



Performance Requirements in Investment Treaties

Best Practices Series - December 2014



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Written by Suzy H. Nikièma

Head Office

111 Lombard Avenue, Suite 325
Winnipeg, Manitoba
Canada R3B 0T4

Tel: +1 (204) 958-7700

Fax: +1 (204) 958-7710

Website: www.iisd.org

Twitter: @IISD_news



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1.0 Introduction

Foreign direct investment (FDI) can play an important role in the development of host countries; however, the positive impacts of FDI do not occur automatically, because the commercial interests of companies do not always coincide with states' development goals. Specific policies are needed to create an environment that encourages the positive impacts of (and best practices for) FDI, while strengthening their contribution to sustainable development. One potential policy is for host states to use performance requirements (PRs).

Conceptually, PRs are “stipulations, imposed on investors, requiring them to meet certain specified goals with respect to their operations in the host country” (United Nations Conference on Trade and Development [UNCTAD], 2003, p. 2). In other words, they are measures requiring investors to behave in a particular way or to achieve certain outcomes in the host country.

PRs have been used in developing countries as well as in developed countries to achieve both economic and non-economic goals. These include strengthening the industrial base and national added value, developing national expertise in a given sector, creating upstream and downstream economic links in a given economic sector, ensuring technology transfer, achieving better environmental or social outcomes, reducing unemployment, avoiding restrictive trade practices, preserving a significant part of national enterprises in key sectors, or guaranteeing security in the industrial sector, etc.¹ The decline in the use of PRs in developed countries is due more to their frequent replacement by other industrial policy measures pursuing the same goals rather than a choice to no longer influence the behaviour of transnational corporations.²

Nonetheless, PRs remain controversial. Some see them as a tool to ensure that investments make an effective, maximum contribution to the development of the host country, and are aligned with its goals and priorities. This approach is increasingly reflected in a number of regional- and continental-scale political instruments, such as the Africa Mining Vision,³ which encourages the use of PRs. Others, though, see PRs as instruments that are ineffective at best—and counterproductive at worst. The latter view is reflected in the prohibition or limitation of PRs in certain international multilateral, regional or bilateral economic agreements.⁴

The fundamental issue analyzed here is how investment treaties prohibiting or limiting the use of PRs impact policy space in developing countries. The analysis begins with an overview of the types of PRs used around the world, to understand their content and objectives. The World Trade Organization's Agreement on Trade-Related Investment Measures (WTO TRIMs), which prohibits certain PRs, will then be briefly summarized. The study then focuses on the meaning and scope of PR-related clauses in bilateral investment treaties (BITs) and the interpretation of such clauses by investment tribunals. Finally, it provides some options to help states to preserve their policy space for imposing, if needed, PRs on FDI in their territory.

¹ For a more detailed study on the economic foundations of PRs, see UNCTAD, 2003, pp. 6–9.

² This is the case, for example, with rules of origin in the context of free trade areas. Rules of origin have an effect similar to that of PRs regarding local content.

³ Documents relating to Africa Mining Vision are available at: <http://www.africaminingvision.org/index.htm>

⁴ This includes those concluded by the United States and Canada.



2.0 An Overview of Performance Requirements

2.1 TYPES OF PERFORMANCE REQUIREMENTS

The forms of PRs are varied and often complex. They can be categorized according to several criteria.

First, mandatory PRs can be distinguished from non-mandatory PRs. Mandatory PRs are linked to the conditions for the entry and operation of the investment. The investor must agree to them to make its investment or continue to operate. Non-mandatory PRs, on the other hand, are linked to access to certain advantages, such as tax exemptions or subsidies by the host country. Thus, in theory, the investor could decide not to comply with them. Nevertheless, the distinction between these two categories is not always clear. Indeed, some incentives do not really give the investor the possibility of refusing to comply with the PRs, because of the attractiveness of incentives offered.

Second, a distinction can be made between PRs imposed on the investor before the investment is made and those imposed afterwards. This distinction has important legal implications. PRs imposed after the investment is made—mandatory PRs in particular—are more likely to breach the host state's commitments in an investment or trade treaty.

Finally, one can distinguish between PRs according to whether they are covered by national legislation or investment contracts between the state and the investor.

It is necessary to clarify at this point that PRs should not be confused with corporate social responsibility (CSR). First, while PRs are set by the government and aligned with its development strategies, CSR policies are set by companies themselves. Second, PRs have a legally binding nature, even when they are not mandatory (in this case, the investor can only access the advantages offered if it complies with the PRs). CSR, meanwhile, remains fundamentally voluntary, even when mechanisms to ensure compliance are in place. In other words, the violation of a PR will be legally sanctioned (withdrawal of operating licence, penalties, loss of rights or benefits), while a violation of CSR will not. PRs and CSR, therefore, are not interchangeable.

2.2 ILLUSTRATIVE LIST OF PERFORMANCE REQUIREMENTS

Among the most commonly used PRs are those requiring the investor to:

- Ensure a level of local content for products and services. This may consist of measures directly imposing a percentage or quota to be achieved or requiring the priority use of local goods and services over foreign goods and services of equal quality. These PRs are intended to create economic linkages upstream and downstream of the investment activity in order to drive the creation and diversification of related economic activities. They are particularly crucial in the extractive industries sector, which is often an economic enclave in host countries.
- Achieve a specific level of local jobs. These measures may also take the form of a quota to be filled or be subject to the condition that jobs be made available in equal quality and quantity over the territory. They may relate to both skilled and unskilled posts, and aim to increase and diversify the number of jobs created by the investments and contribute to reduce unemployment.
- Engage in training programs for the workforce or build the capacities of suppliers of goods and services. These requirements are often a response to demands for the location of the workforce and suppliers of goods and services in order to overcome the critical problem of a lack of appropriate skills or abilities.



