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Making Sense of the CETA

An Analysis of the Final Text of the Canada-European Union Comprehensive Economic and Trade Agreement

Edited by Scott Sinclair, Stuart Trew
and Hadrian Mertins-Kirkwood

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Investment

Investor-State Dispute Settlement

Peter Fuchs, *PowerShift*

Key Points

Unless otherwise noted, all Articles, Annexes and Appendices referenced in this section refer to ***Chapter 10*** *of the August 2014 final version of the CETA text first leaked by German broadcaster ARD and now available at: http://eu-secretdeals.info/ceta.*

- The CETA includes a far-reaching investment chapter that will empower foreign investors and multinational corporations. This is widely seen as the 'new EU model' investment treaty, and as a blueprint for what the EU will try to insert into the EU-U.S. Transatlantic Trade and Investment Partnership (TTIP). Under this chapter, Canada and the EU commit themselves to strong market access rules, prohibition of performance requirements, non-discriminatory treatment of foreign investors and high standards of investor protection. Through the proposed investor-state dispute settlement (ISDS) mechanism, foreign investors will be granted the special privilege of suing host governments and claiming compensation for all kinds of state actions, while bypassing domestic judicial systems and their independent courts.

- Widespread opposition to the inclusion of ISDS in the CETA from the general public, parliamentarians and even EU governments has been ignored. The EU has also failed to take into account any conclusions reached from its three-month public consultation on international investment policy in the TTIP, launched in March 2014.
- No convincing justification for the inclusion of ISDS in the CETA (or the TTIP) has been given. Essential questions remain unanswered, including: Why is ISDS even needed in the CETA? Why give foreign investors greater procedural and substantive rights than domestic investors, or anyone else? Why give private, for-profit arbitrators the power to interpret treaties such as the CETA, to decide over questions of public law and to impose fines paid from public funds?
- The CETA fails to clearly and unequivocally confirm the state's right to regulate; instead it undermines that right.
- While granting foreign investors unprecedented new rights, the CETA fails to introduce any binding responsibilities on their conduct.
- The CETA does not require foreign investors to first resort to domestic courts in solving disputes — it actually discriminates in favour of foreign investors.
- While including the new United Nations Commission on International Trade Law (UNCITRAL) Rules on Transparency in Treaty-Based Investor-State Arbitration, [5] the CETA fails to address the more fundamental absence of institutional independence and procedural fairness in investor-state arbitration.
- The CETA goes beyond the NAFTA in its investor-friendly formulation of the 'fair and equitable treatment' standard, which is the most dangerous investment protection standard in the sense that it has been used most often and most successfully to attack public policy measures.
- The EU has rejected Canada's request that court and administrative tribunal decisions related to intellectual property rights be excluded from investor-state challenge, in an apparent response to Eli Lilly's ISDS challenge under the NAFTA.
- Reservations and exceptions in the CETA remain complex, fragmentary and tied to notions such as the 'necessity' of public policy meas-

ures, which will then be adjudicated by the arbitration tribunals. Moreover, the reservations do not cover substantive investment protection standards such as 'fair and equitable treatment.'

- Mounting public criticism of the ISDS approach taken in the CETA led to minor improvements related to the definition of indirect expropriation and the Most Favoured Nation treatment clause, but important ambiguities remain, and the danger still exists of arbitrators ruling expansively on these and other clauses.
- In addition to the investment chapter, the CETA's financial services chapter creates several new layers of investor rights, including the possibility of recourse to ISDS (see section on Financial Services by Scott Sinclair).

Analysis of Key Provisions

- **(No) Right to regulate:** The 'right to regulate' is mentioned three times in the agreement. In the preamble, the parties simply 'recognize' that the CETA protects the right to regulate ("RECOGNIZING that the provisions of this Agreement preserve the right to regulate…"), yet the text fails to clearly and unequivocally confirm this right, especially in the investment chapter. The other mentions are to be found in the labour and environment chapters, so that, in effect, the CETA shields the right to regulate from any international obligations to protect labour or the environment but not from all the detailed obligations in the investment chapter. Also in the environment chapter, the right to regulate is limited by formulations which require environmental policies to be implemented "in a manner consistent with the multilateral environmental agreements to which they are a party and with this Agreement," meaning that environmental policies have to be consistent with the CETA — not the other way round (see section on Sustainable Development and Environmental Protection by Ramani Nadarajah).
- **The definitions of investment and investors are very broad:** The CETA definition of 'investment' and 'investor' are overly broad and far beyond what would be advisable from a regulatory or public interest perspective. The CETA defines an 'investment' as, "Every kind of asset that an investor owns or controls, directly or indirectly, that

has the characteristics of an investment." It defines an 'investor' as: "a Party, a natural person or an enterprise of a Party, other than a branch or a representative office, that seeks to make, is making or has made an investment in the territory of the other Party. For the purposes of this definition an 'enterprise of a Party' is: (a) an enterprise that is constituted or organised under the laws of that Party and has substantial business activities in the territory of that Party"). The reference to 'substantial business activities' is not enough to prevent 'treaty shopping.' For example, U.S. investors in Canada would be able to use the CETA investment provisions and ISDS to challenge European state measures.

