EUROPEAN VIEW (2015) 14:217–229
DOI 10.1007/s12290-015-0377-z

ARTICLE

TTIP, investor–state dispute settlement and the rule of law

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Published online: 1 December 2015
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Abstract Many European citizens are concerned about the concept of investor–state dispute settlement, which is frequently portrayed as giving companies the right to sue governments for lost profits in secret international courts. Those who favour US–EU collaboration, including through the ambitious Transatlantic Trade and Investment Partnership agreement, can assuage these concerns by explaining how investment treaties strengthen international law. Governments created investor–state dispute settlement for their own purposes, anchoring it deeply in the UN system through numerous multilateral conventions—the most recent of which was adopted by the UN General Assembly in December 2014. By straying from this UN-based approach in its own response to public concerns, the European Commission might unfortunately weaken investor protection and the enforcement of international law. Its proposals on such issues as the right to regulate and the 'investment court system' should be reviewed in light of their impact on 50 years of international law.

The views expressed in this paper are strictly those of the author and do not necessarily reflect those of the German Marshall Fund or the US Chamber of Commerce.

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Springer

Keywords EU | Transatlantic Trade and Investment Partnership | Investor–state dispute settlement | International Centre for the Settlement of Investment Disputes | UN Commission on International Trade Law

Introduction

In June 2013, Presidents Obama, Barroso and Van Rompuy launched negotiations on a Transatlantic Trade and Investment Partnership (TTIP), an agreement meant to create growth and jobs in both the US and Europe by stimulating trade and investment flows between them (The White House 2013). The agreement was also widely heralded as having geostrategic implications, bringing the two largest supporters of democracy and the rule of law closer together.

Instead, several years on, TTIP seems to be pushing them apart. One of the main reasons for this is the public outcry in Europe against investor–state dispute settlement, or ISDS. Indeed, the criticism of ISDS is so heated that many, sick of the topic, will not read beyond the title of this piece—few in Europe want to hear about ISDS again if they can help it. But ignoring the issue does not help. The opposition to ISDS, in TTIP and beyond, has weakened and indeed possibly insidiously undermined support in Europe for the rule of law.

In fact, the reaction in Europe against ISDS has been so strong that in January 2014 the Commission suspended negotiations on the investment pillar of TTIP (European Commission 2014a) and launched a public consultation about it—a consultation in which over 98 % of the 150,000 or so respondents condemned ISDS, and opposed its inclusion in TTIP (European Commission 2015b). In July 2015, the European Parliament responded to this by adopting a resolution on TTIP that, among other things, called for a wholesale reform of ISDS (European Parliament 2015). 'ISDS as we know it is dead,' the President of the Socialists and Democrats Group in the European Parliament, Gianni Pittella, proclaimed (*Euractiv* 2015). Then, in September 2015, the European Commission proposed a new 'court system' for investment disputes under TTIP that it argued would spell the end of ISDS (European Commission 2015a).

In so doing, the Commission has unwittingly reinforced unfounded concerns about ISDS, at the same time causing many to ask whether the fuss is about ISDS, TTIP, the US or, more fundamentally, the rule of law in international relations. This, more than the strife about TTIP, is where the debate in Europe over ISDS threatens to increase the divide between the US and the EU. If the EU walks away from ISDS, an important component of the rule of law, the US will not follow.

Those who see the benefits of bringing the US and the EU closer together, who share the vision of the world's two largest economies working together to strengthen the rule of law, need to better understand what ISDS is, so that they can respond to the concerns people have about it. That is the purpose of this piece: to bring this conversation back to where it belongs—the importance of the rule of law, a principle that citizens on both sides of the Atlantic support.

First principles

One of the major problems with the debate in Europe about ISDS is that it is described, even by such respected business-oriented publications as the *Financial Times*, as the right of a foreign investor to sue a government for lost profits. If that definition was accurate, everyone would be right to be concerned. Governments can and do take measures that affect corporate profitability as they work to protect consumers, workers and the environment. A system where such measures apply to everyone except foreign investors would be untenable and a fundamental violation of the rule of law.

However, the presumption that investment protection and ISDS are about 'lost profits' is simply wrong. Common sense alone demonstrates this. Investment treaties and ISDS were created by governments, for governments. And no government would ever create an instrument that so decidedly circumscribed its ability to adopt laws and regulations in the public interest.