- Carry out a given level of research and development (R&D) activity in the country. These requirements aim at promoting the discovery of new products or technologies to improve the productivity of the activity or reduce its various negative impacts on health, the environment, etc.
- Transfer technology to the country. The investor brings a certain level of a predetermined type of technology, which it often owns, applying the highest industrial standards. These requirements aim at enabling local enterprises to access the best technologies and preparing them for better competitiveness on the world market.
- Carry out environmental and social actions. These PRs should not be confused with requirements for the internationally recognized and required practices of environmental and social impact assessments. These requirements help improve environmental and social conditions in the communities where the investment is located.
- Form a joint venture (JV) with national partners to make the investment. These requirements are intended to ensure that certain key sectors of the economy do not fall under foreign control. They may also foster the transfer of skills, technology and know-how to local companies. Furthermore, they may also be a means of creating national champions in a sector by enabling them to benefit from the experience and strengths of a foreign company.
- Have a minimum level of domestic shares in the company's capital. These requirements help ensure that certain sectors remain under the control of nationals, or generate income to the benefit of nationals.
- Establish the investment activities or the decision-making centre in a given region. The aim of these requirements is to accelerate development in disadvantaged areas of the country.
- Limit itself to a certain volume or quantity of sales of goods or services on the national market.
- Export a certain level of locally produced goods.

2.3 LIMITED SUCCESS AND THE USEFULNESS OF PERFORMANCE REQUIREMENTS

PRs are often cited as brakes on the flow of FDI. According to the Washington Consensus, PRs have a distorting effect that is detrimental to international trade and FDI. However, empirical data show many cases of countries that have used PRs extensively at a certain time in their history, while attracting a high and growing level of FDI. Thus, Chang (2006) surveys the successful use of industrial policy in the economic rise of post-war Japan and modern Korea, Singapore and Taiwan with a suite of tools that included a number of different PRs. Rodrik (2006) describes China's successful efforts to alter the pattern of its export trade, and Mazzucato (2013) documents China's successful push to develop solar PV and wind power sectors specifically, with extensive use of local content and technology-transfer requirements. Ranawat and Tuwari (2009) document the influence of Indian government policy in fostering a competitive domestic automobile sector, and Morris, Kaplinski, and Kaplan (2012) describe the successful efforts of Botswana in fostering a domestic diamond processing industry, with extensive use of performance requirements in both cases.

Nevertheless, critics of PRs accuse them of often being ineffective. It is true that there are many examples of failures all over the world. But these failures demonstrate that PRs are often misused, and not that they are intrinsically poor development tools. In fact, it is essential that countries using PRs avoid the pitfalls that undermine their success.



Indeed, PRs must reflect a fair balance, to produce effects without jeopardizing the economic viability of investments. For example, the imposition of a high quota for the supply of local goods and services will be ineffective in a context characterized by the absence of supporting policies for capacity building or access to finance. Similarly, the failure of many joint venture requirements can be explained by the fact that these kinds of “forced marriages” often lack the basic ingredients for joint venture success: shared objectives, trust and complementary capabilities” (Cosbey & Mann, 2014, p. v).

Capacity to manage and monitor PRs is also a crucial element. R&D requirements are often ineffective, because the success of these measures largely depends on the state’s capacity to absorb, adopt and develop the technology found and cover its associated costs. Similarly, the effectiveness of technology transfer requirements depends on the capacity of the state to specify the type of technology it needs the most and to monitor the implementation of these requirements.

Ultimately, PRs are no panacea, but they do form part of the toolbox governments can successfully use to substantially increase the economic, social and environmental benefits of FDI for their people. As Cosbey and Mann (2014) have stated

while there have been many negative experiences as well as positive, this does not validate the Washington Consensus view that such tools should not be used—a view that underpins the prohibitions PR face in investment law [...]. Rather, it demands a focus on how to do the job right. Doing this is not a formulaic exercise, and the right tools will be different from country to country, sector to sector (p. 12).



3.0 WTO Prohibitions on Performance Requirements

3.1 OVERVIEW OF THE TRIMS AGREEMENT

The WTO Agreement on Trade-Related Investment Measures (TRIMs)⁵ forbids certain PRs. Thus, Article 2.1 of TRIMs Agreement states: “Without prejudice to other rights and obligations under GATT 1994, no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994.” Although not defined, an illustrative list of TRIMs that are incompatible with Articles III.4 or XI.1 is included in the Annex to the Agreement. These requirements, whether mandatory or not, may be grouped into two categories.⁶

The first concerns measures that are incompatible with the national treatment (NT) obligation provided for under Article III.4 of the GATT, because they discriminate between local and foreign products. These are:

- Requirements relating to local content, according to which an enterprise must buy or use products of national origin or from any national source.
- External measures (applied at the border) relating to the balance of trade that limit the purchase or use by an enterprise of imported products to an amount linked to the volume or value of the local products it exports.
- The second concerns measures that are incompatible with Article XI.1 of GATT 1994 on the import or export of products by an enterprise. These include:
 - Internal measures related to the balance of trade that affect the purchase or use of products after their import.
 - Measures limiting imports in the form of a requirement related to trade balancing by virtue of which the possibility of importing products used or related to local production is restricted by the fact that the enterprise’s access to foreign currency is limited to an amount linked to foreign exchange inflows attributable to the enterprise.
 - Measures consisting of restricting the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of the volume or value of its local production.