- **Worse than the NAFTA — wide and open clause on 'fair and equitable treatment':** The 'fair and equitable treatment' (FET) clause in the CETA is highly problematic and arguably more investor-friendly than NAFTA's controversial minimum standards of treatment clause. The clause should at least specify that the closed list of proscribed government conduct does not go beyond the customary international law standard on the treatment of aliens, to be proven by the claimant. The CETA is explicit in stating that a tribunal "may take into account whether a Party made a specific representation to an investor to induce a covered investment, that created a legitimate expectation, and upon which the investor relied in deciding to make or maintain the covered investment, but that the Party subsequently frustrated." This clarification tilts the balance in favour of the investor and poses a clear threat to the rights of governments to regulate, and especially to alter and strengthen regulatory approaches in response to changing circumstances, new knowledge, investor behaviour, public perceptions of risk, and democratic decision-making. It singles out the 'legitimate expectations' that investors may hold for their investments as an interpretive issue that tribunals may consider — even above issues relating to the public interest. The CETA's wording on FET exposes Canada's totally misleading claim in its October 2013 Technical Summary of the Negotiated Outcomes regarding the provision on minimum standard of treatment in the CETA. In that document, Canada stated it would introduce a "new format for article (sic) but substantively the same as NAFTA (that is, substantively the same as the customary international-law minimum standard of treatment)."[6]

- **FET in the CETA — a potential 'umbrella clause through the back-door':** The CETA no longer includes the customary umbrella clause that Parties must "observe any obligation" in their treatment of investors, as had been proposed by the EU in earlier leaked versions. However, the FET formula regarding a Party's 'specific representation' combines a form of umbrella clause with the concept of 'legitimate expectations' as a reference point for any tribunal seeking to give meaning to the various direct components of FET. This will still allow an arbitration tribunal the flexibility to bring back the essence of an umbrella clause, with the potential to elevate all of a state's contractual obligations with the investor to the level of a treaty obligation, without any of the contractual obligations on the investor (e.g. to submit contractual disputes to a forum agreed before in the contract) receiving the same treatment. A "specific representation to an investor" could reasonably be interpreted to include a written contractual commitment by the state. On the question of an umbrella clause, arbitrators retain the capacity to use the treaty language in a 'creative' way in support of corporate interests. This is yet another example of how Article X.9 of the CETA is a significant expansion of FET beyond the NAFTA context.

- **Intellectual Property Rights and court decisions:** The interpretive language in the CETA on intellectual property rights and court decisions is weak (see Declaration to Investment Chapter Article X.11 Paragraph 6). It leaves ample room for arbitrators to say: "We are not an appellate mechanism for courts and we allow states to implement as they see fit, but this is all subject to the specific obligations to protect investors" (see section on Pharmaceuticals by Scott Sinclair).

- **Most-Favoured Nation (MFN) language remains open to interpretation:** The CETA's new language on MFN clarifies that substantive obligations in other treaties do not count as treatment, although measures adopted under those agreements *are* treatment. It remains to be seen, however, how arbitrators will deal with the notion of "measures adopted by a Party pursuant to such obligations" (Article X.7.4). The specific text reads: "Substantive obligations in other international investment treaties and other trade agreements do not in themselves constitute 'treatment,' and thus cannot give rise to a breach of this article, absent measures adopted by a Party pursuant to such obligations."

- **No ISDS for pre-establishment claims**: The CETA does not allow ISDS claims for pre-establishment (market access) restrictions. Article X.1.4 states*:* "Claims in respect of Section 2 (Establishment of Investments) are excluded from the scope of Section 6. Claims in respect of the establishment or acquisition of a covered investment under Section 3 (Non-Discriminatory Treatment) are excluded from the scope of Section 6." (Section 6 is the section on Investor-State Dispute Settlement.) Yet these far-reaching investment liberalization elements are still subject to state-to-state dispute settlement, posing inherent risks to government policy space for adopting sustainable economic, environmental and social policies. These obligations largely surpass what has been agreed to in the WTO, and should not be underestimated.

