the free transfer of capital into the host State may be avoided by virtue of the MFN clause that incorporates the transfer treatment in another BIT of the host State that does not have the same exception or qualification.

C. Application of MFN to Exceptions to Liberalization of Capital Outflows

Many States have BITs that allow exceptions to the free transfer of capital outflows. However, they may have BITs without such exception or with different exceptions. In the case that a developing country includes an exception from the free transfer of capital outflows for economic difficulties; inconsistencies arise, however, between different BITs concluded by the same country on the circumstances that permit the use of such exception, and on the substance and scope of the exception. In some cases, a country will be party to BITs that provide for such an exception and BITs that do not. The following two subsections will illustrate the effect of the MFN applicability on exceptions to repatriation of capital outflows under BITs concluded by two developing countries: Bangladesh and Egypt.

³⁰ *US Model BIT 1992*, art. II (1). See for e.g. of U.S. BITs that follow the Model BIT, *U.S. Argentine BIT*, art. II (1).

³¹ *US Model BIT 2004*, art. 4 (1)-(2).

³² See UNCTAD, *supra* n. 1, at 9; *Siemens A.G. v. The Argentine Republic*, ICSID Award No. ARB/02/8 (Decision on Jurisdiction), 44 I.L.M. 138, para. 92 (August 3, 2004) (stating that “there is no special significance to the differential use of the terms investor or investments in the Treaty.”).

i. Bangladesh

The UK- Bangladesh BIT provides that either country may use the regulatory powers under their laws over investment outflows transfers in “exceptional financial or economic circumstances”.³³ This means that either country facing extraordinary financial or economic hardships may restrict capital outflows related to investment. It is only qualified that these prerogatives be employed “equitably and in good faith”.³⁴

Likewise, the Germany-Bangladesh BIT allows a Contracting Party to restrict the transfer of capital outflows of yields of liquidation.³⁵ This exception only covers restrictions on capital transfer related to liquidation proceeds and does not cover returns of capital provided for in Article (4) of the BIT. “Returns” is defined to include any amount resulting from investment whether “as profit or interest.”³⁶ The restriction is also limited for a maximum of five years, where 20% of the amounts must be permitted every year.³⁷ However, the exception is only in case of “exceptional balance of payment difficulties”.³⁸

The US-Bangladesh BIT is more restrictive to the regulatory power of the host state in cases of exceptional economic circumstances. It provides for the right of Bangladesh to provisionally postpone “transfers of sales or liquidation proceeds”, in case it finds that “its foreign exchange reserves at a very low level.”³⁹ This does not allow Bangladesh to postpone transfers of profits or dividends or any other transfers not arising from “sales or liquidation proceeds”. In addition, this is qualified by three conditions. First, the most favored nation treatment shall apply to this exception.⁴⁰ This means that any treatment of the transfers may not be less than that of foreign investors from other countries. By virtue of an international agreement or otherwise, other

³³ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's of Bangladesh for the Promotion and Protection of Investments*, signed June 19, 1980, art. 6 (entered into force June 19, 1980) [hereinafter *UK- Bangladesh BIT*].

³⁴ *Id.*, art. 6.

³⁵ *Agreement between the Federal Republic of Germany and the People's Republic of Bangladesh Concerning the Promotion and Reciprocal Protection of Investments*, signed on May 8, 1981, Protocol (4) Ad art. (4) (c). [hereinafter *Germany-Bangladesh BIT*].

³⁶ *Id.*, art. 8 (2).

³⁷ *Id.*, Protocol (4) Ad art. (4) (c).

³⁸ *Id.*

³⁹ *Treaty Between the United States of America and the People's Republic of Bangladesh Concerning the Reciprocal Encouragement and Protection of Investment*, signed March 12, 1986, Protocol (4) (entered into force on July 25, 1989) [hereinafter *U.S.-Bangladesh BIT*].

⁴⁰ *Id.*, Protocol (4) (i).

countries foreign investors may have a more favourable treatment. In this case, if those other foreign investor's transfers are not postponed or are given a faster path than the general postponement imposed, US investors will be entitled to the same favourable treatment. This condition can make the exception ineffective in the case that Bangladesh enters into any international agreement with another country that does not provide for this exception. Second, the postponement may not exceed the time required to reinstate the reserves to a minimal satisfactory point.⁴¹ In any case, a maximum of five years is set during which a yearly minimum of 20% of proceeds amount must be allowed transfer.⁴² Third, the US investor must be allowed to invest the delayed transfer amounts in a way that keeps its value.⁴³

The use of different terminology in allowing the restriction on capital movements with different scope of application in different BITs concluded by the same developing country combined with MFN treatment may make the use of this exception problematic. First, the MFN treatment results in restricting the applicability of the exception to the least restrictive in all BITs. It may also end up in making the exceptions totally ineffective.

The BITs concluded between Bangladesh and the UK, the US, and Germany illustrate these concerns. What triggers the exception in the Germany-Bangladesh BIT is the existence of “exceptional balance of payment difficulties”.⁴⁴ The UK-Bangladesh BIT provides for a general and rather ambiguous prerequisite for either party to invoke the exception, namely “exceptional financial or economic circumstances”. The extent of the measures that can be taken by the host state is also not restricted, except in the sense of being “equitable and in good faith”.

The US-Bangladesh BIT, on the other hand, allows Bangladesh to only postpone transfers in cases when Bangladesh's “foreign exchange reserves [are] at a very low level.”⁴⁵

The MFN treatment clause in the UK-Bangladesh BIT prohibit any treatment of UK investment that falls short of any treatment granted to investment from third countries.⁴⁶ Accordingly, it seems that the more discretionary and broad criterion stated in the UK-Bangladesh BIT will not

⁴¹*Id.*, Protocol (4) (ii).

⁴²*Id.*

⁴³*Id.*, Protocol (4) (iii).

⁴⁴*Id.*, Protocol (4) Ad art. (4) (c).

⁴⁵*Id.*, Protocol (4).

⁴⁶ *UK-Bangladesh BIT*, art. 3 (1).

be applicable in any circumstance, except to the extent that the more restrictive criteria stated in the Germany-Bangladesh BIT and US-Bangladesh BIT are applicable.

This may also lead to turning the whole exception futile. An illustration will be if Bangladesh has “exceptional balance of payment difficulties” but the foreign exchange reserve level is satisfactory. Under the Germany-Bangladesh BIT, Bangladesh can restrict liquidation proceeds capital outflows from German investment, but cannot postpone investment proceeds of liquidation of US investments under the US-Bangladesh BIT. However, the MFN treatment provided for in the Germany-Bangladesh BIT will not allow Bangladesh to take such measures, since it will be giving a more favourable treatment to US investors.⁴⁷

The reverse may also be possible. In cases when Bangladesh's “foreign exchange reserves [are] at a very low level”, there are no “exceptional balance of payment difficulties”. Similarly, Bangladesh may not be able to postpone capital outflows that belong to US investors since it is prohibited from imposing the same on German investments. The US-Bangladesh BIT explicitly provides that the enforcement of this exception must be “in a manner not less favorable than that accorded to comparable transfers to investors of third countries”.⁴⁸

ii. Egypt

The Egypt-UK BIT, after stating the principle of freedom of investment returns, allows the host state to restrict these transfers in “exceptional financial or economic circumstances”.⁴⁹ The Egypt-UK BIT provides that

- (1) Each Contracting Party shall in respect of investment guarantee to national or companies of the other Contracting Party the free transfer of the returns from their investments, subject to the right of each Contracting Party in exceptional financial or economic circumstances to exercise equitably and in good faith powers conferred by its laws
- (2) In the case of transfer of capital this shall be effected in accordance with the relevant laws of the two Contracting Parties.⁵⁰

⁴⁷ *Germany-Bangladesh BIT*, art. 2.

⁴⁸ *US-Bangladesh BIT*, Protocol (4) (i).

⁴⁹ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investment*, signed June 11, 1975, art. 6 (entered into force February 24, 1976) [hereinafter *UK-Egypt BIT*].

⁵⁰ *Id.*

This provision allows the host country to restrict capital transfers related to investment in cases of financial or economic crisis. It can also be interpreted to allow the country to impose restrictions before a crisis erupts. The use of the word “circumstances” permits such interpretation. However, as an exception, this must be interpreted narrowly. Only in extraordinary circumstances can the host country invoke this provision.

On the other hand, the US-Egypt BIT provides that

“the Parties recognize that it is possible that the Arab Republic of Egypt may find its foreign exchange reserves at a very low level. In these circumstances, the Arab Republic of Egypt may temporarily delay transfers required under Article V, Paragraph 1(f), but only: (i) in a manner not less favourable than accorded to comparable transfers to investors of third countries; (ii) to the extent and for the time period necessary to restore its reserves to a minimally acceptable level, but in no case for period of time longer than that permitted by the provisions of law 43 in force on the date of signature of this Treaty; and (iii) after providing the investor an opportunity to invest the sales or liquidation proceeds in a manner which will preserve their value free of exchange risk until transfer occurs.”⁵¹

The scope of the exceptional financial clause in the US-Egypt BIT is narrower than the aforementioned one in the Egypt-UK BIT. It can only be invoked by Egypt in the case of an acute foreign exchange reserve. Additionally, the US-Egypt BIT only allows it when the problem occurs, i.e., when the foreign exchange reserves is already “at a very low level”. It does not allow for the possibility of delaying the transfer to prevent the problem.⁵² Even then, the only measure that Egypt can undertake is to postpone “the proceeds of partial or total sale or liquidation of the investment”.⁵³ Other transfers related to investment may not be inhibited. In addition, MFN treatment applies explicitly to this exception. The US-Egypt BIT also imposes a time limit of five years on the period that Egypt can postpone these transfers.⁵⁴

In a case where the Egyptian government is facing an economic crisis that does not result in having a very low foreign exchange reserve, it may not be able to apply the necessary measures

⁵¹ *Treaty between the United States of America and the Arab Republic of Egypt Concerning the Reciprocal Encouragement and Protection of Investment*, signed March 11, 1986 (modified), Protocol (10) (entered into force June 27, 1992) [hereinafter *US-Egypt BIT*].

⁵² Kenneth J. Vandavelde, *United States Investment Treaties: Policy and Practice*, at 145 (Kluwer Law and Taxation Publishers, 1992).

⁵³ *US-Egypt BIT*, art. V (1)(f)

⁵⁴ *Id.*, Protocol 10 (ii) (referring to the maximum period provided by the then existing Egyptian law); Vandavelde, *supra* n. 52, at 145.

on foreign investors (like British investors) as a result of the application of the MFN, since these measures will not be applicable under the US-Egypt BIT. By the same token, if a crisis is fairly imminent and will reduce the foreign exchange reserve to a very low level, Egypt may not be able to take measures under the US-Egypt BIT. This treatment may extend to other investors by virtue of the MFN clause.

It is worth noting that the MFN is restricted to “comparable” transfers in the US- Egypt BIT. This restricts the scope of the MFN to transfers that are similar. This criterion can include “comparable” transfers in terms of quantity and quality. This means that the host country may vary its restriction to the other party investors’ transfer from third parties investors’ transfers depending on the quantity or the kind of capital that is restricted. This is a qualification to the application of the MFN principle in this case.

Other BITs entered into by Egypt include different rules. The Egypt-Japan BIT allows either country to utilize exchange controls as permitted by the IMF Articles.⁵⁵ The Egypt-Japan BIT provides that the rate of exchange shall “include the rate of exchange prevailing under the applicable laws and regulations of each Contracting Party.”⁵⁶

Some BITs concluded by Egypt do not provide for any exception for transfer of outflow capital. The Canada-Egypt BIT and Denmark-Egypt BIT, for example, do not explicitly provide for any exception on the free transfer of capital and returns from investment for exceptional economic difficulties.⁵⁷ However, the MFN is excluded explicitly from some BITs concluded by Egypt with regard to tax issues. This prevents foreign investors from challenging the tax based capital controls on their transfers on the basis that other countries' foreign investors are receiving different treatment. The Egypt-UK BIT exempts tax laws and agreements related to taxes from the application of the MFN treatment and national treatment provided for in the BIT.⁵⁸

⁵⁵ *Agreement between Japan and the Arab Republic of Egypt Concerning the Encouragement and Protection of Investment*, signed January 28, 1977, art. 12 (entered into force January 14, 1978).

⁵⁶ *Id.*, Agreed Minutes (2).

⁵⁷ *Agreement Between the Government of Canada and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investment*, signed November 13, 1996, art. IX; *Agreement between the Government of the Arab Republic of Egypt and the Government of the Kingdom of Denmark Concerning the Promotion and Reciprocal Protection of Investments*, signed June 24, 1999, art. 7.

⁵⁸ *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investment*, signed June 11, 1975, art. 7 (c) (entered into force February 24, 1976).

However, the US-Egypt BIT has a different rule. It provides that:

With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals or companies of the other Party. Nevertheless, all matters relating to the taxation of nationals or companies of a Party, or their investments in the territories of the other Party or a subdivision thereof shall be excluded from this Treaty, except with regard to measures covered by Article III and the specific provisions of Article V.⁵⁹

This explicitly excludes taxation from the scope of the BIT, except with respect to transfers (Article V) and if the taxation is considered indirect expropriation (Article III).

The ability of a British investor to invoke the MFN in order to be entitled to include the taxation of transfers treatment in the US-Egypt BIT is dubious in light of the explicit exclusion thereof from the Egypt-UK BIT.