Furthermore, in accordance with Articles 4⁷ and 5.3⁸ of the TRIMs Agreement, developing countries, particularly the least developed countries (LDCs), are eligible for temporary exemptions from the implementation of the Agreement. In these cases, countries may continue, under certain conditions, to use the PRs prohibited by the WTO. Therefore, the inclusion of a clause prohibiting PRs in an investment treaty would nullify the benefit of this exemption for developing countries in their bilateral or regional relations with one or more countries.

⁵ The English text of the TRIMs Agreement is available at http://www.wto.org/english/docs_e/legal_e/18-trims_e.htm.

⁶ According to the typology available on the WTO website at http://www.wto.org/english/tratop_e/invest_e/invest_info_e.htm.

⁷ Article 4 reads as follows: “A developing country Member shall be free to deviate temporarily from the provisions of Article 2 to the extent and in such a manner as Article XVIII of GATT 1994, the Understanding on the Balance-of-Payments Provisions of GATT 1994, and the Declaration on Trade Measures Taken for Balance-of-Payments Purposes adopted on 28 November 1979 (BISD 26S/205-209) permit the Member to deviate from the provisions of Articles III and XI of GATT 1994.”

⁸ Article 5.3 reads as follows: “On request, the Council for Trade in Goods may extend the transition period for the elimination of TRIMs notified under paragraph 1 for a developing country Member, including a least-developed country Member, which demonstrates particular difficulties in implementing the provisions of this Agreement. In considering such a request, the Council for Trade in Goods shall take into account the individual development, financial and trade needs of the Member in question.”



In sum, the PRs prohibited by the WTO are those linked to local content requirements, trade-balancing requirements, foreign exchange restrictions related to the foreign exchange inflows of an enterprise, and export controls. Moreover, the TRIMs Agreement covers trade in goods only, excluding services. Because of this, PRs are not forbidden in the services sector.

Several disputes based on (among other things) alleged breaches of the TRIMs Agreement have been brought before the WTO Dispute Settlement Body (DSB), the majority of which occurred in the automobile sector.⁹ However, only two main cases, namely the *Indonesia–Automobiles*¹⁰ and *Canada–Renewable Energy*¹¹ cases, have given the panels an opportunity to specify the condition under which a state measure breaches the TRIMs Agreement. It must be a “trade-related” “investment measure,” “in breach of Articles II.4 and XI.1 of the GATT.”¹² In particular, it is considered that the term “investment measures” in the TRIMs Agreement “is not limited to measures taken specifically in regard to foreign investment.”¹³ In addition, non-mandatory TRIMs are also covered, because “[t]he wording of the Illustrative List of the TRIMs Agreement makes it clear that a simple advantage conditional on the use of domestic goods is considered to be a violation of Article 2 of the TRIMs Agreement even if the local content requirement is not binding as such.”¹⁴ Finally, it has been clarified that, “when the TRIMs Agreement refers to ‘the provisions of Article III,’ it refers to the substantive aspects of Article III; [...] and not the application of Article III in the WTO context as such. Thus if Article III is not applicable for any reason not related to the disciplines of Article III itself, the provisions of Article III remain applicable for the purpose of the TRIMs Agreement.”¹⁵

3.2 WTO V. INVESTMENT TREATIES: THE DISPUTE SETTLEMENT MECHANISM ISSUE

At the WTO, cases bearing on a complaint about the use of prohibited PRs are relatively rare. This is not surprising because every state uses or has used PRs in one way or another. Therefore, they are reluctant to resort to dispute settlement mechanisms to resolve their disagreements on these matters.

This is not the case when a private investor is a party to a dispute against a state. In a BIT, the investor has direct access to investor–state arbitration and will be inclined to make more extensive use of it. To date, at least 568 known investment arbitrations have been listed (UNCTAD, 2014, p. 1).

There is a fundamental difference between settling PR-related disputes at the state–state level at the WTO and doing so at the investor–state level. In the first case, the risks of disputes are reduced, and there is an appeal mechanism to ensure the system’s coherence. In the second case, the risks of disputes are increased with all the controversy raised by this mechanism and the need to reform it.¹⁶

In short, only a proportion of PRs in the trade of goods are prohibited in the WTO, and even here some mechanisms allow developing countries to benefit from exemptions to maintain prohibited PR. PRs not listed as breaching Articles III.4 and XI.1 of the WTO GATT remain available to states wishing to use them. However, investment treaties sometimes prohibit PRs beyond those in the TRIMs Agreement list, thus posing risks to host states, particularly in the case of developing countries, as discussed below.

⁹ The complete list of disputes in which the provisions of the TRIMs Agreement have been invoked is available at http://www.wto.org/english/tratop_e/dispu_e/dispu_agreements_index_e.htm?id=A25.

¹⁰ *Indonesia—Certain measures affecting the automobile industry*, Panel Report (2 July 1998); WT/DS54/R, WT/DS55/R; WT/DS59/R; WT/DS64/R.

¹¹ *Canada—Certain Measures Affecting the Renewable Energy Generation Sector*, Panel Report (12 December 2012), WT/DS412/R.

¹² *Indonesia—Automobiles*, Panel Report (2 July 1998), paras. 14.71–14.72.

¹³ *Indonesia—Automobiles*, Panel Report (2 July 1998), para. 14.73.

¹⁴ *Indonesia—Automobiles*, Panel Report (2 July 1998), para. 14.90.

¹⁵ *Indonesia—Automobiles*, Panel Report (2 July 1998), para. 14.61.

¹⁶ On the issues and challenges of investor–state arbitration based on treaties for the protection and promotion of investments, see Bernasconi-Osterwalder, Cosbey, Johnson, & Vis-Dunbar (2012, pp. 44–56).