The basis: investment treaties

The problem is that the definition that concerns 'lost profits' obscures the fact that ISDS is a creation of governments, not corporations. For centuries, as part of their efforts to promote peaceful relations between nations, governments have concluded treaties, instruments of international law that are meant to resolve problems that might lead, in the worst case, to war. Many of these treaties promote economic relations between nations, as closer commercial ties are widely seen as the foundations for peace and prosperity (Indeed, this is the essence of the EU itself, enshrined in treaties from Rome to Lisbon).

Trade and investment are the two channels for international commerce. However, they are fundamentally different. In the first case, numerous parties sell goods and services across borders; in the second, individual investors place their own capital at risk within another country. The rules governing the two channels differ accordingly. Trade is more easily addressed through multilateral treaties (such as the WTO), in which governments act on behalf of the many traders who can be affected if another government restricts imports.

Investment, however, raises a different set of issues. A foreign investment, by definition, is subject to *all* the laws of the country in which it is made—laws governing business activity, labour, the environment, banking and financial requirements, zoning restrictions and so on. Any violation of these laws subjects the foreign investment to the full force of government enforcement, including criminal proceedings and jail for corporate officers and actors.

This starting point is important. As the governments negotiating investment treaties know investments by their citizens are subject to the laws of the other land, the treaties

they create strive only to ensure that *in that context* their investors are treated fairly. Thus, in virtually all investment treaties, the participating governments make four central pledges to each other, namely that

- in adopting and enforcing domestic laws, they will not discriminate against investors of the other party because of their foreign nationality, that is, they will treat them as well as they treat their own investors, or those of any other country (the principles of national and most-favoured-nation treatment);
- where they take exceptions to this pledge of national/most-favoured-nation treatment, they will provide *at least* the *minimum* standard of treatment required by centuries of international law ('fair and equitable' treatment and 'full protection and security' by public authorities such as the fire and police services);
- they will expropriate the investment (a power all governments have) *only* for a public purpose, with due process, on a non-discriminatory basis and in exchange for prompt, adequate and effective compensation; and
- they will allow transfers of funds between the investor and the investment in their territory.

These four simple promises—all of which give foreign investors protection under international law in the other territory—form the basis of the vast majority of investment treaties concluded since 1945, including the 1,500 or so concluded by EU member states and the 46 concluded by the US.[1]

For countries like the US and the EU member states, these promises are fully in line with their own domestic legal traditions. This is the main reason why the US and European governments believe that the investment treaties they enter into give no *greater* rights to foreign investors than those enjoyed by domestic investors. It is also why those governments do not expect to violate those obligations—after all, in many cases doing so could be unconstitutional.

But even when governments entering into these agreements do not expect to violate these obligations, it is important to enshrine them in the agreements between countries because this

- codifies how governments expect other countries to treat their investors,
- offers certainty to investors who put capital into a jurisdiction they may not know well, and

[1] Some countries, notably in Europe, also include 'umbrella' clauses that incorporate all agreements between a government and investors into the treaty, and 'legitimate expectations' into the notion of fair and equitable treatment. These protections, however, differ among treaties; the US, for instance, limits the umbrella clause to major contracts and licences.

- recognises that sometimes governments do make mistakes and adopt laws that might discriminate against or otherwise harm a foreign investor[2] in ways that do not similarly affect their nationals.

Enforcement: the need for ISDS

Treaty promises, to be meaningful, must also be enforced. The vast majority of treaties concluded before 1965 anticipated that the two countries signing the treaties would resolve any disputes occurring under them. In the early 1960s, however, governments began to realise that relying on state-to-state dispute settlement to enforce the treaties could embroil them in disputes affecting individual investors, raising these disputes to diplomatic incidents between governments. If the investor's government took up the case, it could raise tensions with the other party, undermining the purpose of the treaty; if it did not, not enforcing the obligations would undermine the treaty itself.

As a result, governments began to consider giving investors that might be directly affected by a violation of the treaty a 'private right of action' to enforce it through a neutral panel using agreed upon rules—that is, ISDS. The ISDS approach gained broad multilateral recognition with the 1966 Convention on the Settlement of Investment Disputes between States and Nationals of Other States,[3] a multilateral treaty that established the International Center for the Settlement of Investment Disputes (ICSID) as part of the World Bank Group (and thus part of the UN system) (ICSID 1970). ICSID has developed a full set of rules and procedures for resolving these disputes, calls upon hundreds of respected adjudicators nominated by the 151 governments that are party to the Convention (many of them former or sitting high court justices[4]) to hear the disputes, and dedicates a team of experts to each case. Governments concluding investment treaties can also call for the UN Commission on International Trade Law (UNCITRAL) arbitration rules (updated in 2013) to be used by ICSID at the Permanent Court of Arbitration in The Hague or in numerous other respected venues such as the Stockholm Chamber of Commerce.