The above shows how even an exception made by a BIT for the purpose of assisting a developing country in financial or economic hardship can be curtailed by the same BITs broad obligations to the extent of making it futile. It is questionable whether these developing countries intended that their right to temporarily restrict capital outflows in crisis situations that they negotiated with developed countries be taken away by other BITs.

III. Fair and Equitable Treatment Breadth

A. General

FET finds its origin in the US treaties on friendship, commerce and navigation (FCNs), and as in many other BITs obligations, in the private model of Hermann Abs and Lord Shawcross and the OECD Draft Convention on the Protection of Foreign Property.⁶⁰

⁵⁹ *US-Egypt BIT*, art. XI.

⁶⁰ Rudolf Dolzer, *Fair and Equitable Treatment: A Key Standard in Investment Treaties*, 39 *Int'l Law* 87, at 89 (2005); Andrea Menaker, *Standards of Treatment: National Treatment, Most Favored Nation Treatment and Minimum Standards of Treatment*, in *APEC WORKSHOP ON BILATERAL & REGIONAL INVESTMENT RULES AND AGREEMENTS* 106, at 111 (Ministry of Economy, Mexico, 2002); OECD, *Fair and Equitable Treatment Standard in International Law*, Working Papers on International Investment No. 2004/3, at 5 (2004); *Pope & Talbot, Inc. v. Canada*, NAFTA Ch. 11 (Award on the Merits, Phase Two), para. 112 (Apr. 10, 2001) (citing the U.S. submission that the FET term originated from the OECD draft). The Havana Charter of 1948 included similar language, using the words "just and equitable treatment." *Havana Charter for an International Trade Organization*, art. 11(2)(a)(i), 72(1)(c)(i), *reprinted in UNCTAD, International Investment Instruments: A Compendium*, UNCTAD/DTCI/30(Vol.I) (1996).

FET can be interpreted as equivalent to the international minimum standard or as an autonomous standard. Under the first interpretation, a restriction on capital inflows in general should not violate the international minimum standard because under international law has the right to regulate and restrict capital inflows. If this regulation is both arbitrary and discriminatory, it might be found in violation of the minimum standard according to some awards that found that the international minimum standard is violated by arbitrary and discriminatory treatment.⁶¹

If the autonomous standard, which is the prevailing interpretation under BITs, is adopted the substantive obligations would be different. There are different obligations included under the FET and different interpretations given to them—mostly broad interpretations—which may affect the regulatory powers of the host State. FET is interpreted broadly to encompass both substantive and procedural protections, including an obligation of vigilance and protection; an obligation to accord justice and due process; an obligation to maintain a stable and transparent regime of investment regulation; an obligation to respect investor’s expectations; an obligation to act in good faith, an obligation to refrain from discriminatory and arbitrary treatment; and proportionality and reasonableness.⁶²

The autonomous FET was interpreted by tribunals to include the obligation of good faith, obligations of transparency, stability and respect of investor’s legitimate expectations.⁶³ While

⁶¹ See *Lauder v. Czech Republic*, UNCITRAL (Final Award), para. 294 (Sept. 3, 2001) (finding that because the host State’s actions were not arbitrary and discriminatory, there was no FET violation); *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/00/3 (Final Award), para. 98 (Apr. 30, 2004).

⁶² See, e.g., *Tecmed*, para. 154 (fair and equitable treatment requires conforming to foreign investor’s “basic expectations” including full transparency and using legal tools for the purpose they were intended to); *Mondev*, para. 127 (denial of justice exists if a “decision was clearly improper and discreditable”); *MTD*, para. 109 (“‘fair and equitable treatment’ is a ‘broad and widely-accepted standard encompassing such fundamental standards as good faith, due process, nondiscrimination, and proportionality.’”) (quoting Judge Schwebel’s expert opinion with approval); *S.D. Myers, Inc. v. Canada*, (Partial Award), para. 263 (Nov. 13, 2000) (fair and equitable treatment exists “only when it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective.”); *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/00/3 (Final Award), para. 98 (Apr. 30, 2004) (hereinafter *Waste II*) (fair and equitable treatment is violated if the host State’s “conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety . . .”). See also Katia Yannaca-Small, *Fair and Equitable Treatment Standard: Recent Developments*, in *STANDARDS OF INVESTMENT PROTECTION*, at 118-129 (ed. August Reinisch, OUP, 2008); Ioana Tudor, *THE FAIR AND EQUITABLE TREATMENT STANDARD IN THE INTERNATIONAL LAW OF FOREIGN INVESTMENT*, at 156-180 (OUP, 2008).

⁶³ See *Tecmed, S.A. v. United Mexican States*, ICSID award no. ARB (AF)/00/2, para 153 (May 29, 2003); *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/00/3 (Final Award), para. 138 (Apr. 30, 2004); *LG&E v. Argentina*, ICSID Case No. ARB/02/1 (Decision on Liability), paras. 123-127 (Oct. 3, 2006); see also Dolzer & Schreuer, *supra* n. 21, at 133; Christoph Schreuer & Ursula Kriebaum, *At What Time Must Legitimate*

some tribunals referred to certain language in the relevant BIT or to past tribunals to find that transparency was part of FET, some did not state any reason why transparency was part of FET. Tribunals have initially interpreted the content of this obligation in a broad language that imposed positive obligations on government to act to ensure the investor's clear understanding of its legal regime and any proposed changes to it. One oft-cited case is *Tecmed*, which laid down subjective and objective criteria for FET. *Tecmed* interpreted the FET as requiring the host country to conform to the foreign investor's "basic expectations" that were the basis for its decision to invest.⁶⁴ This depends on what the foreign investor based its decision on at the time of taking the decision to invest; which is a subjective standard. It then followed this with objective criteria of what the foreign investor expectations are, stating:

The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations.⁶⁵

The tribunal stated that it based this autonomous interpretation of the fair and equitable standard on the ordinary meaning of the BIT words, "international law and the good faith principle."⁶⁶ No other authority for this interpretation was cited by the tribunal.

Tecmed's interpretation of the FET standard was, rightly, described by Chile as "the Tecmed programme for good governance," and the *MTD* annulment committee has found its approach "questionable."⁶⁷ For one, creating an obligation based on the investor expectations rather than BIT's obligation appears arcane to international law rules, and it does not arise from the ordinary meaning of the BIT FET obligation.⁶⁸ The *Tecmed* tribunal described its interpretation as an

Expectations Exist?, in ALIBER AMICORUM: THOMAS WALDE, LAW BEYOND CONVENTIONAL THOUGHT 265, at 265 (CMP Publishing Ltd, 2009).

⁶⁴ *Tecmed, S.A. v. United Mexican States*, ICSID award no. ARB (AF)/00/2, para 154 (May 29, 2003) [hereinafter *Tecmed*].

⁶⁵ *Id.*

⁶⁶ *Id.*, para. 155.

⁶⁷ *MTD v. Republic of Chile*, ICSID Case No. ARB 01/7 (Decision on Annulment), paras. 66-67 (Mar. 21, 2007).

⁶⁸ *Id.*, para. 67 ("[T]he TECMED Tribunal's apparent reliance on the foreign investor's expectations as the source of the host State's obligations (such as the obligation to compensate for expropriation) is questionable. The obligations

“autonomous interpretation”.⁶⁹ It reasoned that otherwise the fair and equitable treatment provided in the Mexico-Spain BIT will be stripped of any independent meaning or protection to foreign investment.⁷⁰ No explanation how is this so. Why, for example, the international minimum standard would not have provided protection to foreign investment against arbitrary and discriminatory actions of the State.

While what *Tecmed* referred to as a content of the fair and equitable treatment can be viewed as best practice or model for government treatment of investment, it cannot reflect the current customary international law, or what the parties to BITs accepted when they agreed to this provision. Clear evidence to that is the reaction of the NAFTA countries in their interpretation of the FET clause to refer only to minimum standard of treatment under customary international law.⁷¹

Tecmed's criteria do not grant any space for the typical government process which is not always efficient. Different policies may be employed by different parties within different governments, or even within the same government where different objectives might be pursued. It is hardly conceivable that an investor would expect a developing state to have such efficient government that can explain the policies and goals behind each policy and to never be inconsistent or contradictory to satisfy *Tecmed*.⁷² Other tribunals have, nonetheless, followed *Tecmed*.⁷³

B. Application

In the light of the broad application of this standard, one question is whether it has application on the admission and transfer provisions in BITs. All the Model BITs provide for the obligation to accord fair and equitable treatment (FET).⁷⁴ For the U.K. and US BITs, such treatment is

of the host State towards foreign investors derive from the terms of the applicable investment treaty and not from any set of expectations investors may have or claim to have.”).

⁶⁹ *Tecmed*, para. 155.

⁷⁰ *Id.*, paras. 155-156.

⁷¹ *Free Trade Commission Clarifications Related to NAFTA Chapter 11*, (July 31, 2001) available at <http://www.worldtradelaw.net/nafta/chap11interp.pdf>.

⁷² Gus Van Harten, *Investment Treaty Arbitration and Public Law*, 89 (OUP, 2007); Susan D. Franck, *International Decision: Occidental Exploration & Production Co. v. Republic of Ecuador*, 99 Am. J. Int'l L. 675, at 678 (2005) (“No regulatory framework is absolutely clear and free from inconsistencies.”); Bohuslav Klein, *How to Avoid Conflicting Awards: The Lauder and CME Cases*, 5 JWIT 19, at 21 (2004) (“[T]he State administration in all countries is a little bit inefficient.”).

⁷³ See, e.g., *CMS Final Award*, para. 280.

⁷⁴ See *German Model BIT*, art. 2(1); *UK Model BIT*, art. 2(1); *US Model BIT 1992*, art. II(2)(a).

accorded at the post-admission phase. On the other hand, the FET in the German Model BIT might apply on the admission process as well. In the admission phase, this obligation would entail an obligation of good faith, transparency and accord due process in the admission phase. Additionally, the MFN clause in the US BITs could incorporate such treatment, as it applies in the admission and establishment phase. Some tribunals have applied FET that existed by virtue of MFN clauses in other BITs.⁷⁵

Most importantly, FET applies to the obligation to permit inward transfers. Obligation such as respecting investor's expectations may affect the substance of the State's right to regulate capital inflows. If the host State laws and regulation at the time of admission allowed free transfer of capital inflows for this kind of investment, a foreign investor might reasonably expect that its admitted investment is entitled to be allowed to import inward funds to conduct or maintain its operations. Host State actions that fail to meet these expectations might be found in violation of FET.

An analogous situation exists in *MTD* case, where after the admission of the investment the host State actions were found to violate FET as they did not conform to the investor's expectations.⁷⁶ In that case, the foreign investor was seeking to build a residential community over a piece of land which it purchased from a private seller. However, the land was in the agricultural zone and cannot be used for that person. The seller convinced the investor that rezoning is simple, and that the project can be built on the land. The investor did not conduct its own due diligence on the matter. The investor received the approval to invest from Chilean Foreign Investment Commission (FIC), and a foreign investment contract with FIC. The investor attempts to acquire the zoning permit was rejected because there was a policy against changing the zoning in this area. The claimant argued that the host State violated FET by failing to meet its reasonable expectations that it can build in the location which is specified in the foreign investment contract. The respondent argued that FIC's approval and contract was only to guarantee transfer of capital and national treatment, as the foreign investment contract explicitly required the investor to

⁷⁵ *MTD Equity Sdn. v. Chile*, ICSID Case No. ARB/01/7 (Award), para. 104 (May 25, 2004) (the tribunal combined favourable FET clauses from two different BITs entered into by the host State) [hereinafter *MTD*]; *Rumeli Telekom A.S. and Telsim Mobil Telekomikasyon Hizmetleri A.S. v. Kazakhstan*, ICSID Case No. ARB/05/16 (Award), para. 591 (July 29, 2008) (respondent State admitted that FET was applicable by virtue of MFN that existed under another BIT it concluded).

⁷⁶ *MTD Equity Sdn. v. Chile*, ICSID Case No. ARB/01/7 (Award), (May 25, 2004).

acquire zoning permit and other authorizations. It further argued that if the investor had made its due diligence it would have found such policy.

The tribunal stated that the FET entailed “an even-handed” and “just” treatment.⁷⁷ It agreed with *Tecmed* that the legitimate expectations of the foreign investors must be respected.⁷⁸ It further found that the FET requires the host State to be proactive. It stated:

[I]n terms of the BIT, fair and equitable treatment should be understood to be treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment. Its terms are framed as a *pro-active statement*—“to promote”, “to create”, “to stimulate”—rather than prescriptions for a passive behavior of the State or avoidance of prejudicial conduct to the investors.⁷⁹

The tribunal applied this standard finding that the different organs of the host State have acted incoherently and applied their policies inconsistently. The tribunal found that FIC’s approval gave the investor the expectations that the project could be undertaken in the specified location. The tribunal found that the host State “has an obligation to act coherently and apply its policies consistently, independently of how diligent an investor is.”⁸⁰ The approval of the FIC was inconsistent with the urban policy of the government, which constituted a violation of FET.⁸¹

Likewise, a host State that approves an investment and fails to permit inward capital required for its business may be held in violation of FET, even if no transfer provision existed in the relevant BIT or if the transfer provision did not include inward transfer. In addition, if the host State changes its laws and regulation after the admission of investment and restricts the ability of the investment to bring capital inflows, the obligations of stability and due process might be invoked by the investor.