4.0 Performance Requirements in BITs

Under international law, every state has the right to set the conditions under which it admits investments (national and foreign) in its territory, including the use of the PRs described above, unless it has made international commitments limiting its sovereignty in this area, particularly by means of investment treaties. An analysis of BITs shows that the majority of these texts do not prohibit the use of PRs, but that a prohibition has been appearing in a growing number of them for a decade. The precursor texts were the North American Free Trade Agreement (NAFTA) and the free trade agreements (FTAs) concluded by the United States, Canada and Japan.

4.1 THE MAJORITY TRADITIONAL APPROACH: NO PROHIBITION ON PERFORMANCE REQUIREMENTS

The vast majority of BITs make no reference to PRs. This silence does not mean that the parties can apply all PRs. In fact, insofar as they are also parties to the WTO, they are subject to the limitations of the TRIMs Agreement. Nevertheless, all PRs not prohibited by the WTO remain available.

However, this silence means—and this is crucial—that any PR-related disputes that arise, even those prohibited in the WTO, cannot be subjected to the investor–state dispute settlement system provided by the BIT, subject to the other BIT provisions. This does not, however, prevent states parties from turning to the WTO dispute settlement system.

4.2 THE GROWING MINORITY APPROACH: A PROHIBITION ON PERFORMANCE REQUIREMENTS

Clauses prohibiting PRs in BITs are formulated in a range of ways. They go from a limited restriction to very wide-ranging prohibitions.¹⁷ From a review of BITs prohibiting PRs it is possible to group them into four broad categories. Each type of formulation has specific legal implications. Whether or not a PR breaches a treaty will largely depend on the terms used in each particular case.

4.2.1 The Principle of Prohibition of PRs

So-called “TRIMs clauses”

BITs in this category simply refer to the TRIMs Agreement, when the two parties are also WTO members. This incorporation by reference makes the prohibition of the PRs listed under the WTO TRIMs Agreement obligatory under the BIT.

This situation seems identical to that in which the BIT does not cover PRs, but the parties are WTO members. However, there is a fundamental difference here: disputes related to PRs prohibited by the WTO are subject to the investor–state dispute settlement system provided under the BIT, unless expressly excluded.

An example of a TRIMs clause is available in Article 9 (performance requirements) of the 2012 China–Canada treaty:

¹⁷ A non-exhaustive list of BITs limiting or prohibiting PRs includes: India–Kuwait BIT (2001), Article 4.4; Japan–India Comprehensive Economic Partnership Agreement (CEPA 2011), Article 89; El Salvador–Peru (1996); Bolivia–Mexico (1995); Dominican Republic–Ecuador (1998); Chile–Mexico FTA (1999); Chile–South Korea FTA (2003).



The Contracting Parties reaffirm their obligations under the WTO Agreement on Trade-Related Investment Measures (TRIMs), as amended from time to time. Article 2 and the Annex of the TRIMs are incorporated into and made part of this Agreement.

There is also a very common clause in BITs that could have the same result as a TRIMs clause. Whether or not they are included in a separate article, these clauses are sometimes entitled “Application of other rules” or “Other agreements.” These provisions enable investors to benefit from more favourable terms set out in other international agreements between the same parties. Clauses of this type, whose exact scope has not yet been established, could have the effect of importing WTO TRIMs provisions under the treaty. However, this has not yet been tested before the tribunals. Although the mechanism is similar to that of the most-favoured nation (MFN) clause (see below), it is different because the agreements are concluded between the parties to the BIT, and not between one party to the BIT and a non-party state.

A clause of this kind is available in Article 10 of the Belgium–Guinea treaty:¹⁸

If an issue relating to investments is governed both by this Agreement and by the national legislation of one of the Contracting Parties, **or by international conventions currently in force or contracted to in the future by the Parties**, [emphasis added] the investors of the other Contracting Party may invoke the provisions that are most favourable to them.

Post-establishment “TRIMs+” Clauses

Whether by TRIMs or by TRIMs+ clauses, certain BITs only prohibit PRs after the investment establishment phase. Thus, Article 4.4 of the India–Kuwait BIT (2001) reads:

Once established, investment shall not be subjected in the host Contracting State to additional performance requirements which may hinder or restrict their expansion or maintenance or adversely affect or be considered as detrimental to their viability, **unless such requirements are deemed vital for reasons of public order, public health or environmental concerns and are enforced by law of general application** [emphasis added].

However, this BIT provides that PRs may be imposed after the establishment to protect public order, public health and the environment. Therefore, it is a rather limited prohibition.

On the contrary, Canadian and U.S. BITs and FTAs extend the prohibition on PRs to the pre-establishment phase.

So-called “TRIMs+” Clauses Pre- and Post-establishment

Some BITs do not limit themselves to prohibiting the PRs listed in the WTO TRIMs Agreement. At the regional level, the typical example of a TRIMs+ clause is Article 1106 of the NAFTA Agreement between Canada, Mexico and the United States (excerpts):

1. **No Party may impose or enforce any of the following requirements**, or enforce any commitment or undertaking, in connection with the **establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory**:
 - a) To export a given level or percentage of goods or services;
 - b) To achieve a given level or percentage of domestic content;

¹⁸ See also the United Kingdom–Kenya (1999) and Burundi–Comoros (2001) BITs;



- c) To purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;
- d) To relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment;
- e) To restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings;
- f) To transfer technology, a production process or other proprietary knowledge to a person in its territory, (...) or
- g) To act as the exclusive supplier of the goods the investment enables it to produce or services it enables it to provide to a specific region or world market.

(...)

3. **No Party may condition the receipt or continued receipt of an advantage**, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with any of the following requirements:

a) (...)

d) (...)