The broader point here is that it was the *governments* that, over 50 years ago, chose, for their own reasons, to develop a UN-based approach to ensure investment treaties are enforced and to help investors from one state resolve differences with another. They chose binding arbitration as the form of dispute resolution precisely because, by definition, governments are always the 'defendants' in these cases (since the complaint is over an alleged violation of a treaty), and arbitration is a more conciliatory approach than a suit before a court.

[2] The 2008 European Commission proposal of the Third Energy Package, for instance, included the 'Gazprom clause', which, as drafted, ironically would not have affected Russian investors but would have harmed Americans. It was changed during the legislative process to allow discrimination based on assessments of energy security.

[3] All EU member states except Poland are parties to the Convention, and many were original signatories of it.

[4] The curricula vitae of most ICSID panellists are available in ICSID (2015).

Naturally, the governments have set boundaries for ICSID and other means of dispute resolution. Most importantly, panels can *only* award monetary damages to the investor; they *cannot* order the underlying law or measure to be changed. Given that governments write the treaties containing the obligations on the treatment of investments, and that they created the UN-based system of arbitration to enforce those obligations, it is not surprising that of the 405 known ISDS cases concluded in 2014, governments won most of them, with all claims dismissed; in only 27 % of the cases was the respondent government found to be at fault (UN Conference on Trade and Development 2015). Even in those cases, however, compensation was generally a tenth of the amount initially requested by the investor (Franck 2015; Miller and Hicks 2015).

Addressing legitimate concerns

This background is essential to explaining to citizens why some of the concerns they have after hearing that 'ISDS allows big companies to sue governments for lost profits' are unfounded.

The right to regulate

Chief among the concerns is whether ISDS restricts the right of governments to regulate in the public interest. The answer is no, and yes. Investment treaties and the concept of national treatment *assume* that governments can and will adopt laws and regulations affecting all businesses in their country. Of course they have the right to regulate.[5] An investment treaty *does* oblige them, however, to regulate in a way that does not discriminate based on nationality, to provide the minimum standard of treatment required by international law, to compensate in the event of an expropriation, and to allow transfers of funds to and from the investment. In this sense, all of these treaty commitments restrict the right to regulate. But so does every constitution. Democracy limits the power of government: that is the essence of the rule of law. And only if a foreign investor believes a government has violated one of these treaty pledges can it file a claim using ISDS.

'Better rights' for foreign investors

As noted above, the US and EU member state governments believe that the protections they provide in their investment treaties are consistent with their approach to the rule of law, and that the four substantive obligations of the treaty are thus no greater

[5] For instance, the French firm Veolia's ISDS case against Egypt is not and cannot be about the general increase in the minimum wage; its 2012 complaint is that it was not allowed to increase fees for its waste disposal services in light of the increase in the cost of labour, as its contract allowed. The case is pending (ICSID Case ARB. 12/15) (Federation of German Industry 2015).

than those provided under domestic law. That the foreign investor has access to the ISDS procedure while a domestic investor does not is inherent to ISDS being an instrument of international law. Domestic investors would not have cause to use international law against their own government. Instead, the investment treaty gives them reciprocal rights—that is, the right to bring the other government to dispute settlement should they make investments there.

Domestic courts

Many believe foreign investors should resolve any problems they have with the government through the domestic court system just like everyone else does. This, they say, is especially so where the rule of law is well developed—as it is in the US and Europe. And indeed, foreign investors will generally turn first to local courts—not least because most problems an investor faces will not violate the four treaty obligations noted above. But if the investor feels the action of the other government is so egregious it violates the treaty, it needs another system of enforcement: in the vast majority of legal systems—including that of the US—one cannot enforce *international* law directly in local courts. This is true no matter how good the domestic legal system is, especially if the problem stems from a law adopted *after* the treaty, since in most democracies, laws adopted later in time take precedence. This is precisely why governments created the UN-based mechanism of ICSID to enforce international law.