Some case law found that amending investors’ rights that existed in the regulatory framework at the time of its admission were in violation of FET obligation of to ensure stability and

⁷⁷ *Id.*, para. 113.

⁷⁸ *Id.*, para. 114.

⁷⁹ *Id.*, para. 113 (emphasis added).

⁸⁰ *Id.*, para. 165.

⁸¹ *Id.*, para. 166.

predictability.⁸² Also, some awards explicitly rejected the need to a specific guarantee or undertaking by the host State to justify the foreign investor's expectations.⁸³

For example, in *LG&E*, under US-Argentina BIT, the ICSID tribunal found that fair and equitable treatment includes stability of the legal regime.⁸⁴ It based its finding on the preamble of the BIT that states that "fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective use of economic resources," and other statements in the preamble on promoting mutual investment and cooperation.⁸⁵

It also referenced *Tecmed* for the proposal that FET "involves consideration of the investor's expectations when making its investment in reliance on the protections to be granted by the host State."⁸⁶ It thus found that transparency is required from the State to meet the investor's expectations, while rejecting that bad faith is required to find the State in breach of FET.⁸⁷

The tribunal clarified what the protected "fair expectations" were. They must be in reliance on "conditions offered by the host State at the time of the investment," which "must exist and be enforceable by law."⁸⁸ Based on this, the tribunal found Argentina's amendments of its investment legal regime and its guarantees to foreign investors, including computing tariffs in US dollar, the exchange rate from pesos to dollars, and periodical adjustment of tariffs, have violated FET as it did not preserve the stability and predictability requirements.⁸⁹ It also found that the treatment of investments in the gas sector of the economy violated the FET because these amendments were not applied to other sectors, most notably, the export sector.⁹⁰

LG&E thus stands for finding that an incentive in a law to certain sector should be preserved because it constitutes a specific guarantee to investors in that sector and FET's stability and respect of investors' legitimate expectations require not amending these incentives. The tribunal

⁸² See, e.g., *CMS Final Award*, para. 276.

⁸³ *Saluka Investments BV (The Netherlands) v. The Czech Republic*, UNCITRAL (Partial Award), para. 329 (Mar. 17, 2006).

⁸⁴ *LG&E v. Argentina*, ICSID Case No. ARB/02/1 (Decision on Liability), paras. 123-124 (Oct. 3, 2006) [hereinafter *LG&E*].

⁸⁵ *Id.*, para. 124 (quoting the U.S.-Argentina BIT Preamble).

⁸⁶ *Id.*, para. 127.

⁸⁷ *Id.*, paras. 128-129.

⁸⁸ *Id.*, para. 130.

⁸⁹ *Id.*, paras. 132-139

⁹⁰ *Id.*, para. 135.

does not address whether the guarantee should be permanent or if it could be changed after certain reasonable period.

What's more, when other different sectors were treated more favourably, the tribunal found that this violates the FET without considering if there is any reason for such different treatment between different sectors.

Accordingly, if a the host State laws provided for the free transfer of capital inflows in general or for the specific sector where the foreign investor is investing and after the admission of the investment, and later the host State amended its laws and imposed capital controls on capital inflows in general or on the specific sector of the investor, *LG&E* would suggest that these changes in regulation might violate FET. It follows that indirect capital controls such as taxing capital inflows or exchange restriction may violate the FET because it changes legal framework upon which the investor has invested.

In addition, if *LG&E* reasoning is adopted, capital controls that distinguish between different types of capital inflows such as long term and short term capital or based on the underlying investment type may violate FET because it discriminates between different recipients of capital inflows.

What's more, under *Tecmed*, fair and equitable treatment is interpreted to require a host state to inform an investor beforehand of its intention to change these rules. This could inhibit any use of capital controls, since any such prior notice could lead to massive capital outflows, preventing the exact purpose of capital controls.⁹¹ Likewise, notifying investment that temporary taxes on transfers will be imposed will *defacto* prohibit the host state from imposing taxes for the same reason.

Some disputes arising from the measure taken by Argentina to deal with its financial crisis illustrate this point. These measures were considered a violation of fair and equitable treatment.

⁹¹ Abba Kolo, *Investor Protection vs Host State Regulatory Autonomy During Economic Crisis: Treatment of Capital Transfers and Restrictions under Modern Investment Treaties*, 8 *JWIT* 457, 499 (2007) (“But in the context of exchange restrictions, it might be argued that sometimes letting the public (especially portfolio investors) know of an impending restriction might cause panic and a rush to exit the host state which might exacerbate the economic problem sought to be addressed through the restriction”).

In *Sempra*, the tribunal found that the change in the legal regime that the investor entered under to its detriment, even if done in good faith, constitutes a breach of fair and equitable treatment. It stated:

The measures in question in this case have beyond any doubt substantially changed the legal and business framework under which the investment was decided and implemented. Where there was business certainty and stability, there is now the opposite.

...

Even assuming that the Respondent was guided by the best of intentions, what the Tribunal has no reason to doubt, there has here been an objective breach of the fair and equitable treatment due under the Treaty. The Tribunal thus holds that the standard established by Article II(2)(a) of the Treaty has not been observed, to the detriment of the Claimant's rights.⁹²

Similarly, in *CMS*, the Tribunal found that the devaluation accompanied by not allowing the adjustment of the tariffs charged by the foreign investor resulted in increasing the costs and loss of the investor's income, which is not "fair and reasonable."⁹³ The tribunal found that although the devaluation is a general economic measure, it has a particular impact on the foreign investor that is within its jurisdiction.⁹⁴ The tribunal did not, however, consider the devaluation an expropriation, but ordered compensation on the basis of the breach of FET treatment and non observance of agreed upon obligations.⁹⁵

In this case, the claimant asserted that it was not accorded fair and equitable treatment because Argentina changed its regulatory system in relation to its investment. Argentina argued that the FET standard was vague, and that it only granted international minimum standard protection.⁹⁶

The dispute relates to the 1989 privatization program in Argentina that included public utilities, and established TGN as the gas transportation operator for the north of the country. CMS, a US company, acquired a minority stake in TGN from Argentina. Argentina laws provided that gas transportation tariffs were to be calculated in US dollars, converted into Argentine pesos at the time of the billing, and begged pesos to US dollars at an exchange rate of 1 to 1. These tariffs must be adjusted biannually in accordance with the US Producer Price Index (PPI). In 2000, Argentina suspended the tariff adjustment and the exchange rate of 1 to 1. The devaluation of

⁹² *Sempra Energy International v. Argentine Republic*, ICSID Arb/02/16 (Award), paras. 303-304 (Sept. 28, 2007) [hereinafter *Sempra*].

⁹³ *CMS Final Award*, para 182.

⁹⁴ *Id.*, para. 186.

⁹⁵ *Id.*, para 472.

⁹⁶ *Id.*, paras. 270-271.

pesos reduced the value of the tariffs by over two-thirds when calculated in dollars, which negatively affected TGN.

The tribunal considered the “stability and predictability” as an integral part of the fair and equitable treatment standard.⁹⁷ This is based on the purpose of the US-Argentina BIT as provided for in its preamble.⁹⁸ The tribunal noted that this does not mean that FET required that the laws regulating investment “be frozen as [they] can always evolve,” but this does not mean that the laws “can be dispensed with altogether when specific commitments to the contrary have been made.”⁹⁹ Since Argentina has completely changed the legal framework that the claimant’s made its investment under, and especially the elements that were “crucial for the investment decision,” it found Argentina in violation of FET.¹⁰⁰

The tribunal in *CMS* thus based its finding partly on the BITs’ preambles, which state that FET is desirous to achieve stability. Still, it did not explain why such statement was not included as an obligation in the operative part of the BIT. Indeed, if the States desired to have a clear obligation of stability, they would have stated so explicitly in the operative part of the BIT, or in a definition of FET. *CMS* also placed certain emphasis on the subjective elements that the investor took into account when it invested. But these elements could be viewed as objective elements because any investor would have taken into account the exchange rate and tariffs system that existed at the time into consideration.

Conversely, some recent awards have recognized the flaws in an interpretation that emphasizes the expectation of stability without limiting it to some reasonable and legitimate conditions. For example, in *Parkerings*, the tribunal followed previous tribunals’ interpretation of the FET, finding that this obligation entails a treatment that is not discriminatory, arbitrary, and protects the investor’s legitimate expectations.¹⁰¹ On the question of discriminatory treatment, the

⁹⁷ *Id.*, para. 276.

⁹⁸ *Id.*, para. 274.

⁹⁹ *Id.*, para. 277.

¹⁰⁰ *Id.*, paras. 275, 281.

¹⁰¹ *Parkerings-Compagniet AS v. Lithuania*, ICSID Case No. ARB/05/8 (Award), paras. 287, 300, 329-330 (Sept. 11, 2007).

challenged treatment must be compared to a treatment accorded to a comparable investor.¹⁰² The tribunal found that while the State's actions might be considered a contractual violation, such violations were not proven to be discriminatory as the claimant had not proven that a comparable investor was treated better.¹⁰³ It observed that any reasonable investor could not have expected the legal environment to be stable at the time, since substantial political and economic changes were happening at the time.¹⁰⁴

The tribunal also dealt with the legitimate expectations. The criterion for the expectations to be legitimate is "if the investor received an explicit promise or guaranty from the host-State, or if implicitly the host-State made assurances or representation that the investor took into account in making the investments."¹⁰⁵ In the absence of such representation of the host State, one must examine the circumstances surrounding the making of the investment, including the host State actions at the time.¹⁰⁶ Finding that there was no explicit or implicit guarantee or representation, the tribunal confirmed that the State may amend its laws, and do without a stabilization agreement, exercise its regulatory and legislative power at its discretion.¹⁰⁷ The tribunal summarized the extent of the right to stability, stating:

In principle, an investor has a right to a certain stability and predictability of the legal environment of the investment. The investor will have a right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances. Consequently, an investor must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment.¹⁰⁸

¹⁰² *Id.*, para. 288 ("In order to determine if there is discrimination in violation of the standard of the fair and equitable treatment, one has to make a comparison with another investor in a similar position (like circumstances).").

¹⁰³ *Id.*, paras. 289-290.

¹⁰⁴ *Id.*, para. 306 ("In fact, it would have been foolish for a foreign investor in Lithuania to believe, at that time, that it would be proceeding on stable legal ground, as considerable changes in the Lithuanian political regime and economy were undergoing.").

¹⁰⁵ *Id.*, para. 331.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*, para. 332. ("It is each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time.").

¹⁰⁸ *Id.*, para. 333.

Since the country was in transition and many legal changes were expected, the investor could not have legitimately expected the legal framework to stay unchanged.¹⁰⁹ If it wished so, it should have included a stabilization clause.¹¹⁰ Meanwhile, any frustration to its contractual right is a contractual matter that is not protected by international law.¹¹¹

Parkerings thus limits the positive obligation of the State to actively inform the investor of any uncertainties to only the facts are not available to the public which the investor cannot independently obtain. It also takes into account the host State's circumstances that are or should be known to any diligent investor. This is contrasted with the active duty imposed by *Tecmed*, the duty of "vigilance" imposed by *AMT*, and other decisions that followed them.

Similarly, in *EDF*, the tribunal criticized the broadly stated principle of stability under FET, which might amount to freezing the legal regime.¹¹² Under FET, an expectation must be legitimate and reasonable. The tribunal found that an investor's legitimate and reasonable expectation cannot be that the legal system will not develop and change.¹¹³ It held that such expectations may be reasonable and legitimate only if host State explicitly expressed specific undertakings to the investor.¹¹⁴ The FET, the tribunal noted, "cannot serve the same purpose as stabilization clauses specifically granted to foreign investors."¹¹⁵

The tribunal also confirmed that the investor's "subjective expectations" may not be the only basis for deciding what the legitimate and expectations are, but that these "must be examined as the expectations at the time the investment is made, as they may be deduced from all the circumstances of the case, due regard being paid to the host State's power to regulate its economic life in the public interest."¹¹⁶

¹⁰⁹ *Id.*, para. 335.

¹¹⁰ *Id.*, para. 336.

¹¹¹ *Id.*, paras. 342-345.

¹¹² *EDF (Services) Limited v. Romania*, ICSID CASE NO. ARB/05/13 (Award), para. 217 (Oct. 8, 2009) [hereinafter *EDF*].

¹¹³ *Id.*, para. 217.

¹¹⁴ *Id.*

¹¹⁵ *Id.*, para. 218.

¹¹⁶ *Id.*, para. 219.

C. Summary

Under the independent interpretation, many tribunals developed different principles in order to give content to FET. Many tribunals used the preamble of the BIT to find specific obligations under FET while others built on interpretations of previous tribunals to reach their own accumulated interpretation of the FET or just to state the accumulated content based on all previous tribunals findings without examining the exact language of the relevant BIT.¹¹⁷

Based on this, the tribunals found that FET included several different obligations or components like good faith, denial of justice, due process, lack of arbitrariness and discrimination, freedom from coercion, transparency, stability of the legal regime, and respecting investors' expectations. These specific components, the tribunals found, were to be part of the obligation, but not the complete numeration of the components of the obligation. Specific obligations, such as respecting investors' expectations, are as vague and subjective as the FET obligation. Some tribunals gave them more content and broader reach, while other tribunals imposed reasonable limits to this interpretation.