(...)

5. Paragraphs 1 and 3 do not apply to any requirement other than the requirements set out in those paragraphs [emphasis added].

At the bilateral level, this type of clause is shown by treaties negotiated by Canada and the United States, which are the two countries with the most BITs with clauses restricting PRs. The terms of Canadian and U.S. BITs and FTAs made after 1994 are generally inspired by NAFTA Article 1106 and by their subsequent model BITs. Thus, of the 20 U.S. FTAs currently in force, every one of them includes a chapter on the protection of investments with a clause on PRs that is very similar to that in the 2004 U.S. model BIT.¹⁹

Article 8 of the U.S. 2012 model BIT offers an example of a very sophisticated clause widely prohibiting the use of PRs.²⁰

Non-binding Clauses

Some old BITs simply encourage the parties not to apply PRs. This is the case of Article II.7 of the DRC–U.S. BIT (1984):

Within the context of its national economic policies and goals, each Party **shall endeavor to avoid imposing** on the investments of nationals or companies of the other Party conditions which require the export of goods produced or the purchase of goods or services locally. This provision shall not preclude the right of either Party to impose restrictions on the importation of goods into their respective territories [emphasis added].

¹⁹ This is the case of FTAs made with the following countries: Australia, Chile, Israel, Morocco, Oman, Peru, Singapore, CAFTA-DR (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Dominican Republic)

²⁰ The text is available at: <http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf>.



This provision illustrates the wish of the countries at that time not to waive the right to impose PRs. Nevertheless, similar clauses no longer appear in post-NAFTA U.S. BITs.

4.2.2 Exceptions and Reservation on the Prohibition of PRs

Some treaties prohibiting PRs, including those of the TRIMs+ type, include limits on that prohibition. But this is not the case for all treaties.

The objective of these limits is to enable the host state to impose certain PRs in certain circumstances, despite the general prohibition. These limits take the form of exceptions (whether general or specific) or reservations in treaties.

For example, a general exception to the prohibition of certain mandatory and non-mandatory PRs on local content and the purchase of local products and services is provided for in NAFTA Article 1106.6. It is aimed at measures of this kind taken to protect the environment. Nonetheless, the state measure must not be arbitrary or unjustified, and neither must it constitute a disguised restriction on international trade:

Nothing in paragraph 1b) or c) or 3a) or b) shall be construed to prevent any Party from adopting or maintaining measures, including environmental measures:

- a) Necessary to secure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement;
- b) Necessary to protect human, animal or plant life or health; or
- c) Necessary for the conservation of living or non-living exhaustible natural resources,

Provided that such measures are not applied in an arbitrary or unjustifiable manner, or do not constitute a disguised restriction on international trade or investment [emphasis added].

One exception granted solely to certain non-mandatory PRs in paragraph 3 (such as R&D work) is also provided for in the same Article 1106:

5. Nothing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, **on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory [emphasis added].**

Still in Article 1106, one specific exception for mandatory PRs related to technology transfer reads as follows:

2. A measure that requires an investment to use a technology to meet **generally applicable health, safety or environmental requirements shall not be construed to be inconsistent with paragraph 1f) [emphasis added].**

Regarding reservations, one may highlight NAFTA Article 1108.1(c), which allows states to maintain and amend existing measures that do not conform to the treaty at the time of its entry into force. These nonconforming measures (NCMs) are listed in Annexes to the Agreement. To be effective, this type of article requires states to be able to identify and then negotiate the inclusion of all PRs in force. This is not always an easy task. Moreover, this reservation does not cover new nonconforming PRs adopted after the treaty is concluded. The scope of Article 1108.1(c) was at the heart of an investment dispute discussed below (section 5.2).



4.3 OTHER CLAUSES IMPACTING ON THE SCOPE OF THE PROHIBITION OF PRS (CONTENT AND SCOPE)

These clauses do not directly address PRs in treaties but, depending on the way in which they are formulated, they can indirectly have the same effect as TRIMs or TRIMs+ clauses.

Pre-establishment Clauses (Market Access Rights)

These clauses extend the benefit of NT or MFN treatment since the establishment phase of the investment. This means that the host state is not able to give less favourable treatment to investors from the other state than to its nationals or other foreign investors, with regard to the conditions for the entry and establishment of investments on its territory. This is called investment liberalization or the granting of pre-establishment rights.²¹ This clause usually reads as follows (Article 1103.1 of NAFTA):

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

The granting of pre-establishment rights is accompanied by exceptions for sensitive measures or sectors in which signatory countries can freely regulate the entry of foreign investment. The choice of the areas excluded from liberalization is particularly crucial. These clauses pose critical problems for the sovereignty of states and must be considered with caution.²² Moreover, it is important to recall that a state does not need to include clauses of this type in a BIT to liberalize a sector of its choice, just as an investor has no need of such a clause to be able to invest in a country.

Considered in isolation, pre-establishment rights may already have an impact on the possibility of imposing PRs. For example, even if the imposition of creating a joint venture is not a prohibited PR under the BIT, it would breach the pre-establishment rights of the protected foreign investor. Indeed, this requirement is a condition for establishing an investment in the territory that is not imposed on nationals, and which therefore violates the NT obligation at the pre-establishment phase.

Very often, a PR prohibition is associated with pre-establishment rights in BITs. The proportion increases further when it is an FTA containing a chapter on investment. This is because these clauses are part of the same logic of reducing the sovereignty of states in the selection of foreign investment and in the regulation of conditions for establishment and operation. The combination of the two clauses can extend the prohibition on PRs to as early as the establishment phase of an investment. Ultimately, this ensures greater liberalization of market access for foreign investment and operating conditions.