Saying ISDS is not needed for countries with ‘developed’ systems of law also raises moral and ethical questions. Who is to judge whether the legal system of one country is better or worse than that of another’s? Indeed, even posing the question has echoes of colonialism, for it overlooks that treaties are *reciprocal*, not unilateral. In every treaty the US, Germany or the UK has signed, at least one ‘developed’ country is bound and subject to ISDS by the investors of the other party—whether China, South Korea, Mexico or Jamaica.[6]

‘Frivolous’ claims

While most Americans and Europeans might accept that ISDS could be used to resolve differences caused by a government violating its treaty commitments, some may believe that foreign investors might abuse such ‘vague’ concepts as ‘fair and equitable treatment’ to bring frivolous complaints. Of course, anyone can always bring any complaint to court. But accusing a government of violating a treaty is not a matter that either the foreign investor or the government will take lightly. The government will be upset,

[6] During the negotiations for a US–Jamaica Bilateral Investment Treaty in 1992, the lead Jamaican negotiator, Patrick Robinson (now at the International Court of Justice) passionately argued that Jamaica should not be subject to ISDS as it had a well-developed system of law despite its low income; he accepted ISDS only because it applied to the US as well.

to put it mildly, so foreign investors are only likely to bring cases under international law as a matter of last resort. Furthermore, all systems of arbitration have procedures to dispense with unfounded complaints, and indeed a substantial number of cases are dismissed, with tribunals exercising their discretion to apportion legal fees against claimants where they see abuse. Finally, governments can limit the scope for frivolous claims by careful drafting of the substantive obligations. For example, US government lawyers define the term 'fair and equitable treatment' as being 'in accordance with customary international law', as that gives the government considerable latitude to defend 'normal' state actions.

Indirect expropriation

Most people see a government taking a person's property as wrong, excusable only if done for a public purpose, using due process and with compensation. There are more complicated cases, for instance when the Russian government was found to have illegally used tax measures to force the bankruptcy of Yukos, which it then confiscated and sold to Gazprom and Rozneft (Brauch 2014). But dispute panels can distinguish between valid cases, like that of Yukos, and invalid cases, such as Methanex's complaint about California's ban of a fuel-additive, which the panel determined was a science-based decision applied in the public interest.[7]

The European Commission's (flawed) solution

In September 2015, in response to public concerns about ISDS, the European Commission adopted a 'new approach' to investment disputes in the context of TTIP and other negotiations (European Commission 2015a). Substantively, the Commission proposes provisions that 'ensure the right to regulate', define 'fair and equitable treatment', and limit the scope of indirect expropriations, among other things. But the highlight is a procedural change that creates an 'investment court system' under which the two governments appoint a standing body of 15 'judges' (5 from each nationality; 5 more of a third nationality); judges are selected on a 'random' basis to hear complaints; an appeals process formed of 6 panellists exists; and all are subject to strict ethical requirements.[8]

[7] The Phillip Morris dispute with Australia is not about plain-paper packaging per se but about the lack of compensation for an action that the Australian High Court agrees is a 'deprivation' of property (Australia 2012; see, for example, paragraphs 38, 42–4, 100–1), albeit not compensable because the government did not acquire the property. Cf. European Charter of Fundamental Rights, Article 17: 'No one may be deprived of his or her possessions . . . except subject to fair compensation'. The case is pending (Federation of German Industry 2015).

[8] The proposal also enshrines other procedural 'reforms' including on transparency, frivolous claims, binding interpretations of the parties, amicus briefs and so on, all of which are covered in the US model Bilateral Investment Treaty and the revised UNCITRAL rules.

This is a well-intentioned desire to respond to public criticism of ISDS in Europe. But in trying to develop a solution to a problem that does not really exist, the Commission's proposal creates new problems. These problems are exacerbated when one considers them in relation to countries other than the US.

Right to regulate

As noted, the right to regulate is *assumed* in investment treaties as investments are *always* subject to the laws of the land in which they are located. In many treaties this is so self-evident that the 'right to regulate', if mentioned at all, is referred to only in the preamble.[9] By making the right to regulate a *substantive* provision, the Commission at the least creates the negative inference that perhaps this does not exist in other treaties. More insidiously, whether intentionally or not, the Commission proposal arguably implies that the 'right to regulate' trumps the other provisions in the treaty.[10] Language that may make sense in a trade context has much broader implications for investment when it implies, for instance, that concerns for public health allow a government to violate a promise not to discriminate against an investor *because of its nationality*. When the grounds that allow violation of the obligations extend to 'public morals' and 'social or consumer protection', the danger becomes even more obvious.