On one end of the spectrum, *Tecmed* interpretation of FET stands out in its overreaching and lack of any ground. It does not arise from the ordinary meaning of FET nor in many BITs from the context of the BIT. It is, however, cited by many tribunals as authority of what FET means, and by others as authority of what customary international law minimum standard stands now.

Also, many tribunals refrained from stating a specific and exhaustive content of FET as they retained discretion to decide on a case by case basis. Other awards like *Parkerings* and *EDF*, while maintaining that FET is independent from the minimum standard, limited it to a more reasonable standard that does not depend on the subjective expectations of investors, and that take into consideration the host State circumstances. These limitations include requiring that the expectation be reasonable and maintaining that the stability obligation is not absolute and must relate to a specific undertaking by the host State.

¹¹⁷ See for e.g. *Siag v. Egypt*, ICSID Case No. ARB/05/15 (Award), para. 450 (June 1, 2009) (“While [FET] precise ambit is not easily articulated, a number of categories of frequent application may be observed from past cases. These include such notions as transparency, protection of legitimate expectations, due process, freedom from discrimination and freedom from coercion and harassment.”).

The danger of these interpretations is that they entail the risk of halting regulation in the public interest, and encourage challenges to bona fide regulation. Thus, in addition to being groundless, they threaten the normal regulatory process of government. Indeed, the question remains, exactly what government can fully satisfy the *Tecmed* interpretation in its regulation?¹¹⁸

It is not surprising that FET has proven to be an important standard routinely invoked by plaintiffs in recent disputes under BITs.¹¹⁹ This is due to its flexibility, ambiguity, and convenience in terms of application to any State conduct or omission that, although may not be unlawful, is objectionable. It serves as a fall back claim for claimants where the host State conduct does not rise to expropriation or to a violation of other specific obligations under the BIT.¹²⁰ It was also used successfully in Argentina's financial crises cases.

IV. Investor-State Arbitration Incoherence

A. General

Customary international law does not recognize a private person's standing in international law to bring a claim against a sovereign state. A treaty or a national law is required to bestow such standing on a private person.¹²¹ Under customary international law, a foreign investor's remedies against a host country are limited to suing the host country in its own courts, requesting diplomatic interference from the home country, and requesting the home country to adopt the foreign investor's claim before international tribunals.¹²²

Yet almost all BITs allow foreign investors to seek direct redress of any alleged violation to its rights under BITs through arbitration. Under this regime, a foreign investor is not dependent on

¹¹⁸ See James Crawford, *Ten Investment Arbitration Awards That Shook the World: Introduction and Overview*, 4 *Dispute Resolution International* 71, at 87 (2010) ("*Tecmed* is very frequently cited before BIT tribunals by claimants; as to the merits of the fair and equitable treatment standard, it may be summarized by the biblical injunction—to governments—'be ye therefore perfect'. That tends to ignore the point that while governments are often composed from the elite, that is different from being composed of the elect!").

¹¹⁹ Andrew Newcombe & L. Paradell, *Law and Practice of Investment Treaties*, at 255 (Kluwer Law International, 2009).

¹²⁰ See Rudolf Dolzer, *Fair and Equitable Treatment: A Key Standard in Investment Treaties*, 39 *Int'l Law* 87, at 87 (2005) ("Nearly every claimant or counsel who brings a suit feels tempted to argue that the treatment accorded by the host state was in violation of the standard of fair and equitable treatment.")

¹²¹ Norbert Horn, *Arbitration and the Protection of Foreign Investment: Concepts and Means*, in *Arbitrating Foreign Investment Disputes*, at 9 (ed. Norbert Horn, Kluwer Law International, 2004).

¹²² Susan D. Frank, *Symposium: Judicial Independence and Legal Infrastructure: Essential Partners for Economic Development: Foreign Direct Investment Treaty Arbitration, and the Rule of Law*, 19 *Pac. McGeorge Global Bus. & Dev. L.J.* 337, at 343 (2007).

its home country to adopt its claim.¹²³ Most BITs and the Model BITs thus allow state parties and private investors to initiate arbitration against the host country for violations of the rights of the foreign investor under such BITs. The foreign investor is free to seek redress in its own name. This investor-state arbitration is often very broad and covers most conceivable disputes that may arise out of investment between a foreign investor and a host State.¹²⁴

This investor-state arbitration adds to the BITs regulatory dilemma. On the one hand, it guarantees to investors the right to have their cases adjudicated before a forum that is not an organ of the host country and without the need to rely on its home state to adopt its claim.¹²⁵ It thus provides a direct enforcement mechanism to their rights under BITs and encourages foreign investment to invest in developing States, confident that there is an independent mechanism to adjudicate their rights.

Because arbitration adds to the guarantees provided to private foreign investment, it may help in increasing such investment by guaranteeing to the foreign investor its ability to seek adjudicating disputes against a foreign host State in a neutral forum.¹²⁶ It increases the confidence of foreign investors to invest in the host state, allows foreign investors to avoid the assumed bias in the host

¹²³ Jeswald W. Salacuse, *Is there a Better Way? Alternative Methods of Treaty-Based, Investor-State Dispute Resolution*, 31 Fordham Int'l L.J. 144, at 144 (2007). See, e.g., *Treaty between United States of America and the Argentine Republic concerning the Reciprocal Encouragement and Protection of Investment*, signed November 14, 1991; art. VII (3) (entered into Force October 20, 1994) [hereinafter *US-Argentine BIT*]; *Agreement between the Government of Canada and the Government of the Republic of Argentina for the Promotion and Protection of Investment*, art. X (signed November 5, 1991) [hereinafter *Canada-Argentine BIT*]; *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China concerning the Promotion and Reciprocal Protection of Investment*, signed May 15 1986, art. 7 (entered into force May 15 1986) [hereinafter *UK-China BIT*]; *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Chile concerning the Promotion and Reciprocal Protection of Investment*; signed January 8, 1996, art 7 (entered into force April 21, 1997).

¹²⁴ Shane Spelliscy, *Burning the Idols of Non-Arbitrability: Arbitrating Administrative Law Disputes with Foreign Investors*, 12 Am. Rev. Int'l Arb. 95, at 96 (2001); Elihu Lauterpacht, *The Inaugural Earl A. Snyder Lecture in International Law: International Law and Private Foreign Investment*, 4 Ind. J. Global Leg. Stud. 259, at 271 (1997).

¹²⁵ Joel C. Beauvais, *Regulatory Expropriations Under NAFTA: Emerging Principles & Lingering Doubts*, 10 N.Y.U. Env'tl. L.J. 245, at 261 (2002).

¹²⁶ See UNCTAD, *Investor--State disputes and policy implications*, UN doc. TD/B/COM.2/62, at 4 (2005); David R. Sedlak, *ICSID's Resurgence in International Investment Arbitration: Can the Momentum Hold?*, 23 Penn St. Int'l L. Rev. 147, at 153, 155 (2004); Rainer Geiger, *Regulatory Expropriations in International Law: Lessons from the Multilateral Agreement on Investment*, 11 N.Y.U. Env'tl. L.J. 94, at 105 (2002); Horn, *supra* n. 121, at 6 .

state courts, provides more flexibility, and allows parties to choose arbitrators with an expertise in the subject matter.¹²⁷

Arbitration is also favoured because of its decisions' finality, speed, and confidentiality, and also because it is generally less expensive than courts litigation.¹²⁸ It is also a means to avoid the differences in legal traditions and remedies in different countries.¹²⁹ Furthermore, investor-state arbitration grants foreign investors the ability to directly challenge host states' actions without the need for the political interference of the home country.¹³⁰ It is thus observed that “[w]ithout the option to arbitrate, the specter of unfair expropriation might chill cross-border economic cooperation and capital flow.”¹³¹

On the other hand, it affects and burdens substantially sovereigns, in general, and developing States, more specifically, in taking necessary regulation for public interest purposes.¹³² Investor-state arbitration allows the foreign investor to directly challenge the host State regulation.¹³³ In this respect, it can be used to challenge the regulatory autonomy of the host state to impose capital controls.

B. Scope

Most BITs and the Model BITs permit investors from the State parties to initiate arbitration against the other State to settle disputes relating to its investment in that State. The consent of the host State to arbitration is included in the BIT.

The scope of the arbitration clauses in BITs is very broad. In both the UK Model BIT and the German Model BIT, the dispute has to be in relation to an “investment” by a national of the other

¹²⁷ Beauvais, *supra* n. 125, at 261-262; UNCTAD, *supra* n. 126.

¹²⁸ Jan Paulsson, *Dispute Resolution*, in *Economic Development Foreign Investment and the Law*, at 211 (ed. Robert Pritchard, Kluwer Law International, 1996).

¹²⁹ Scott R. Jablonski, *NAFTA Chapter 11 Dispute Resolution and Mexico: A Healthy Mix of International Law, Economics and Politics*, 32 *Denv. J. Int'l L. & Pol'y* 475, at 494-495 (2004).

¹³⁰ Daniel M. Price, *NAFTA Chapter 11 Investor-State Dispute Settlement: Frankenstein or Safety Valve?*, 26 *Can.-U.S. L.J.* 1, at 6 (2001).

¹³¹ William W. Park, *NAFTA CHAPTER 11: Arbitration and the Fisc: NAFTA's "Tax Veto"*, 2 *Chi. J. Int'l L.* 231, 231 (2001).

¹³² See for a detailed discussion and criticism to investor-state arbitration, Van Harten, *supra* n. 72, at 152-184; Marc R. Poirier, *The NAFTA Chapter 11 Expropriation Debate Through the Eyes of a Property Theorist*, 33 *Env'tl. L.* 851 (2003); Jeffery Atik, *NAFTA Chapter 11: Repenser NAFTA Chapter 11: A Catalogue of Legitimacy Critiques*, 3 *Asper Rev. Int'l Bus. & Trade L.* 215 (2003); Dana Krueger, *The Combat Zone: Mondev International, LTD. V. United States and the backlash Against NAFTA Chapter 11*, 21 *B.U Int'l L.J.* 399 (2003).

¹³³ Price, *supra* n. 130, at 426.

party.¹³⁴ As previously discussed, the prevailing interpretation of investment under BITs is very broad and covers almost any right that has economic value.

The US Model BIT arbitration clause, on the other hand, is more detailed, although similarly broad—it provides for investor-State arbitration for disputes “arising out of or relating to (a) an investment agreement between” the host State and the foreign investor; (b) “an investment authorization”; or (c) an alleged violation of any right under the BIT.¹³⁵

For the right to transfer capital inflows or outflows to exist under BITs, there must be an investment in the host State: the investment must be made or admitted. The treatment of the right to make investment varies between different BITs. The question is whether there is a right to arbitrate a decision not to admit investment under BITs: whether the investor-State arbitration covers admission of investment?

Both the German and UK BITs are concerned with the protection of the investment after its admission. The dispute settlement provision in both BITs is only applicable to “investments,” which, by definition, are already admitted.

As for the US BITs, they prohibit discrimination against foreign investors from State parties thereto with respect to the right of establishment.¹³⁶ The question is whether a private investor can use the dispute settlement mechanism under US BITs to enforce the right of establishment or get damages for the violation thereof. If this right exists, a private investor may challenge many direct and indirect capital controls, like screening procedures.

US BITs define the scope of the investment dispute between a state party and an investor from the other party. An example of a relevant provision provides that

For purposes of this Article, an investment dispute is a dispute between a Party and a national or company of the other Party arising out of or relating to (a) an investment agreement between that Party and such national or company; (b) an investment authorization granted by that Party's foreign investment authority to

¹³⁴ *UK Model BIT*, art. 11 (1); *German Model BIT*, art. 8(1).

¹³⁵ *US Model BIT 1992*, art. VI (1).

¹³⁶ See, e.g., *Treaty Between the United States of America and the Republic of Armenia Concerning the Encouragement and Reciprocal Protection of Investment*, signed September 23, 1992; art. II (2)(C) (entered into Force March 29, 1996).

such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment.¹³⁷

It lays down three cases where the investor can invoke the arbitration against the host country. The first two cases require the existence of an agreement between the state and the investor, or authorization from the state. They do not cover the case of an investor who applies for authorization to establish a business but gets rejected. The third case covers the violation of the BIT by a state party regarding “an investment.” The investment is defined as “every kind of investment in the territory of on one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and service and investment contracts....”¹³⁸

This means that there should be an already established investment in the host state’s territory as a prerequisite for allowing investor state dispute.¹³⁹ An investor cannot challenge through the arbitration provided for in the US BIT a host state denial of establishing or acquiring a business, even if such rejection violates the US BIT.

In *Mihaly*, a dispute under US-Sri Lanka BIT, the claimant submitted a bid to build a power plant on a Build-Own-Transfer basis to improve the supply of power in Sri Lanka. After negotiations with several bidders, the government chose the claimant to enter into a letter of intent, which included an exclusivity period for negotiations to conclude the final agreement. After further negotiations, the claimant and the government entered into a letter of agreement that stated the agreed issues and provided that further negotiations are needed to agree on all issues. The parties concluded another agreement to extend the exclusivity period. All agreements explicitly stated that they did not create any obligation upon the parties. The parties failed to conclude a final agreement. The claimant initiated this arbitration, asserting that its

¹³⁷ *U.S. Model BIT 1992*, art. VI (1); *see, e.g., US-Argentine BIT*, art. VII (1) (“For the purpose of this Article an investment dispute is defined as a dispute involving (a) the interpretation or application of an investment agreement between a Party and a national or company of the other Party; (b) the interpretation or application of any investment authorization granted by a Party’s foreign investment authority to such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment.”).