Financial Services

Scott Sinclair, *Canadian Centre for Policy Alternatives*
Alternate Contact
Markus Henn, *Weltwirtschaft, Ökologie & Entwicklung (WEED e.V.) / World Economy, Ecology & Development*

Key Points

Unless otherwise noted, all Articles, Annexes and Appendices referenced in this section refer to ***Chapter 15*** *of the August 2014 final version of the CETA text first leaked by German broadcaster ARD and now available at: http://eu-secretdeals.info/ceta.*

- In early 2013, Canada's financial services negotiators warned EU negotiators that giving foreign investors new CETA rights to sue governments over financial regulation would "create a chilling effect that will have negative consequences for the overall economy of the country."[7]
- Unfortunately, those warnings have gone largely unheeded. The CETA financial services chapter creates several new layers of investor rights and dispute settlement recourse that will hamstring financial regulators charged with protecting consumers and the overall stability of the financial system.

- Having weathered the financial crisis reasonably well, Canada should have been in a strong position to withstand European demands for further restrictions on regulatory autonomy over financial services. Instead, it has bowed to EU and financial industry pressure on most key points.

- Under the CETA, foreign investors would have broader rights to challenge financial regulations through investor-state dispute settlement (ISDS). The CETA expands the grounds for foreign investors to challenge government measures regulating financial services sectors.

- In addition, the agreement includes new disciplines on Domestic Regulation that apply to financial services. These apply to *non-discriminatory* regulations related to licensing requirements and procedures and qualification requirements and procedures for financial services, greatly expanding the degree to which non-discriminatory regulations are subject to binding trade treaty restrictions.

- The CETA's controversial market access rules also restrict certain types of non-discriminatory regulation. These rules prohibit certain broad forms of regulation, such as measures to limit the size of financial firms, even when these regulations treat domestic and foreign firms even-handedly.

- A "prudential carve-out" does insulate "reasonable" financial regulation (e.g. to protect consumers, the safety and soundness of financial institutions, or the stability and integrity of the financial system) from challenge. This protection, however, is both procedurally and substantively weaker than under the NAFTA.

- The CETA will constrain financial regulation in both Canada and Europe. A particular challenge from the European perspective is the negative list approach to reservations, with which European member states and financial services regulators have limited experience. Under this approach, if a non-conforming measure is not listed, it is lost. European member states are already facing a number of ISDS claims related to the aftermath of the financial crisis, so any mistakes or oversights could prove costly.

Analysis of Key Provisions

Domestic regulation

- The CETA disciplines on Domestic Regulation (Chapter 14) are incorporated into the Financial Services chapter in Article 1.6. *Non-discriminatory* regulatory decisions in relation to "measures adopted or maintained by a Party relating to licensing requirements and procedures and qualification requirements and procedures" must be based on criteria that preclude the competent authorities from exercising their power of assessment in an arbitrary manner (Chapter 14, Article 2). These criteria must be clear and transparent, objective, established in advance and made publicly accessible (Chapter 14, Article 2). The Parties must establish independent, arms-length administrative tribunals to adjudicate complaints from foreign suppliers regarding alleged violations of the domestic regulation provisions.

- This type of international trade law restriction on the exercise of non-discriminatory regulation is unprecedented. The GATS Article VI called for the negotiation of domestic regulation disciplines, but these talks have not been completed. Comparable NAFTA obligations regarding Domestic Regulation call for governments to make "best-efforts," but impose no binding restrictions.

Market access

- The CETA's market access obligations prohibit government measures that limit the number of service operations, the value of service transactions or assets, the number of operations or quantity of output, the number of persons supplying a service and the participation of foreign capital, and also any requirements for specific types of legal entities. These "market access" rules are enforced through government-to-government dispute resolution (not ISDS).

- Such regulations are prohibited even when they apply equally to domestic and foreign firms. All such measures must be protected by reservations, or eliminated. For example, Canada, has exempted its "widely held" rule, which limits any single shareholding in a large Canadian bank to less than 35%, from the market access provisions of the CETA.

- Trans-Atlantic consumer protection groups have expressed concerns that these market access rules, which arose before the financial crisis, are outdated and could interfere with beneficial financial regulation, such as limiting the growth or transactions of financial firms "so that they do not become 'too big to fail.'"[8]
- The CETA market access text clarifies that Parties may continue to require financial firms to supply services through "separate legal entities" (Article 6.1[o]). This appears to shield domestic regulations which demarcate pillars of the financial system, for example by separating insurance from banking, or investment from retail banking. Nevertheless, the EU took an unbound reservation exempting its authority in this area.[9]
- Statutory systems of social security, e.g. public health insurance, are excluded from the financial services chapter, but only if there is no competition (Article 1.5). If a province or state allowed private health insurance for medically necessary services, then the obligations under the CETA's financial services chapter would apply. Canada has reserved public automobile insurance in four provinces, but other provinces could not adopt public auto insurance without running afoul of the CETA's market access obligations.