Most-Favoured Nation Clause (MFN)

The MFN clause can play an important role in a treaty that does not prohibit PRs. This clause obliges the signatory state to grant “no less favourable treatment” to the investors of the other party than that granted to

²¹ The purpose of these clauses is to open access to the market for foreign investors, particularly in the area of natural resources. The majority of BITs worldwide, including those signed by developing countries, do not contain pre-establishment clauses. Nonetheless, there is growing pressure for the inclusion of these clauses in BITs on the part of the United States and Canada, whose nationals are investing heavily in the natural resources sector of developing countries.

²² For a more detailed critique of the issues of clauses of this kind for developing countries, see Bernasconi-Osterwalder et al. (2012, pp. 23 ff.).



investors of any non-party state. Given the broad interpretation of the MFN clause, it can cover advantages granted by a state in its other BITs. The consequence is that an investor protected by a treaty without a prohibition of PRs may use the MFN clause to import a prohibition of PRs from another of the host country's treaties and benefit from it as more favourable treatment. Although criticized, this is the prevailing interpretation, unless the parties have been careful to exclude their other BITs and international agreements from the scope of the MFN clause.²³

States wishing to retain their sovereignty with regard to PRs must, therefore, be sure to have a consistent approach in all BITs, or at least include clear exclusions and exceptions. An example of a restrictive MFN clause can be found in Annex 3 of the Canadian model BIT (FIPA 2004):

Article 4 [Most-favoured Nation Treatment] shall not apply to treatment accorded under all bilateral or multilateral international agreements in force or signed prior to the date of entry into of this Agreement.

The Canadian model only excludes prior agreements here, but it is also possible to exclude future agreements and to exclude expressly from the scope of investor–state dispute settlement mechanism, as in Article 4.4 of the model BIT of the Southern African Development Community (SADC):

Notwithstanding any other provision of this Agreement, the provisions of this Article shall not apply to concessions, advantages, exemptions or other measures that may result from:

(a) (a) **A bilateral investment treaty** or free trade agreement [that entered into force prior to this agreement]; or

(b) (b) **Any multilateral or regional agreement relating to investment** or economic integration in which a State Party is participating or may participate [emphasis added].

The Employment Clause

This clause, also common in BITs, guarantees the foreign investor the right to employ staff of the nationality of its choice without interference from the host state. Nevertheless, it enables the host state to require a minimum percentage of its own nationals in senior management positions, on condition that this does not impair the investor's ability to exercise control over its investment.

When the investor's rights are particularly broad, this clause can have the effect of significantly limiting the use of PRs with regard to employment. It is then important to ensure this clause allows the state to impose such PRs when the measures are reasonable, non-discriminatory and suited to the needs of the business. There is an example of such a clause in Article 7.4 of the SADC model BIT:

Notwithstanding any provisions of this Agreement, a State Party may require an Investor of the other Party or its Investment, **in keeping with its size and nature**, to have progressive increases in the number of senior management, executive or specialized knowledge positions that nationals of the Host State occupy; institute training programs for the purposes of achieving the increases set out in the preceding paragraph and to Board of Director positions; and to establish mentoring programs for this purpose [emphasis added].

²³ For more information on MFN clauses and their issues, see Bernasconi-Osterwalder et al. (2012, pp. 29–31).



5.0 The Interpretations of Investment Tribunals

To date, there have been relatively few investment arbitrations focusing on a challenge to a host country's PRs. The majority of known cases were on the basis of NAFTA.²⁴ All known cases covering PRs involved a Canadian or U.S. BIT or FTA. This is probably due to the fact that, to date, most BITs other than those negotiated by Canada or the United States do not include clauses prohibiting PRs. To present an overview of the tribunals' decisions on PR prohibitions, two recent differing cases are examined here: the *Mobil Oil v. Canada* case of 2012²⁵ based on NAFTA (1992), and the *Lemire v. Ukraine* case of 2010²⁶ based on the Ukraine–U.S. BIT (1994).

5.1 THE RESTRICTIVE INTERPRETATION OF THE PROHIBITION ON PERFORMANCE REQUIREMENTS

In *Lemire v. Ukraine*, a U.S. national holding a radio licence in Ukraine alleged, among other things, that Article 9.1 of the Law of 2006 on TV and radio broadcasting was a prohibited PR, because it required that 50 per cent of each station's broadcasting time should be reserved for music produced in Ukraine. The objective of this law was to promote Ukrainian music. "Music produced in Ukraine" was defined by the law as any music whose author, composer or performer was Ukrainian. The investor argued that the 2006 law violated Article II.6 of the Ukraine–U.S. BIT, which reads as follows:

Neither party shall impose performance requirements as a condition of establishment, expansion or maintenance of investments, which require or enforce commitments to export goods produced, or which specify that goods and services must be purchased locally, or which impose any other similar requirements.