¹³⁸ *U.S. Model BIT 1992*, art. I(1).

¹³⁹ *Cf. Mihaly International corporation v. Democratic Socialist Republic of Sri Lanka*, ICSID award no. ARB/00/2, at 19, para. 60-61 (Mar. 15, 2002) (for the argument that expenses incurred cannot be considered investment if the host state does not admit the investment. Under BITs host states have the certain prerogatives in this respect. Accordingly this falls outside the jurisdiction of ISDM).

expenditures should be considered investment under the BIT.¹⁴⁰ The fact that claimant had incurred expenditures after the conclusion of the letter of intent was certain.¹⁴¹ The tribunal found that Sri Lanka never admitted these expenditures as investment. All the agreements between Sri Lanka and the claimant explicitly stated that they did not create any obligation. The claimant's expenditure before the admission of investment that never realized cannot be considered an investment.

The tribunal noted that the BIT, ICSID Convention and States practice under the facts in this case do not support the contention "that pre-investment and development expenditures . . . could automatically be admitted as 'investment' in the absence of the consent of the host State to the implementation of the project."¹⁴²

Most importantly, the tribunal found "that while the US-Sri Lanka BIT contains provisions regarding the definition of investment and conditions for its admission, they recognize the Parties' prerogative in this respect."¹⁴³ It refused "to accept as a valid denomination of 'investment' the unilateral or internal characterization of certain expenditures by the Claimant in preparation for a project of investment."¹⁴⁴

The decision was thus based on the fact that there was no investment admitted by the host State. This suggests that even though the US BIT provides for national and most favoured nation treatment on the pre-entry phase, the enforcement of such provision through investor-State arbitration is dubious. The state party to the BIT may discriminate against national investors of the other party in authorizing the establishment of investment without an effective international dispute settlement mechanism available to the private investor to enforce such right.

Accordingly, through screening or performance requirements, capital controls may escape investor-state dispute settlement mechanism. This is, however, limited to an investor who does not have any investment in the territory of the state party to the BIT. In case of an investor who is discriminated against with regard to extending its investment in the host country, this dispute

¹⁴⁰ *Id.*, para. 48.

¹⁴¹ *Id.*

¹⁴² *Id.*, para. 60.

¹⁴³ *Id.*

¹⁴⁴ *Id.*, para. 61.

would be covered under the dispute settlement mechanism because an already admitted investment is entitled to the right to expand.

Additionally, in the case of expansion, it is submitted that a foreign investment that is already established under the UK and German Model BITs would be able to challenge a denial of the right to expand, since this would be a dispute related to an investment as required under these Model BITs.

Furthermore, after admission, an investment would be entitled to import the necessary capital to conduct its business under German and US Model BITs. In addition, such right might be found under the UK Model BIT by virtue of MFN, or fair and equitable treatment clauses. In such cases, the foreign investor would be entitled to seek arbitration for denial or restriction of its rights to transfer inward capital necessary for its investment.

Thus, except in a case of an expansion of an already established investment, the state investor dispute settlement mechanism is not available to private investors for the phase prior to admittance.¹⁴⁵ However, once admitted, a foreign investor will be entitled to seek arbitration to import capital necessary for its investment.

This conclusion may not seem reasonable, since a wrongful rejection to admit a foreign investor appears to be more substantial violation of the BIT than discrimination after admission.

However, a foreign investor who is already in the host country and has already committed capital therein is probably in a worse position than a foreign investor who is not in the host country. A foreign investor who is already in the host country may need additional capital to face certain financial or other circumstances without which the investment may be lost by not being able to compete or continue. On the other hand, a foreign investor who is not admitted loses only preparatory expenses, but not the main investment capital.

¹⁴⁵ Cf. *Mihaly International corporation v. Democratic Socialist Republic of Sri Lanka*, ICSID award no. ARB/00/2, at 15, para. 49-50 (March 15, 2002) (for the proposition that expenses incurred before establishment can be considered investment under ICSID Convention if the negotiation between the investor and the host state was successful and the investor was admitted. In such case, the preadmission expenses may retroactively be deemed investment).

C. Main Characteristics

Under most BITs, contrary to customary international law, a foreign investor does not need to exhaust all host state remedies before seeking arbitration under BITs. Further, these disputes normally challenge a measure -- e.g. a legislation or regulation -- made pursuant to the regulatory power of the host state. Any decision against the host state might require the state to change or cancel its measure.¹⁴⁶ This is because, in addition to the damages that the claimant investor will be entitled to, other similarly situated foreign investors will have a claim under the same BIT, or a similarly worded BIT or treaty.¹⁴⁷

Although arbitration is the method used for resolving these disputes, these are not mere contractual claims, but rather claims arising from an alleged breach by the host country of an international law obligation.¹⁴⁸ In a dispute under a BIT, the applicable rules and laws are the relevant BIT provisions and its choice-of-law provision, if any.¹⁴⁹ The BIT's choice of law provision could be the host State law or international law or both.¹⁵⁰ If there is no choice of law, the tribunal chooses the applicable law. There, the rules of arbitration and *lex arbitrii* are relevant. In ICSID arbitration, for example, the ICSID Convention provides that if there is no choice of law, the tribunal must apply the host State law and applicable rules of international law.¹⁵¹

In any case, because the BIT is an international treaty, one of the applicable laws applied by investment arbitral tribunals would always be public international law, at least in interpreting

¹⁴⁶ Salacuse, *supra* n. 123, at 141.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*, at 140.

¹⁴⁹ *ADC Affiliate Limited and ADC & ADMC Management Ltd v. Republic of Hungary*, ICSID Case No. ARB/03/16 (Award), ¶ 290 (Oct. 2 2006) (finding that by consenting to arbitration under a BIT, the applicable law is the BIT and international law rules on interpretation and application of the BIT's provision).

¹⁵⁰ See, e.g., *UK-Argentina BIT*, art. 8(4) ("The arbitral tribunal shall decide the dispute in accordance with the provisions of this Agreement, the laws of the Contracting Party involved in the dispute, including its rules on conflict of laws, the terms of any specific agreement concluded in relation to such an investment and the applicable principles of international law."); *Treaty Between the United States of America and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment*, signed November 4, 2005, Art. 30 (*entered into force* Nov. 1, 2006) (providing for the application of international law except for disputes relating to an investment agreement or investment authorization, where the host State laws and applicable rules of international law shall apply if there is no agreement otherwise); Dolzer & Schreuer, *supra* n. 21, at 266 ("[T]he clause on applicable law in the [IIA] becomes a choice of law agreed by the parties to the arbitration.").

¹⁵¹ Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, done at Washington DC on 18 March 1965, Art. 42 (*entered into force* 14 Oct. 1966).

BIT's provision.¹⁵² This means that changes in local laws will not substantially affect the rules applicable to these disputes, and will leave the host state without the ability to amend the rules applicable to these disputes.¹⁵³

Most importantly, investor-State arbitration also differs from commercial arbitration because it involves general policy decisions that involve the public. Such arbitrations are usually publicized and attract a great deal of public and media attention. Many groups, including parliamentarians, get to announce their views, and this might affect the host countries and investors' approaches during the arbitration.¹⁵⁴

Another feature of the BIT's investor-State arbitration is that only the investor can file for arbitration and not the host State: the claimant will always be the investor and the respondent is always the State, even when the BIT's provision allows the host State to file for arbitration. For example, under the UK Model BIT, each contracting state gives its unilateral consent to submit to ICSID's jurisdiction regarding any dispute in relation to an investment in its territory.¹⁵⁵ This allows a foreign investor to request arbitration under ICSID if the dispute is not solved within three months.¹⁵⁶ Although the provision allows both the host country and the investor to submit the dispute to ICSID, the investor has to consent to ICSID's jurisdiction because only the host state is obligated to submit to ICSID under this provision.¹⁵⁷ Thus, only the foreign investor decides whether to submit the dispute to ICSID.

Additionally, many BITs and Model BITs dispute settlement provisions give the foreign investor the option to choose the arbitration forum and rules for arbitration from several options, including the International Centre for the Settlement of Investment Disputes (ICSID), International Chamber of Commerce (ICC) and the United Nations Commission on International

¹⁵² See Salacuse, *supra* n. 123, at 140.

¹⁵³ *Id.*

¹⁵⁴ *Id.*, at 141.

¹⁵⁵ *UK Model BIT*, art. 8 (1) ("Each Contracting Party hereby consents to submit to the International Centre for the Settlement of Investment Disputes (hereinafter referred to as "the Centre") for settlement by conciliation or arbitration under the Convention on the Settlement of Investment Disputes between States and National of Other States opened for signature at Washington on 18 March 1965 any legal dispute arising between that Contracting Party and a national or company of the other Contracting Party concerning an investment of the latter in the territory of the former.").

¹⁵⁶ *UK Model BIT*, art. 8 (3).

¹⁵⁷ *UK Model BIT*, art. 8 (3) ("[I]f the national or company affected also consents in writing to submit the dispute to the Centre for settlement by conciliation or arbitration under the Convention, either party may institute proceedings by addressing a request to that effect to the Secretary-General of the Centre as provided in Articles 28 and 36.").

Trade Law (UNCITRAL). The Model UK BIT allows the investor and the host state to choose between ICSID, the Court of Arbitration of the International Chamber of Commerce, and an arbitrator or ad hoc arbitral tribunal. If they cannot agree on one of these methods, the arbitration must take place in accordance with UNCITRAL Arbitration Rules.¹⁵⁸

The US Model BIT allows the foreign investor to choose between ICSID arbitration and UNCITRAL arbitration.¹⁵⁹ Similarly, the German Model BIT contains two models of arbitration between the State and investors. One is under ICSID Convention and the other is under UNCITRAL.¹⁶⁰ All of these choices are of ad hoc tribunals, meaning that there is no permanent tribunal that decides cases and there is no hierarchy between these tribunals.

D. Breadth

The broad provisions and scope of BITs arbitration provisions mean that laws and regulation of host States would be subject to this arbitration. There are many reasons that arbitration under BITs could negatively affect the regulatory powers of the State, especially the developing States. These reasons are not theoretical; as will be shown, practice has revealed their validity.

First, the scope of the tribunal's coverage *ratione materiae* is very broad—it applies to any dispute relating to investment under the German and UK Model BITs, and to alleged violation of the BIT in relation to investment under the US Model BIT. Accordingly, general regulatory measures that affect investment fall under the scope of the tribunal's jurisdiction.

Second, given the broad definition of investment, the broad and ambiguous meanings of the standards and obligations under BIT, and the applicable laws to these obligations—especially international law—that leave a wide discretion to tribunals to determine the substantive content of the rules, tribunals have formulated different rules that encroach on the regulatory discretion of host States.¹⁶¹

Third, there is no precedent system in international arbitration and no appellate body to ensure the coherence, stability and certainty—an essential basis to exercise regulatory powers and for

¹⁵⁸ *UK Model BIT*, art. 8 (Settlement of Disputes between an Investor and a Host State).

¹⁵⁹ *U.S. Model BIT 1992*, art. VI.

¹⁶⁰ *German Model BIT*, art. 11.

¹⁶¹ See Van Harten, *supra* n. 72, at 72-74.

investors to know the extent of their rights and risks—of the legal rules.¹⁶² This is because in arbitration, arbitral tribunals are not obliged to follow precedents.¹⁶³

Accordingly, some tribunals have issued contradictory decisions under BITs and other investment agreements. Contradictions come in cases that can be divided into the following categories: (i) cases with same facts filed by different but related legal personalities for the same claims before different tribunals under different treaties with similar provisions; (ii) cases where different tribunals interpret the same provisions in the same treaty differently; and (iii) cases with different circumstances but similar investor's rights alleged to be violated.¹⁶⁴

For example, in several awards against Argentina arising from its financial crisis, arbitral tribunals have reached contradictory interpretations and results as to whether there was a necessity that excused Argentina's violation of its BITs obligations. resulting from the same financial crisis under the same BITs and similar BITs provisions.¹⁶⁵

The state of necessity was invoked by Argentina in several cases arising from its financial crisis. Several arbitral tribunals have ruled differently on the conditions for this defense and on its availability in investor-state disputes.

In *CMS*, a dispute that resulted from measures taken by Argentina during its financial crisis, Argentina argued that it should be exempt from liability for these measures by reason of "state of

¹⁶² See Christoph Schreuer & Matthew Weiniger, *A Doctrine of Precedent?*, in *The Oxford Handbook of International Investment Law*, at 1189 (eds. Peter Muchlinski *et al.*, OUP, 2008) ("The need for a coherent case-law is evident. It strengthens the predictability of decisions and enhances their authority. . . . [I]t is also well established that the doctrine of precedent, in the sense known in the common law, does not apply in international adjudication."); *El Paso Energy International Company v. Argentine Republic*, ICSID Case No. ARB/03/15 (Decision on Jurisdiction), para. 39 (Apr. 26, 2006) ("ICSID arbitral tribunals are established ad hoc, from case to case, in the framework of the Washington Convention, and the present Tribunal knows of no provision, either in that Convention or in the BIT, establishing an obligation of *stare decisis*." [hereinafter *El Paso Jurisdiction*]; *Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3 (Decision on Jurisdiction—Ancillary Claim), para. 25 (Aug. 2, 2004) [hereinafter *Enron*] ("The Tribunal agrees with the view expressed by the Argentine Republic in the hearing on jurisdiction held in respect of this dispute, to the effect that the decisions of ICSID tribunals are not binding precedents . . .").