ISDS and financial services

- Due to concerns about insulating regulatory authority from challenge, previous Canadian treaties strictly limited recourse to ISDS with regard to financial services. The CETA will greatly expand the scope for challenges by foreign investors to government measures in the financial services sectors. Article 1.3 incorporates key provisions of the investment chapter into the financial services chapter. The CETA allows ISDS claims related to Article X.3 (National Treatment), Article X.4 (Most-favoured Nation Treatment), Articles X.12 (Investment — Transfers), X.11 (Investment — Expropriation), X.10 (Investment Compensation for Losses), and X.9 (Investment — Treatment of Investors and of Covered Investments).
- The exposure to investor lawsuits based on the national treatment and fair and equitable treatment clauses is of great concern. The CETA's approach contrasts sharply with the treatment of financial services under the NAFTA (Article 1401[2]), where financial regulators were

successful in limiting the application of ISDS to only free transfers of currency, expropriation and some other relatively minor provisions.

The prudential carve-out

- The CETA includes a prudential carve-out for financial regulation that is weaker than its NAFTA counterpart.[10]
- Procedurally, there is a filter that allows the Parties to jointly determine to set aside a claim on grounds that it falls within the prudential carve-out. But they must decide by consensus, or the claim proceeds.
- If a defendant government invokes the prudential carve-out as defence, the matter is referred to a Financial Services committee, and (if the committee cannot agree) to the CETA Trade commission, for decision. These bodies are comprised of representatives of both Parties and operate by consensus. If no consensus is reached, the matter of whether the prudential carve-out applies is left to the investor-state tribunal to decide.
- In most cases, rather than pre-empt a complaint by one of its own investors, a home government will likely let the matter proceed to arbitration. By contrast, under the NAFTA's filter mechanism, if the Parties fail to reach consensus, the defendant government can send the matter to a state-to-state dispute panel for a determination (NAFTA Article 1415).
- Parties may, for prudential reasons, ban risky types of financial services (Article 15.3). Such bans may not discriminate on the basis of nationality. Parties could, for example, ban risky practices — such as naked short-selling[11] — but if challenged they would have to justify this as falling within the prudential carve-out. Otherwise, such a ban would violate CETA's market access obligations.
- Substantively, guidance to tribunals for applying the prudential carve-out exhorts tribunals to defer "to the highest degree possible" to domestic financial regulatory authorities (Annex XX: Guidance on the application of Article 15.1 (Prudential Carve-out) and Article 20 (Investment Disputes in Financial Services)). But the chapter also provides considerable scope for tribunals to impugn prudential regulation on grounds, for example, that it constitutes "arbitrary or unjustifiable discrimination" or a "disguised restriction" on foreign investment.

Reservations and exceptions

- The CETA financial services chapter adopts a "negative list"-approach, meaning its core rules apply unless a government specifically lists measures it wants to exclude from these obligations in an annex to the financial services chapter.

- European member states and financial services regulators have limited experience with negative listing. It will be difficult or impossible to correct mistakes, since the CETA, unlike the GATS, does not provide any procedure for the withdrawal of services commitments. If, for example, in a future dispute the prudential carve-out is interpreted in a restrictive manner, it will not be possible to adjust reservations to safeguard regulatory authority.

- European member states already face a number of ISDS claims related to financial regulation. Foreign investors have turned to investor-state arbitration to try to recover losses incurred during Europe's seemingly interminable financial crisis. In the first investor-state case ever by a Chinese mainland investor, a financial services company is suing Belgium under a 2005 Belgium-China investment protection treaty. Ping An, the largest single shareholder in the Belgian-Dutch bank Fortis, allegedly lost US$2.3 billion when government authorities stepped in to rescue the financial giant and subsequently sold off assets over the objections of minority shareholders. Foreign investors have also filed investor-state claims against both Greece and Cyprus to recover losses incurred under financial restructuring programs.

- The CETA mandates further negotiations to develop disciplines on performance requirements, such as domestic content or technology transfer conditions on investors or service suppliers. If, within three years of entry into force of the CETA, these talks do not result in an agreement, the performance requirements prohibitions in the CETA's investment chapter will automatically apply to the financial sector. Governments will then have a one-time opportunity to negotiate reservations for the performance requirements provisions, but future policy flexibility cannot be preserved as these reservations can only protect existing non-conforming measures (see Article X: Performance Requirements).