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Dissertation Exposé

Dissertation Title:

Stabilizing development? Finding the balance between the right of states to regulate issues in public interest, their obligations arising from stabilization clauses, and investors' expectations of a stable regulatory environment

Doctoral Candidate:

Peter Riznik (1046585)

Supervisor:

Univ.- Prof. MMag. Dr. August Reinisch, LL.M.

Research Field:

Public International Law

Vienna, January 2015

Table of Contents

1. Introduction – finding the balance

The balance between the rights of the states and investors has been described as one of the core issues of the present international investment law.[1] Whereas at its dawn international investment law was primarily intended to protect investments made by investors from capital exporting States against discriminatory measures by capital importing States, today we are facing multi-faceted investments in all directions. Where until recently it was mostly the developing states who made concessions of their sovereignty by giving investors certain rights, today, given the flux of investments in all directions, this may well apply to any State, regardless whether developing or developed.[2] This is particularly important when it comes to the balance between the right of the state to regulate and the right of the investor to be accorded a stable regulatory environment.

A stable investment environment is an important concern for investors when deciding whether to invest in a specific host state. A risk of circumstances that could negatively affect a prospective investment will most likely also affect the influx of foreign capital. Namely, the expectations of the investor regarding the profits and existing risks pertaining to the investment have been said to "have a crucial influence on the investor's decision to invest."[3] Thus, to attract foreign investment states strive to present their investment environment as stable and investment friendly. To achieve this they are willing to enter into international agreements providing for obligations to ensure stability and thereby limiting their future regulatory powers.

By accepting such obligations, a state will be prevented from enacting certain changes in its legislation. However, there is growing concern that this limitation may also apply to those changes genuinely taken in public interest (such as the ones relating to the protection of the environment, human rights and fostering sustainable development). Breaching such assurances may well result in a claim for damages against the state based on an investment treaty mechanism. This has re-

[1] B. STERN, *Confronting Global Challenges: From Gunboat Diplomacy to Investor-State Arbitration*, Speech at the PCA Peace Palace Centenary Seminar, The Hague, 11 October 2013.

[2] *Ibid*.

[3] See, e.g., N. SCHRIJVER, *Sovereignty over Natural Resources: Balancing Rights and Duties*, Cambridge University Press, 2008, p. 278.

cently been the source of considerable criticism targeted at investor-state dispute resolution (ISDS), particularly in the context of the ongoing negotiations of major investment treaties, in particular the Transatlantic Trade and Investment Partnership (TTIP), and a number of controversial cases recently filed.[4]

The proposed thesis will attempt to find a balance between the obligations of states to provide a stable investment environment (where entered into) and their right to adopt regulatory measures, particularly issues in public interest such as environmental protection, human rights, and sustainable development.

2. Stability of Foreign Direct Investments - Background

While, compared to the investor, a host state may often have inferior bargaining power when negotiating a foreign direct investment (FDI), this imbalance in power is typically shifted for the benefit of the state as soon as the investment is made. An investment will inherently be subject to the regulatory powers of the host state and, at the latest when the investment is made, the risk of changing conditions in the regulatory environment becomes apparent. This is particularly true for long-term investment projects which are usually capital intensive and, during their lifetime, possibly subject to the regulatory power of a state governed by multiple subsequent governments.[5]

That is why, to foster foreign investments, states are willing to accept certain obligations regarding the stability of their regulatory framework. They do so by entering into international treaties which, *i.a.*, usually contain provisions on the standards of treatment of investors and their investments. Among these standards, the proposed thesis will focus in particular on the standard of

[4] *E.g. Philip Morris Asia Limited v. The Commonwealth of Australia*, UNCITRAL, PCA Case No. 2012-12 and *Vattenfall AB and others v. Federal Republic of Germany*, ICSID Case No. ARB/12/12. *See* L. JOHNSON, O. VOLKOV: State Liability for Regulatory Change: How International Investment Rules are Overriding Domestic Law, *Investment Treaty News*, International Institute for Sustainable Development, 6 January 2014, available at: http://www.iisd.org/itn/2014/01/06/state-liability-for-regulatory-change-how-international-investment-rules-are-overriding-domestic-law/

[5] The investor has been described as a "hostage of the host state" once the long-term and capital-intensive investment has been made. *See* L. COTULA, Regulatory Takings, Stabilization Clauses and Sustainable Development, OECD Global Forum on International Investment 27-28 March 2008, available at: http://www.oecd.org/investment/globalforum/40311122.pdf, p. 2.

fair and equitable treatment (hereinafter: FET) and its element of required stability and the protection of investor's legitimate expectations.

Nevertheless, some states are willing to take a step further by offering a more encompassing assurance of the stability of the regulatory environment. This is achieved by committing not to change certain laws and regulations relating to the framework of a specific investment for a certain period of time (which may often correspond with the lifetime of the investment). States do this by entering into obligations for the stabilization of the regulatory framework pertaining to the project. Such provisions are usually referred to as stabilization clauses and are included into individual agreements with investors and, in some cases, in the national legislation governing foreign investments.