¹⁶³ Beauvais, *supra* n. 125, at 263; Price, *supra* n. 130; Alan Redfern & Martin Hunter *et al.*, *Law and Practice of International Commercial Arbitration*, at 25 (Sweet & Maxwell, 2004).

¹⁶⁴ Franck, *supra* n. 72, at 1558.

¹⁶⁵ See, e.g., *CMS Final Award*, paras. 320-324 (finding that the financial crisis did not excuse Argentina's violation of its BITs); *Sempra*, paras. 363, 388 (same), *Enron*, paras. 294-312 (same); *LG&E*, para. 201 (finding that a state of necessity excused Argentina's violation of its BITs).

necessity”.¹⁶⁶ In dealing with this defence, the tribunal based its analysis of the state of necessity on Article 25 as reflecting customary international law on the issue.¹⁶⁷ It described the crisis as resulting from “economic conditions that made it impossible to maintain the fixed exchange rate and which gradually led to the greatest default on foreign debt in history and the collapse of the Argentine financial markets.”¹⁶⁸

The tribunal conceded that such change in circumstances affects “the governing legal and contractual arrangements.”¹⁶⁹ It further maintained that it was controversial whether the financial crisis is caused by foreign investment resulting from opening the country thereto, or by the partial reform by Argentina which did not stop the government interference.¹⁷⁰

The tribunal further added that, although the crisis is “severe,[...] in international affairs and international law, situations of this kind are not given in black and white but in many shades of grey.”¹⁷¹ Because the crisis had what the tribunal called “relative effect,” it cannot be invoked to preclude wrongfulness on the part of the host country even though the crisis was severe, and the circumstances warranted the host country measures to avoid “total economic collapse.”¹⁷²

Regarding whether the measures are the only means available for Argentina, the tribunal found this issue controversial, because some economists have suggested different methods to deal with the crisis other than what Argentina has taken.¹⁷³ The tribunal relied on the commentary of the International Law Commission to the effect that if there are other ways to deal with the necessity, albeit “more costly or less convenient”, the necessity ground shall be dismissed.¹⁷⁴

¹⁶⁶ *CMS Final Award*, para 304. Argentine raised this argument by using other legal bases like *force majeure*. The Tribunal, apparently, understood these terms as interchangeable terms for state of necessity, which do not refer to different basis. *Id.* However, *force majeure* constitutes a different basis under Article 23 of The International Law Commission’s Articles on State Responsibility. See James Crawford, *The International Law Commission’s Articles on State Responsibility: Introduction, Text and Commentaries*, at 170 (Cambridge University Press, 2002). The commentary on Article 23 states that “*force majeure* does not include circumstances in which performance of an obligation has become more difficult, for example due to some political or economic crisis.” *Id.* at 171.

¹⁶⁷ *CMS Final Award*, para 315.

¹⁶⁸ *Id.*, para. 153.

¹⁶⁹ *Id.*, para. 154.

¹⁷⁰ *Id.*, para. 153.

¹⁷¹ *Id.*, para. 320.

¹⁷² *Id.*, paras. 321-322.

¹⁷³ *Id.*, para. 323.

¹⁷⁴ *Id.*, para. 324.

Accordingly, it found that these measures were not the only method available as required by Article 25.¹⁷⁵

The tribunal also distinguished between “severe” crisis and “a situation of total collapse” -- only in the latter case can the host state invoke the necessity or emergency clause in the BIT.¹⁷⁶

What’s more, the tribunal found that Argentina had created the crisis by the policies of its different governments that went back to the 1980s crisis.¹⁷⁷ It did not conceal its disapproval of the government’s policies and the measures taken by the government “that reached its zenith in 2002 and thereafter.”¹⁷⁸

The tribunal’s reasoning in *CMS* makes it hard, if not impossible, to invoke the state of necessity. By its introduction of the concept of “relative effect”, it is creating a general rule that the necessity cannot be invoked because in the international arena, these issues are “relative”. This reasoning evades evaluating the circumstances of the crisis and contradicts the tribunal’s description of the crisis as “severe”, and could have cause a total collapse of the economic system.

In addition, it is hardly conceivable that economists will ever agree on one solution for a financial crisis. By the tribunal’s reasoning regarding the condition that the measures should be the only means available, it closed the door for any host country to invoke necessity in a financial crisis. With regard to the means available, it seems the tribunal does not accord any degree of deference to the host country in such situations.

The distinction between “severe” and “total collapse” situation is without basis, vague enough to be objectively considered, and the tribunal itself used both terms to describe the crisis in Argentina.

It should be noted that the reasoning of the *CMS* tribunal regarding the state of necessity was criticized as an error of law by the ad hoc annulment committee, which found that the tribunal had committed an error of law by equating the BIT Article XI on the effect of state of emergency

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*, para. 354.

¹⁷⁷ *Id.*, para 329.

¹⁷⁸ *Id.*

with customary law on the defense of necessity and by dealing with the latter only, and that its interpretation of Article XI was erroneous.¹⁷⁹

In *BG*, a dispute under the Argentina-UK BIT, the tribunal refused outright to apply the necessity defense. It reasoned that this is a defense that is available under customary international law between States, but is not available in case of State-investor dispute under a BIT.¹⁸⁰ It further added that since the Argentina-U.K. BIT does not provide for necessity defense, such defense is implicitly precluded. It stated:

[T]he Commentary to the ILC Draft Articles indicates that a defense based on necessity is precluded “where the international obligation in question explicitly or implicitly excludes reliance on necessity.” It can be argued that the Argentina-U.K. BIT implies such exclusion. Thus, Argentina would not be entitled to invoke necessity to unilaterally revoke vested rights (e.g., a dollar denominated tariff and economic equilibrium) designed precisely to operate in situations where a run on the currency would lead to a situation of necessity. There is no question that Argentina is entitled to adopt such measures as it deems appropriate to emerge from the state of emergency. However, it remains obligated to pay compensation. This is one view as to how bilateral investment treaties operate to induce foreign investment. Assuming that necessity were to justify some fair and non-discriminatory measure by Argentina, an obligation to compensate would still obtain by virtue of the BIT.¹⁸¹

Yet in *LG&E*, the tribunal found that necessity under public international law applied and that that Argentina’s financial crises justified its violation of its BITs obligations.¹⁸²

Another example is related to two cases that had the same facts where a Dutch company (CME) and its American owner, Mr. Ronald Lauder, initiated two arbitration proceedings under two different BITs. The facts relate to an investment in television channel operation in the Czech Republic, where Mr. Lauder decided to invest in a corporation that applied for a television operating licence.

¹⁷⁹ *CMS Gas Transmission Company v. Argentine Republic*, ICSID Case No. ARB/01/8 (Annulment Decision), paras. 129-135 (Sept. 25, 2007).

¹⁸⁰ *BG Group Plc v. Argentina*, UNCITRAL (Award), para. 408 (Dec. 24, 2007) (“Article 25 may relate exclusively to international obligations between sovereign States. From this perspective, Article 25 would be of little assistance to Argentina as it would not disentitle BG, a private investor, from the right to compensation under the Argentina-U.K. BIT.”).

¹⁸¹ *Id.*, para. 117.

¹⁸² *LG&E*, para. 201.

In *Lauder*, the tribunal dismissed claims that the initiation of investigation against CNTS was arbitrary and discriminatory. It found that the investigation was not arbitrary because there were valid reasons to suspect that CNTS was not complying with the law as amended to require only the person who was awarded the licence to broadcast.¹⁸³ Furthermore, the initiation of investigation was not discriminatory because similar investigations were launched against a domestic corporation.¹⁸⁴

The tribunal also dismissed the investor's allegation that the Media Council interference in the contractual relations between CNTS and CET 21 was arbitrary and discriminatory. The tribunal found that the contractual relation was vague and cast suspicion on whether the licence was illegally transferred to CET 21.¹⁸⁵ Therefore, the Media Council had "an objective ground" to ask for a clear contractual relation compliant with the law.¹⁸⁶ The tribunal then turned to allegations of violation of FET. It found that the State's actions were reasonable and consistent with the proper application of its laws.¹⁸⁷

The above reasoning of *Lauder* is at odds with *CME*'s reasoning.¹⁸⁸ The CME tribunal found that the changes made in 1996 to grant CNTS only the know-how of the license instead of the use of the license amounted to a "coercion" that changed the legal foundation for the investor's investment, and destroyed the legal protection of the investment.¹⁸⁹ The agreement of CNTS to these changes does not change the nature of its illegality, since CNTS was forced to accept them because it did not want to risk losing its investment if the licence was cancelled.¹⁹⁰

In reaching its conclusion, the tribunal found the criterion suggested by Professor Vagts for a code of unfair bargaining practices in the negotiations between investors and governments governing, which states: "Cancellation of the franchise, permit, or authorization to do business in which the investor relies, except in accordance with its terms; and Regulatory Action without bona fide governmental purpose (or without bona fide timing) designed to make the investor's

¹⁸³ *Lauder v. Czech Republic*, UNCITRAL (Final Award), para. paras. 248-252 (Sept. 3, 2001).

¹⁸⁴ *Id.*, paras. 256-258.

¹⁸⁵ *Id.*, paras. 263-266.

¹⁸⁶ *Id.*, para. 270.

¹⁸⁷ *Id.*, para. 296.

¹⁸⁸ *CME Czech Republic B.V. v. Czech Republic*, UNCITRAL (Partial Award), (Sept. 13, 2001).

¹⁸⁹ *Id.*, para. 505.

¹⁹⁰ *Id.*

business unprofitable.’”¹⁹¹ The tribunal concluded that requiring the 1996 changes was in breach of this criterion, and in breach of the BIT, and that the Media Council should have refrained from altering the structure it previously agreed upon.¹⁹²

The tribunal, in finding that the Czech Republic breached its FET obligation, rejected the defense that other broadcasters were required to have similar arrangements dividing the licence holder from the provider of the service as irrelevant.¹⁹³ The criterion of FET is not national treatment, but rather the breach of international law. By destroying the legal foundation under which the foreign investor relied on and made its investment under, the government breached the FET obligation.¹⁹⁴

While both tribunals have referred to international law in their analyses, a methodological difference led to different results. In *Lauder*, the tribunal analysis assumed the government actions were valid, and asked if there was a proof of discrimination or arbitrariness on the government side. Finding no discrimination and legitimate concerns to take the measures, it did not find that violation was established. In *CME*, on the other hand, the tribunal started its analysis by suspecting any measures, including general laws that affect the legal structure of the investment.

This shows that even though the facts were the same, the submissions were identical to both tribunals, and the legal provisions were similar and the applicable law was the same; tribunals end up issuing completely contradictory awards in light of the ambiguous standards and the absence of supervisory or appellate authorities. In addition, many tribunals have ignored State practice when interpreting international law and State submissions on the interpretation of substantive rules. For example, the NAFTA tribunal in *Pope & Talbot* rejected previous tribunal’s interpretation of the same provision, the interpretation submitted by all NAFTA State parties and the claimant, and interpreted the provision differently while acknowledging that the plain meaning of the provision did not conform to its interpretation.¹⁹⁵

¹⁹¹ *Id.*, para. 526 (quoting Detlev F. Vagts, *Coercion and Foreign Investment Re-Arrangements*, American Journal of International Law at 34 (1978)).

¹⁹² *Id.*, para. 520.

¹⁹³ *Id.*, para. 611.

¹⁹⁴ *Id.*

¹⁹⁵ *Pope & Talbot, Inc. v. Canada*, NAFTA Ch. 11 (Award on the Merits, Phase Two), paras. 106-110 (Apr. 10, 2001).

To conclude, this shows a jurisprudence that is not coherent, and arbitral awards which are usually unforeseeable.¹⁹⁶ Part of the incoherence can be explained by the ambiguity of the terms and broad language used in these agreements, and the ambiguity in customary international law regarding investment.¹⁹⁷ In cases where customary international law was found to be applicable, different tribunals used different criteria and standards.¹⁹⁸ This adds to the existing ambiguity in this branch of international law and in already ambiguous general international obligations under BITs.¹⁹⁹ Some of these cases, which were decided without public involvement, implicated public policy issues and have different political and economic effects.²⁰⁰ This threatens the stability of the legal system and does not allow for the establishment of coherent and foreseeable norms that regulate the actions of countries and foreign investors.²⁰¹

Furthermore, the current ad hoc arbitral tribunals regime is not the appropriate forum for challenging general regulatory measures of the host State.²⁰² Without the power to correct and unify the interpretation of BITs obligation, balance private and public interest investor-State arbitration may not be the best regime to deal with general regulatory issues—arbitration may be appropriate in private commercial relations where parties may choose for the convenience of flexible procedures and confidentiality, however, it may not be the appropriate forum for adjudicating public interest cases involving regulatory powers of states and public policy decision.²⁰³ Arbitrators are chosen on a case-by-case basis by parties to the dispute. They do not have the independence and accountability attributes of judges, which constitute the basis of their legitimacy.²⁰⁴

¹⁹⁶ Rudolf Dolzer, *Indirect Expropriations: New Developments?*, 11 N.Y.U. Envtl. L.J. 64, at 68 (2002).