Fair and equitable treatment and indirect expropriation

In a sense, the same can be said for the Commission's attempt to 'define' fair and equitable treatment and to circumscribe indirect expropriation. The Commission proposes that fair and equitable treatment is denied by 'manifest arbitrariness', or 'targeted discrimination on manifestly wrongful grounds' (European Commission 2015a). But does this mean arbitrariness and targeted discrimination that are not 'manifestly wrongful' are acceptable? Similarly, if indirect expropriation is narrowed to 'the rare circumstance when the impact of a measure or series of measures is so severe in light of its purpose that it appears manifestly excessive' (European Commission 2015a), the treaty is clearly giving space to governments to do things that are excessive, even if not manifestly so. This would be a far lower standard than many Europeans and Americans would permit from their own governments.

[9] Including the EU–Canada *Comprehensive Economic and Trade Agreement* (European Commission 2014b; see Chapter 10, 'Investment').

[10] In 1911, the US abrogated its 1832 treaty with Russia because Moscow used the 'right to regulate' in Article 2 to deny visas to Americans of Jewish or Catholic faith (US Congress 1911).

Procedural changes

There is a certain chutzpah in the Commission's desire to create a new 'international court system' to replace the 50 years of international law behind ICSID when the EU has not yet concluded a single investment treaty. The UN-based ICSID was created specifically to address the problem of resolving disputes between investors and states through years of negotiation involving some of the best legal minds in the foreign ministries of the original contracting parties, including most European states. They chose not to call it a court because states did not want to be hauled up as defendants before courts for alleged treaty violations. The European Commission and EU member states may feel this is acceptable after 50 years of working with the European Court of Justice, but many other countries—including the US—may ask why there is a need for change. The ICSID negotiators also intentionally tried to avoid bias by stipulating that panellists may not be of the nationality of either the claimant or the respondent; in contrast, the Commission has reinserted this nationality bias. The negotiators of ICSID chose the traditional arbitration approach of having each of the parties to the dispute choose one panellist (ideally from the roster of those nominated by the other ICSID members) and then have those panellists choose the presiding panellist, both to balance the process and to avoid creating a 'court' system (ICSID 1970).

By and large the system has worked well. There have been a very few outcomes where states have lost which have been criticised by some, but there will always be critics of rulings in any legal system. And the vast majority of cases where governments have lost have been seen by most observers to be correct. Where members have seen the need, they have updated the rules and procedures, both in ICSID and UNCITRAL, to ensure greater transparency, binding joint interpretations and so on. However, rather than a wholesale call for reform, the members instead continue to rely on and build upon the system. Indeed, as recently as December 2014, the UN General Assembly adopted the Mauritius Convention on Transparency in Treaty-based Investor–State Arbitration (UNCITRAL 2014), and the traditional approach to ISDS forms the basis for the 12-nation Trans-Pacific Partnership Agreement concluded in September 2015.

Conclusion

This is not to say that the process of ISDS cannot or should not be changed; it can, should and indeed has been, as with the 2013 update of the UNCITRAL rules and the 2014 Mauritius Convention that allows parties to 'back-date' treaties to incorporate the new rules. Similarly, the US model Bilateral Investment Treaty has been significantly expanded and clarified since its inception in 1980, most recently in 2012 after three years of scrutiny and debate under the Obama administration.[11]

[11] It is somewhat ironic, given the outcry about ISDS and the lack of transparency in the TTIP negotiations, that the US model Bilateral Investment Treaty—the US government's TTIP negotiating text on this sensitive subject—is readily available online (US Government 2012).

The EU member states only gave the EU the power to negotiate investment protection treaties in the 2009 Lisbon Treaty, and it is understandable that the Commission, and the EU as a whole, should want to use this occasion to modernise and unify the approaches the member states have been using over the past 50 years. Many of the changes incorporated into the EU's draft trade agreement with Canada follow the direction of the new ICSID and UNCITRAL rules, and those of the US Bilateral Investment Treaty, and are widely heralded as an improvement over the member state traditions.

Some of the Commission's proposals may indeed foreshadow possible future steps. For example, while ICSID has a procedure to annul rulings if necessary, some parties, such as the US, also consider that the introduction of an appeals process may make sense. This would be difficult however, as international investment law is an amalgam of three thousand different treaties, in which the parties have agreed on sometimes slightly different wordings that may convey very different meanings and legal obligations (Hindelang and Sassenrath 2015). It would, however, make far more sense if there was a single broad multilateral investment treaty covering numerous countries, where disputes were about the same obligations.

In making its proposals, the Commission must carefully consider the work that has gone before it. Some of the wholesale changes the Commission has proposed both weaken substantive protection for investors and the mechanisms the broader UN system created to enforce these protections. If, as many hope, TTIP is to provide the basis for the EU and the US to work together to create a coherent, broader-based system for the protection of foreign investment under international law, the European Commission will need to rethink its approach.

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