The BIT does not provide any exceptions or reservations on the prohibition of PRs.²⁷

Interpreting this very broad clause, the tribunal concluded that the Ukrainian law of 2006 did not violate Article II.6 of the BIT. To do so, the arbitrators started from the premise that the law did not require music to be produced locally, even recognizing that, in fact, Ukrainian authors, composers and producers were based in Ukraine.²⁸ Nevertheless, the decisive argument was the recognition of the objective of the Ukrainian measure. The tribunal understood that, when the measure was adopted, "the underlying reasons were not to protect local industries and restrict imports, but rather to promote Ukraine's cultural inheritance, a purpose which is compatible with Article II.6 of the BIT."²⁹ It may be noted here that, in *Merrill & Lynch v. Canada*, the tribunal also concluded that a measure that is not targeted at local purchases and that leaves the investor free to use services of any origin does not breach NAFTA Article 1106, even if, for practical and economic reasons, recourse is made to local persons or enterprises.³⁰

²⁴ These are: *Pope & Talbot Inc. v. Government of Canada*, UNCITRAL, Interim ruling of 26 June 2000; *S.D. Myers Inc. v. Canada*, UNCITRAL, partial award of 13 November 2000; *ADF Group Inc. v. United States of America*, ICSID Case No. ARB (AF)/00/1, award of 9 January 2003; *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas, Inc. v. United Mexican States*, ICSID Case No. ARB (AF)/04/5, award of 21 November, *Corn Products International, Inc. v. United States of America*, ICSID, Case No. ARB (AF)/04/1, award of 15 January 2008; *Cargill, Incorporated v. United Mexican States*, ICSID Case No. ARB(AF)/05/2, award of 18 September 2009; *Merrill & Ring Forestry L.P. v. Government of Canada*, UNCITRAL, ICSID, award of 31 March 2010; *Mobil Investments Canada Inc. and Murphy Oil Corporation v. Government of Canada*, ICSID Case No. ARB(AF)/07/4, Decision of 22 May 2012. All the awards are available at <http://italaw.com>.

²⁵ *Mobil Investments Canada Inc. and Murphy Oil Corporation v. Government of Canada*, ICSID Case No. ARB(AF)/07/4, Decision of 22 May 2012, paras. 172 et seq. Retrieved from <http://italaw.com/sites/default/files/case-documents/italaw1145.pdf>.

²⁶ *Joseph Charles Lemire v. Ukraine*, ICSID Case No. ARB/06/18, Award of 14 January 2010, paras. 499–511. Retrieved from: <http://italaw.com/sites/default/files/case-documents/ita0453.pdf>.

²⁷ The Annex to the BIT does give an exception to NT for the Ukraine regarding the ownership and operation of TV and radio stations.

²⁸ *Lemire v. Ukraine*, para. 509.

²⁹ *Lemire v. Ukraine*, para. 510.

³⁰ *Merrill & Lynch v. Canada*, paras. 113, 115.



Nonetheless, the Ukraine was ordered to pay approximately US\$8.7 million for breaching fair and equitable treatment during the procurement procedures (Johnson, 2011).

This case is among those that demonstrate high deference to the sovereignty of the host state, even though the clause prohibiting PRs was particularly broad.

5.2 THE BROAD INTERPRETATION OF THE PROHIBITION ON PERFORMANCE REQUIREMENTS

*Mobil Oil v. Canada*³¹ put two oil companies based in the province of Newfoundland and Labrador up against the government of Canada in a dispute rooted in the province’s R&D spending requirements. Pursuant to provincial and federal legislation, the committee (Canada–Newfoundland Offshore Petroleum Board) had been issuing guidelines since 1986 on R&D spending in the companies’ “social benefits programs.” The 2004 guidelines were at the root of the dispute. Unlike earlier guidelines, those of 2004 set a fixed amount for R&D spending based on average expenditures by sector, and extended this spending to the production phase, instead of limiting it to the exploration and development phases. These new guidelines were put in place following a decline in R&D spending, and were recommended by a public auditor.

Among other things, the claimants alleged that, by setting a fixed amount for R&D and obliging them to buy goods and services in the province of Newfoundland and Labrador, the guidelines breached Article 1106.1(c) of NAFTA on the prohibition of PRs.

As a reminder, Article 1106.1.c of NAFTA reads as follows:

1106.(1) No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory: (...) (c) to purchase, use or accord a preference to goods produced or services provided in its territory, or **to purchase goods or services from persons in its territory** [emphasis added].

Canada argued in turn that R&D did not constitute a “service,” and that, even if it did, Canada would have immunity under a Canadian reservation by virtue of Article 1108. Indeed, the list of Canada’s reservations did include the federal law based on which the 2004 guidelines were enacted. We recall here that, under Article 1106.4 of NAFTA, only mandatory PRs related to R&D are prohibited; PRs on non-mandatory R&D (imposed in exchange for benefits) are not prohibited.

First, the tribunal concluded that the Canadian measure breached Article 1106. To do this, the tribunal held that the term “service” in Article 1106 was “broad enough to encompass R&D.”³² It then concluded that the 2004 guidelines imposed a de facto obligation on investors to buy R&D-related services locally, even though they did not have such a goal at the outset. Thus, unlike *Lemire v. Ukraine* or *Merrill & Lynch v. Canada*, the objective of the measure was irrelevant, compared to its effect.³³

Second, a majority of the tribunal concluded that the 2004 guidelines were not covered by the Canadian reservation under Article 1108 (excerpts):

1. Articles 1102, 1103, 1106 and 1107 do not apply to: (...) (c) an amendment to any nonconforming 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 (...). And Annex I, paragraph (2)(d)(ii) reads as follows: A measure cited in the Measures element ... (ii) includes any subordinate measure adopted or maintained under the authority of and consistent with the measure.

³¹ For a summary of the case, see Vis-Dunbar (2013).

³² *Mobil Oil v. Canada*, para. 216.

³³ *Mobil Oil v. Canada*, para. 222.



Article 1108.1(c) and the annexes have the effect of allowing the states parties to maintain NCMs adopted before NAFTA came into force, to be able to amend these NCMs and adopt later subordinate measures (here, the 2004 guidelines). Nonetheless, amendments to NCMs must not “decrease the conformity” of the measure in question to the treaty, and the new subordinate measures must be taken “under the authority of and consistent with the measure.”