¹⁹⁷ See Charles H. Brower II, Structure, Legitimacy and NAFTA's Investment Chapter, 36 Vand. J. Transnat'l L. 37, at 41 (2003) (noting the ambiguous language and obligation in NAFTA); Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine*, 78 N.Y.U. L. Rev. 30, at 51-54 (2003) (arguing that there is ambiguity in the terms "indirect expropriation" and "tantamount to expropriation" used in the BITs and NAFTA whether it is meant to follow customary international law or establish new criteria. It also discusses the ambiguity of customary international law.)

¹⁹⁸ Been & Beauvais, *supra* n. 197, at 53–54.

¹⁹⁹ Beauvais, *supra* n. 125, at 263 (2002)

²⁰⁰ Franck, *supra* n. 72, at 1521-1522.

²⁰¹ Dolzer, *supra* n. 196, at 73.

²⁰² See generally, Van Harten, *supra* n. 72, at 152-184; Geiger, *supra* n. 126, at 109.

²⁰³ Beauvais, *supra* n. 125, at 262.

²⁰⁴ *Id.*, at 262-263.

This is partly a result of there being no body responsible for resolving the inconsistencies of the decisions under the BITs.²⁰⁵ The absence of binding authorities or an appellate mechanism has led to inconsistent body of case law and interpretations. Although many arbitral awards cite to and adopt reasoning of other awards, this is not mandatory, and thus many awards did not follow previous decisions.²⁰⁶

In addition, the arbitral tribunals established under BITs have a broad discretion to award different kinds of remedies. The tribunal in *Enron* affirmed its right to issue declaratory decisions, injunctive relief, and other non-pecuniary remedies.²⁰⁷ It based this power on previous decisions and academic opinions. The inherent power of an international tribunal to order the end of an illegal action or omission that violates international obligations is recognized in these authorities.²⁰⁸ In this regard, some FTAs such as NAFTA has restricted the remedies that a tribunal can grant to monetary compensation and restitution of property.²⁰⁹ NAFTA expressly prohibits injunctions of host States' measures.²¹⁰

V. Conclusion

Some interpretations of standards like, MFN and FET give them broad applications that apply the most favourable treatments provided in different BITs to allow the foreign investor to avoid limitations or exceptions in the transfer provisions, restrict the regulatory powers of States to vary their treatment to different sectors or to make amendments to their regulatory frameworks. Accordingly, under MFN, if the host State has a BIT or other treaty that has free transfer of capital inflows or a more favourable treatment in any way from the foreign investor home State BIT, the most favourable treatment would apply.

²⁰⁵ Franck, *supra* n. 72, at 1546.

²⁰⁶ See *El Paso Jurisdiction*, para. 39 (“It is, nonetheless, a reasonable assumption that international arbitral tribunals, notably those established within the ICSID system, will generally take account of the precedents established by other arbitration organs, especially those set by other international tribunals.”).

²⁰⁷ *Enron*, para 81.

²⁰⁸ *Enron*, paras.78-80.

²⁰⁹ *North America Free Trade Agreement (NAFTA)* signed Dec. 17, 1992, NAFTA, art. 1135 (entered into force Jan 1994).

²¹⁰ *Id.*, art. 1134.

The broad obligation of MFN combined with different levels of substantive rights in different BITs concluded by a developing country, narrows the regulatory autonomy of this country in controlling capital outflows.

Furthermore, other broad and absolute obligations such as FET result in denying the host State the ability to amend, even temporarily, its legal regime in response to a crisis. Other obligations such as the prohibition of indirect expropriation could be relevant. However, given the FET broad interpretation, it is recognized that it would be the more relevant and applicable to capital transfers regulation.

Finally, investor-state arbitration, however, suffers from systemic shortcomings that exacerbate the substantive problems. There is no mechanism to ensure coherence or consistent application of the law, which leads to uncertainty and inconsistent interpretations. Tribunals come to different conclusions for the same facts and different interpretations for the same provisions. It was shown how tribunals decide in inconsistent ways, even when applying the same rules.

To conclude, direct and indirect regulation of investment and capital movement under the Model BITs may provide rights to transfer capital that considerably restricts the host State monetary sovereignty to regulate capital flows, especially during financial crises. This is augmented by a dispute settlement mechanism that is not able to produce consistent and coherent law.

Chapter Six: Conclusion

The issue of international capital movement is an important subject in international economics given the amount of international capital movement and its effect on the global economy. It is also important in international investment law. After all, there is no foreign investment without transfer of capital.

While much academic work has focused on the transfer of capital in international economics, as well as general discussion of the benefits and disadvantages of liberalization of international capital movements, writings in international investment law have generally discussed the interpretation of transfer provisions in treaties. Occasionally, they have also addressed other treaty obligations and their possible effect on capital controls and restrictions. The latter works have emphasized the importance of BITs' guarantee of the free transfer of capital without analyzing their defects. They have also focused on the repatriation of capital, rather than the admission of capital and the underlying investment.¹ In this context, BITs have been advocated as a means to induce investment, which may lead to growth and development. To encourage foreign investment, BITs provide that foreign investors are entitled to transfer capital relating to their investment.

While the evidence suggests that foreign direct investment leads to economic growth, it is also true that some kinds of investment and capital movement may cause or contribute to economic crises.² This study has analyzed BITs' regulation of capital movements in the context of its effect on the liberalization of capital account and such liberalization's relationship to financial crises. Its principal conclusion is that BITs regulation of capital movement is defective and imbalanced. It is in need of reform so that there can be balance between foreign investors' need to transfer funds and the states' right to regulate the transfer of funds. This study emphasizes the importance of the regulation of international capital movement, and the effect of the liberalization of capital transfers on financial crises. This is where there is an inherent imbalance

¹ See e.g. Abba Kolo & Thomas Walde, *Capital Transfer Restrictions under Modern Investment Treaties*, in STANDARDS OF INVESTMENT PROTECTION (ed. August Reinisch, OUP, 2008).

² See Chapter II.

in BITs that might negate the goals of economic growth and development of the host State. This study concludes that the existing regulation of capital movement under the BIT framework is deficient, both substantively and procedurally.

Substantively, in endeavouring to protect and liberalize foreign investments and capital, BITs, by and large, include absolute, broad, and immediate obligations that liberalize the movement of capital. These obligations do not distinguish between different kinds of investment and capital. They effectively curtail the regulatory power of the host state without providing criteria to strike a balance between investors' rights and states' regulatory rights to protect their economies against volatile capital, and to prevent and mitigate economic crises. The substantive defects are augmented by a dispute settlement mechanism that has resulted in ambiguous and incoherent interpretation of what were already dysfunctional provisions.

The BITs and case law examined in this study reveal that the substantive defects result in a state of incoherence and ambiguity amplified by the existence of ad hoc investor-state arbitration that has its own structural deficiencies. These defects are interconnected. They reinforce each other in curtailing the host State's ability to regulate capital movement. Yet this study recognizes that foreign investors may be victims of these defects as much as States. There is no guarantee that the ambiguity of the content of BITs' obligations, or the incoherence, inconsistency, and unpredictability of their interpretation and application will protect the legitimate interests and rights of either investors or States.

This concluding chapter starts with a discussion of the necessity of regulating capital movement. It then proceeds to identify the substantive and procedural defects in BITs and their interrelationships. Finally, it proposes some suggested reforms to BITs.

I. The Necessity of Regulation

Without regulation, liberalization of all kinds of capital movement is likely to cause financial difficulties and crises. Indeed, some kinds of capital flows are inherently volatile. They follow differences in interest rates or speculate on currencies targeting short term gain, without adding any value to the economy. Once the interest or exchange rates change, or interest rates in

another country provide a better profit margin, this capital leaves the host state. Investors in such capital typically move in herds, and their movement can cause financial difficulties and crises.

The destabilizing effect of these flows should not be underestimated. A sudden influx of short term capital inflows in a country may change its fundamentals, such as raising its currency exchange rates. When this capital moves out of the country for any reason not relating to its fundamentals, which were not accounted for in the first place, they cause financial difficulties and crises.

In addition, while some kinds of capital flows may not be inherently volatile, they may require the existence of an advanced economy and regulation to achieve growth and development in the economy. If no such environment exists, they may also cause economic difficulties. This makes it even more important for developing states to regulate the admission of capital and to have some regulatory discretion, in case of financial crises, to regulate capital outflows.

The movement of capital is not only caused by internal factors related to the host State economy or fundamentals. It also results from external factors that are completely unrelated to the host State economy (such as self fulfilling attacks and contagion problems). This is particularly true in developing States where investors may not trust in the host State's ability to avoid or withstand the consequence of crises or financial difficulties that take place internally or in similarly situated countries. Even developed countries may be subject to self-fulfilling attacks or contagion problems, as illustrated in the recent financial crisis.

To avoid the destabilizing effect of certain kinds of capital, States must be able to regulate capital movements according to their circumstances. They may have to use different kinds of capital controls and exchange controls on both capital inflows and outflows. Certainly, the need to use capital controls, and their intensity, will depend on the sophistication of the host State's market and its ability to deal with different kinds of capital.

In normal circumstances, capital controls on the inflow of capital appear to be necessary to avoid destabilizing capital, such as capital transfers that follow differences in interest rates for short-term gain. The host State may impose direct or indirect capital controls, such as requiring approval or registration of capital inflows, whereby the admitted capital stays in the host State

for a certain period, or whereby certain taxes are imposed on the admission of capital or unremunerated reserve requirement on foreign obligations to avoid speculative capital.

Also, controls on capital inflows and outflows may be needed in exceptional circumstances to prevent or mitigate financial crises or balance of payment difficulties. Almost all major multilateral and regional instruments that deal with foreign investment and capital include certain exceptions to allow States to restrict capital movements in these cases.

II. Immediacy of Liberalization

The obligations regarding the transfer of capital and other obligations are effective immediately. The immediate liberalization covers all kinds of capital in all sectors except for sectors included in a list: the negative list. Immediate liberalization combined with the negative list stands in contrast with the liberalization of capital under other multilateral agreements and instruments that promote gradual liberalization through a positive list. The available evidence indicates that immediate liberalization of all sectors, and for all kinds of capital, does not favour developing countries and restricts their ability to prevent and mitigate the consequences of financial crises.

The immediacy combined with absolute and broad obligations does not allow for the development of a sophisticated market that can absorb the various different kinds of capital. Accordingly, it is not suitable for developing states. Further, regulation of capital movement may be necessary -- not in relation to the sector or industry, but rather in relation to the kind of capital, transaction or investor that should be restricted or accredited.

This study therefore concludes that the immediate liberalization of capital movement without sequencing, distinguishing between different kinds of capital, or allowing for exceptions for economic crises and balance of payment difficulties does not consider the different circumstances of different states, the history of economic crises, nor the experience of most states with capital account liberalization.

III. Breadth and Ambiguity of Liberalization

“Breadth” relates to the concepts of investment and related capital; the scope of the transfer provisions; the obligation to grant fair and equitable treatment (FET); the obligation to accord

foreign investment most favoured nation treatment (MFN) and national treatment (NT); and the prohibition of indirect expropriation. Each of obligations is broadly drafted, defined and interpreted. This breadth is a source of ambiguity and incoherence, and unduly restricts the regulatory powers of the host state over capital movements.

First, while the transfer provisions are not uniform and interpretation may vary, they are all broad in terms of their scope and subject. This stems from the broad definition of investment, which determines the scope of BITs and is broadly defined to include not only foreign direct investment, indirect investment and other kinds of investment, but also any kind of asset that has economic value. This, in turn, is reflected in transfer provisions that provide for the free transfer of funds related to investment and its returns. This broadens the scope of BITs, its obligations and the funds entitled to free transfer far beyond what is necessary to protect and promote investment, The capital subject to the transfer obligation includes almost any transfer of funds for transaction or asset that has a financial value.

Second, transfer provisions do not distinguish between long term capital, short term capital, and non-productive destabilizing capital that seeks short term gains, since the investment definition covers all these kinds of capital; transfer provisions do not always distinguish between them, and many cover both inflows and outflows of capital.

Third, other obligations and standards of treatment that apply to the transfer of funds are broad and some lack a clear content and meaning. They have been interpreted by many tribunals in favour of the foreign investor and given broad content under which several broad and unreasonable obligations were imposed. These obligations are interpreted without being limited to the ordinary meaning of the words of the treaty or to state practice.

A clear example of this is the FET obligation, with all its breadth and ambiguity. It has been interpreted to include obligations that do not stem from its ordinary meaning, nor are they supported by States' practice. Such obligations overlap with other obligations under BITs including the obligations of transparency, stability; acting consistently, without discrimination or arbitrariness; the obligation on the host State to ensure that its regulation and policies are clear, and to act pre-emptively to prevent any misunderstanding that a foreign investor may have; and the obligation to notify investors beforehand of any changes it seeks to introduce to its laws and

policies. These obligations can paralyze the regulatory powers of States over capital movements. They also include obligations that are included in other standards of treatment, like national treatment and most favoured nation treatment.

FET has also been interpreted to mean no more than the minimum standard of treatment. Yet while some tribunals interpreted the minimum standards narrowly, many tribunals have broadened the scope and content of the minimum standard.

It is not only FET that has been interpreted expansively and inconsistently by arbitral tribunals. The NT and MFN clauses have also been broadly interpreted. In particular, when it came to identifying the appropriate comparator (whether it must be an identical competitor of the foreign investor, or merely an entity in a similar class which is not identical), tribunals have reached inconsistent decisions. The broader interpretation, when applied to treatment of capital movement, may restrict the ability of the host state to treat different kinds of capital differently.

Similarly, the prohibition of indirect expropriation, which also applies to the transfer of capital, is broadly defined and ambiguous. It does not clearly distinguish between compensable and non-compensable measures. This results in an expansive definition of indirect expropriation that covers legitimate regulation.

The broad meaning given to investment combined with the rather ambiguous standards which are interpreted broadly hinders the regulatory powers of State parties. These obligations, as interpreted by many tribunals, are not always reasonable and do not conform to the rules of interpretation under international law nor to expectations of state parties that their legitimate regulatory powers would be respected. While some tribunals, and some State practice, have tried to limit these obligations to reasonable standards, inconsistencies and different interpretations are bound to continue because of the breadth and ambiguity of the standards, and the freedom of each tribunal to interpret the obligations without regard to other tribunals' interpretations.

Of course, some state practices, such as in the US, have recognized this defect and tried to limit and clarify the content of the broad concepts and obligations in its most recent model BIT. Yet the bilateral nature of BITs does not permit these defects to be treated globally and only applies to future BITs concluded by these countries.

IV. Absoluteness of Liberalization

One of the main problematic issues in BITs is that the liberalization of capital flows is absolute and immediate. The term absolute is used here to refer to two concepts: (i) the absolute nature of the obligation; and (ii) the non-contingent nature of the obligation. The former means that the obligation to permit capital transfers does not generally provide for restrictions or exceptions. The latter means that the obligation to permit the unrestricted flow of capital is not contingent on a third party's treatment, whether that third party is a national or other foreigner.

First, many BITs require the transfer of capital related to investment, as illustrated in the Model BITs and BITs discussed in this study. This requirement is absolute – the BITs do not permit the host state to impose any restrictions or capital controls on the transfer of funds relating to an investment regardless of the national treatment of similar transfers. BITs also specify the exchange rate and time of transfer. Accordingly, a host state cannot impose administrative capital controls. Moreover, it may not be able to impose taxes on transfers.

This applies to both the repatriation of capital and to the admission of capital. Yet the UK Model BIT takes a different position with regard to capital inflows: it provides that an admission of capital shall be in accordance with the host state's laws and regulations.

Secondly, the Model BITs do not explicitly permit exceptions for economic crises or balance of payment difficulties. This approach is adopted in many BITs. In other words, host states may not be permitted to take certain measures, including capital controls, to prevent or mitigate financial crises.

Third, even when a BIT provides that the host state shall have discretionary powers in regulating admission or repatriation of capital – or for exceptions to the absoluteness of freedom to transfer funds -- application of other obligations and standards may lead to negating this discretion. Most importantly, the application of the most favoured nation treatment and national treatment as broadly drafted in BITs and interpreted by some tribunals could lead to restricting the ability of the host state to regulate capital flows or to restrict it in economic difficulties. If the host state has a BIT or another treaty that has free transfer of capital inflows or a more favourable

treatment in any form from the foreign investor home state BIT, the most favourable treatment would apply.

This problem is most acute for developing countries that conclude different BITs with different transfer provisions and exceptions. The application of the MFN principle, for instance, may lead to negating the exceptions to the liberalization obligations provided for under one BIT in favour of the absolute terms of liberalization that bind the state under another BIT. This in effect renders obligation to permit the transfer of funds absolute. While it could be argued that it is the host state duty, in that case, to keep its obligations under different BITs consistent to protect its legitimate interests, many developing countries sign these agreements in the context of receiving certain economic aid without having the capacity to comprehend their consequences or the ability to negotiate their terms.

Similarly, if a host state is enforcing exchange controls or capital controls on certain sectors or industries, national treatment may lead to absoluteness in treatment because, under one interpretation, foreign investment may be entitled to national treatment granted to another industry or sector, even if its national competitors in the identical sector do not benefit from the same. This may apply when a state is providing different exchange rates for different industries or sectors.

Likewise, the interpretation of fair and equitable treatment that restricts the change in the regulatory regime of the host state and ensures that the expectations of the foreign investor must be protected even if there was no specific guarantee from the government could lead to absoluteness of the obligation and restrict the ability of the host state to enforce capital controls, even temporarily.

Fourth, one way to restrict the inflow of certain kinds of capital is to restrict the underlying transactions. This means that the host state may restrict inward capital movement by restricting the admission of the underlying investment. One of the main methods of such regulation is when the host state requires prior registration or screening of investment. While most BITs grant the host state the discretion to admit investment according to its laws and regulations, tribunals have not always given effect to this provision and did not find registration requirement under the host state laws applicable under that provision, except when registration is specifically required under

the BIT. Such interpretations further restrict the host state's discretion to regulate admission of capital by restricting its ability to regulate the permission of the underlying transaction.

Furthermore, many BITs, such as the US BITs, provide for national treatment and MFN in the admission of investment, which puts the foreign investors on equal footing with nationals and other foreigners in the admission of investment. While non-discrimination in the admission of investment might be favoured to avoid inefficiency and distortions, it further restricts the state ability to regulate capital since nationals do not have the same right to free transfer of capital under BITs in contrast to foreign investors. Accordingly, the host state might be more willing to permit certain kinds of investment by nationals, while prohibiting foreign investors from the same or imposing certain conditions on them. This would be in violation of the US BITs admission provision. Granted, US BITs permit the state parties to derogate from this provision in certain sectors included in a list. However, this method might not be sufficient to protect the host state from volatile capital, and many developing countries may not have the capacity to determine the sectors they need to include in this list. Even if there is capacity to determine the sectors or transactions that should be included in this list, economic circumstances may change to necessitate adding to this list, which are not subject to unilateral change.

Fifth, even when the host state is dealing with economic crisis, the necessity defence under customary international law, as codified by the Vienna Convention, may not be enough to permit the state to restrict capital movements to mitigate the crisis, since some tribunals have interpreted this exception very narrowly, and still others have found that it does not apply to the relationship between a foreign investor and the host state. Thus, where there is no exception provided for in BITs, the necessity provisions might not be available for the host state to restrict capital movements during financial crises.

It is thus submitted that the combination of BITs direct and indirect regulation of capital transfers and admission of investment in many cases would lead to liberalization of capital inflows, without leaving discretion to the host state to regulate capital inflows directly or through regulating the admission of the underlying investment. This results in complete liberalization of capital inflows without restriction as to the kind of capital or exception to deal with economic

crises, which is a result of incidental applications and interpretations of different standards and obligations and may not have been intended by the parties to BITs.

V. Inconsistent and Incoherent Enforcement

BITs include a dispute settlement provision that allows foreign investors to seek arbitration to resolve disputes with the host state, which covers disputes related to transfer of both capital inflows and outflows. This investor-state arbitration is ad hoc in nature: there is no permanent tribunal and for every dispute a new arbitral tribunal is established. The broad terms of BITs, their sweeping effects, and the sometimes incoherent interpretations of these provisions, could be partly mitigated if the mechanism for their enforcement created coherent and consistent law. Investor-state arbitration, however, has demonstrated its lack of capacity in this respect.

This system of arbitration consists of ad hoc tribunals, which are not bound by precedent, there is no hierarchy in their structure, and their decisions are not generally subject to substantive review. Accordingly, each tribunal decides the case without need to comply with prior precedents or being subject to a revision or appeal by a higher tribunal.

This results in inconsistencies in the interpretation of BITs obligations and contradictions in the results of similar disputes without the chance of correcting and unifying these interpretations. The result has been an inconsistent and incoherent body of law, which protects neither the state's regulatory powers nor the legitimate expectation of investors. These inconsistencies and contradictions add to the ambiguity and incoherence in the rules applicable to transfer of capital. In addition, they make it more difficult for the host state to ascertain the content of the rules it should follow in regulating capital or in case of financial crises.

For example, after the Argentinean financial crisis, many disputes arose from the measures taken by Argentina, which included restricting the movement of capital. When Argentina invoked necessity to defend its measures, several tribunals reached contradictory decisions. Some found that the financial crisis did not satisfy the requirements of necessity under international law; others found that the requirements were satisfied, and a tribunal found that the necessity cannot be invoked in investor-state arbitration. The Argentinean example shows the difficulty of permitting an ad hoc arbitration system to resolve general regulatory and policy issues.

Furthermore, this system may not be able to maintain the balance between states and investors' rights in light of its ad hoc nature and the fact that it can only be invoked by foreign investors. It is submitted that the current investor-state arbitration regime is deficient, and adds to the substantive deficiencies in BITs treatment of capital movement.

The regulation of international capital movements should not be left to a case by case approach. It is hardly conceivable for a state to regulate in general under this kind of fragmented dispute resolution system, let alone a subject such as the regulation of capital movement.

VI. Reform

Appropriate reforms are structural, substantive, and procedural. The first basis for reform is the recognition that the regulation of international capital movement is a issue that is appropriate for a global agreement rather than a bilateral one. Second, the substantive rules governing the transfer of capital under BITs need to be amended to allow for the State's control over capital inflows and for the State's discretion in dealing with financial crises. Third, broad rules need to be clarified to enable all stake-holders to understand their rights and obligations. Fourth, the existing investor-state arbitration system itself requires reforms that will promote coherence of interpretation, and consistent application, of the relevant international law.

A multilateral agreement is preferred over the current fragmented web of BITs. This would allow for both an international standard for the regulation of capital movement and for a balanced approach to regulation. This is because it would be applicable to all States, rather than under the current regime where developing countries are the principal focus of BIT obligations. It would also allow for a unified policy for dealing with the issue of capital movement, which is a global issue that requires a global agreement.

It is vital that the host State be able to regulate the admission of investment and capital to prevent destabilizing capital from causing financial crises. As the most recent financial crisis has proven, States that regulate the admission of capital are able to prevent the global financial crises from

threatening their economies.³ Conversely, by allowing the free movement of capital inflows without distinguishing between different kinds of capital or the sophistication of the host state market, the host state will be subject to the risk of financial crises caused by destabilizing capital.⁴ It is thus proposed that the admission of investment and capital inflows should be subject to the host state's discretion.

For repatriation of capital, the investor should be permitted to repatriate capital relating to its investment. However, general exceptions to prevent and mitigate economic crises are required for sustainable liberalization of capital movement. Clear and specific exceptions to the freedom to repatriate capital for financial difficulties are needed. These should be temporary and balanced to protect the investors' legitimate expectations by including certain safeguards to protect investors' rights, such as the ability to make transfers required for loan repayments during the temporary period. They should also allow for the transfer of a certain percentage of the capital arising from investment to pay other stakeholders. This proposal conforms with the practice of many states in their BITs and of developed states in making certain binding commitments, such as the OECD Codes of Liberalization of capital movements (which permits its members to make reservations to liberalization,⁵ and allows member states to derogate from its obligations if they are experiencing economic problems).⁶

Third, the content of the broad and absolute obligations and standard of treatment under BIT should be more specifically and clearly drafted. NT and MFN should only apply to similar competitors such that the host State may vary its regulation according to different activities of investors. FET should be limited to cases where there is specific guarantee of the State for free transfer and should not be used to prevent the host state from amending its regulatory policies according to its needs. Also, rules on indirect expropriation should be clarified to enable the distinction between the normal regulation of capital and expropriation. It should not only be dependent on whether an economic harm has been caused by the regulation.

³ Jonathan D. Ostry, Atish R. Gosh, et al, *Capital Inflows: The Role of Controls*, IMF Staff Position Note No. SPN/10/04, at 13 (2010) (“[T]he empirical evidence suggests that the use of capital controls was associated with avoiding some of the worst growth outcome associated with financial fragility.”).

⁴ *See Id.*; *see also* Chapter II.

⁵ *OECD Code of Liberalisation of Capital Movements*, reprinted in OECD, OECD CODE OF LIBERALISATION OF CAPITAL MOVEMENTS, art. 2 (b) (OECD, 2003).

⁶ *Id.*, art. 7.

Fourth, measures to promote coherent and consistent application of the law by investor-state tribunals should be introduced. This may include a move to a system in which arbitrators are appointed from a standing body by institutions (rather than by the parties to the arbitration themselves), as well as the establishment of a permanent appellate body charged with developing consistent and coherent law. Both States and investors could be entitled to appeal arbitral tribunals' decisions to such a body.

It is recognized that there are obstacles to reforms of this comprehensive nature, not least of which is a possible lack of political will to unify the rules applicable to foreign investment. Many developed countries would not be willing to have the same rules apply to them, which might result when developed countries are parties to the same agreement. Yet it will be difficult for the current BIT regime to endure in the face of the concerted and well-founded criticism of its shortcomings. For instance, the European Commission has successfully challenged the current transfer provisions in BITs concluded by European countries because they do not allow for derogation in exceptional circumstances. Similarly, many states have voiced their concerns. Some have started to terminate BITs to avoid the imbalanced restriction on their regulatory rights. It would be better for States and investors to take the initiative to propose a new multilateral regime that balances the rights and obligations of all parties.

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