The tribunal proceeded here to an original interpretation. It concluded that, to benefit from the reservations, the new subordinate measure:

- Must not “unduly expand the nonconforming features of the reservation.”³⁴ This amounts to requiring the new subordinate measure not to “decrease conformity” of the NCM with the treaty, instead of simply being “consistent” with the NCM. So, it uses a test similar to a “non-decreasing conformity” test, instead of a less narrow “consistency” test, as was noted by one author (Genest, 2014, pp. 309–310).
- Must conform to the legal framework applicable to the NCM rather than just to the measure; this includes prior subordinate measures taken in application of the NCM. The tribunal’s view was, indeed, that the term “measure” used at the start of paragraph 2(f)(ii) of Annex 1 included the NCM and its subordinate measures.³⁵

In requiring so broad a level of control, the tribunal considerably reduced the scope of the reservations in Article 1108, because the 2004 guidelines should not have reduced the conformity of the provincial and federal applicable laws (“Accords Acts”), instead of just being consistent with it, and should not have aggravated the violation of the previous guidelines of 1986, 1987 and 1988. Noting that the effect of the 2004 guidelines is to indicate a set of requirements for buying, using or granting preference to local goods and services which has considerably expanded in comparison with the previous legal framework, the tribunal found that they were not consistent with Canada’s reservation.³⁶

This interpretation of Article 1108 gave rise to a dissenting opinion by one member of the tribunal, Professor Philippe Sands, who considered that a new subordinate measure should simply have to be consistent with and under the authority of the measure excluded from NAFTA by the reservation of a state party.³⁷ According to Professor Sands, the interpretation of the tribunal was problematic because it established a constantly evolving norm, with the adoption of new subordinate measures, and destroyed transparency, because the new subordinate measures were not added to the list of NAFTA reservations.

However, the tribunal did not award damages to the investors, in the absence of losses—Canada had not yet claimed payments under the 2004 guidelines—and of proof of certain future losses.

Ultimately, “the majority award in *Mobil Oil v. Canada* demonstrates the risk of tribunal interpreting reservations provisions in unexpected ways and defeating carve-outs for certain measures” (Genest, 2014, p. 306).

In conclusion of the review of arbitration awards, and although the terms of NAFTA and the Ukraine–U.S. BIT are not identical on the prohibition of PRs, these two main cases illustrate again the problem of unpredictability and inconsistency in international investment law, as interpreted by investment tribunals. Neither case gave priority to finding a proper balance between the objective of the contested state measures and their detrimental impact on the investor. The proliferation of future awards due to the increase in BITs prohibiting or limiting PRs will serve to confirm or contradict these divergent views.

³⁴ *Mobil Oil v. Canada*, paras. 336, 341.

³⁵ *Mobil Oil v. Canada*, paras. 309–310, 315, 317, 324–327.

³⁶ *Mobil Oil v. Canada*, paras. 405–413.

³⁷ See the partial dissenting opinion of Professor Philippe Sands, particularly para. 30 et seq., available at: http://italaw.com/sites/default/files/case-documents/italaw1146_0.pdf.



6.0 Options

Developing countries have realized that, going beyond tax issues, it is essential to find other means to make better use of FDI in their territory for the well-being of their populations.

Starting from the premise that well-formulated and applied PRs can be effective tools to maximize the economic, environmental and social benefits of foreign investment, it is consequently important for states, particularly developing countries, to retain the possibility of using them when the circumstances warrant so doing.

There are several options that states may adopt for the use of PRs:

- The simplest and most effective approach consists of not prohibiting or limiting PRs in BITs—legally, there is no obligation under international law to include a clause on PRs in a BIT. This approach has the advantage of allowing states to retain the flexibility needed in the sphere of economic policy. Also, this approach enables them to avoid complex, uncertain formulations and to guard themselves against the unpredictability of tribunal interpretations, while avoiding having to take a cut-and-dried position on the effectiveness of PRs. To be effective, an approach of this kind would preferably be consistent throughout the state’s BITs.
- Another option would be to include a clause expressly authorizing PRs. The clause could limit their use solely before establishment (and not after the investment has been made), so that the investor could make an informed decision. This limited authorization of PRs should be excluded from the scope of the NT and MFN clauses. This would mean that pre-establishment PRs could be imposed on domestic investors, and the MFN clause would not enable the import of more favourable provisions from other treaties.
- In cases where a state chooses to limit its choice of industrial and economic policies through a prohibition on the use of PRs in a BIT, it could make various stipulations, in cumulative way:
 - » Restrict mandatory PRs only (but not non-mandatory PRs), or restrict only PRs prohibited by the WTO, by means of a reference to the TRIMs Agreement.
 - » Expressly exclude NT and MFN treatment from the scope of the prohibition on PRs, for the same reasons described below.
 - » Create a list of sectors to which the prohibition on PRs applies or does not apply (a positive or negative list). This exercise requires prior analysis of sensitive and priority sectors for the host state.
 - » Grandfather existing PRs and existing nonconforming measures in order to be able to maintain them. It is also important to safeguard any future amendments made to existing measures, on condition that they do not expand non-conformity with the treaty. In every case, it is more appropriate to grandfather all existing measures than to create a list, which would be difficult to make and would risk having important omissions.
 - » Expressly exclude certain categories of performance requirements from the scope of the prohibition. It is for each state to determine its list according to its needs and realities.
 - » Exclude the prohibition on PRs from the investor–state dispute settlement mechanism. This does not preclude submission to the mechanism for settling state–state disputes.



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Head Office

111 Lombard Avenue, Suite 325
Winnipeg, Manitoba
Canada R3B 0T4

Tel: +1 (204) 958-7700
Fax: +1 (204) 958-7710
Website: www.iisd.org
Twitter: @IISD_news



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