In my research project, I will compare these two methods of protection of the stability of the regulatory environment and the level of protection offered by each of them. In doing so, I intend to focus on the specific areas of legislation regulating the protection of the environment, human rights, sustainable development, and other issues in public interest.

Regulatory stability – A legitimate expectation of the investor?

The vast majority of investment treaties contain an obligation of the host state to accord to the investor fair and equitable treatment. Furthermore, the FET standard has been described as "the most frequently invoked standard in investment disputes".[6] In current practice, there has hardly been a dispute where a relevant treaty clause requiring the accordance of fair and equitable treatment was not invoked.[7]

The standard is an important element of protecting investments as it "protects investors against serious instances of arbitrary, discriminatory or abusive conduct by host States".[8] The broad

[6] R. DOLZER and C. SCHREUER, *Principles of International Investment Law*, Oxford University Press, Oxford, New York, 2008, p. 119. The Standard has been said to have "replaced expropriation as the most important standard in the protection of foreign investment."

[7] See, e.g, R. DOLZER, Fair and Equitable Treatment: A Key Standard in Investment Treaties, *39 Int'l Law. 87*, para. 1: "Indeed, in current litigation practice, hardly any lawsuit based on an international investment treaty is filed these days without invocation of the relevant treaty clause requiring fair and equitable treatment."

[8] *Fair and Equitable Treatment*, UNCTAD Series on Issues in International Investment Agreements II, United Nations, New York and Geneva, 2012, p. 3.

range of the meaning of the words “fair and equitable treatment” means that the scope of protection offered by the FET standard can only be determined on a case-by-case basis.[9] However, it is widely believed that the protection of legitimate expectations of investors is one of its key elements.[10] Further, the tribunal in *CMS Gas Transmission Company v. The Argentine Republic* noted that “the Treaty standard of fair and equitable treatment and its connection with the required stability and predictability of the business environment, founded on solemn legal and contractual commitments, is not different from the international law minimum standard and its evolution under customary law. “[11]

It appears from case law that the protection of the investor’s legitimate expectations will protect the investor against “unfair changes”, while “it is well established that the host State is entitled to maintain a reasonable degree of regulatory flexibility to respond to changing circumstances in the public interest”.[12] In *EDF v. Romania*, the tribunal noted that legitimate expectations cannot be solely the subjective expectations of the investor but must rather be examined "as the expectations at the time the investment is made, as they may be deduced from all the circumstances of the case, due regard being paid to the host State's power to regulate its economic life in the pub-

[9] See *Mondev v USA*, where the tribunal pointed out that “[a] judgment of what is fair and equitable cannot be reached in the abstract; it must depend on the facts of the particular case. It is part of the essential business of courts and tribunals to make judgments such as these.” *Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, 11 October 2012, para. 118. Similarly, in *Waste Management v Mexico*, the tribunal noted that “the standard is to some extent a flexible one which must be adapted to the circumstances of each case." *Waste Management, Inc. v. United Mexican States (“Number 2”)*, ICSID Case No. ARB(AF)/00/3, para. 99.

[10] In *Electrabel v. Hungary* the tribunal noted that »It is widely accepted that the most important function of the fair and equitable treatment standard is the protection of the investor’s reasonable and legitimate expectations« *Electrabel S.A. v. Republic of Hungary*, Decision on Jurisdiction, Applicable Law and Liability, ICSID Case No. ARB/07/19, 30 November 2012, para. 7.75. See also DOLZER, Fair and Equitable Treatment: Today's Contours, p. 17. This belief, however, is not universally shared and has been criticized. For an alternative view see Separate Opinion of Arbitrator Pedro Nikken in *AWG Group Ltd. v. The Argentine Republic*, UNCITRAL, 30 July 2010.

[11] *See CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, 12 May 2005, para. 284. More on the specific applications of the FET standard regarding transparency, stability and protection of the investor's legitimate expectations in DOLZER, and SCHREUER, *Principles of international investment law*, pp. 133-140.

[12] *Electrabel v. Hungary*, para. 7.77.

lic interest."[13] It added, citing the partial award in *Saluka v. Czech Republic* that a "foreign investor protected by the Treaty may in any case properly expect that the [host state] implements its policies *bona fide* by conduct that is, as far as it affects the investor's investment, reasonably justifiable by public policies and that such conduct does not violate the requirements of consistency, transparency even-handedness and non-discrimination."[14]

Stabilization clauses

Stabilization clauses are a popular means to mitigate the risk of changes. While, from the point of view of the investor, they have the obvious advantage of ensuring a high degree of stability of the regulatory environment this stability may prevent or at least hinder states in enacting regulatory changes, including those in public interest. Thus, one may assume that such a limitation of the legislating power of the host state might have further reaching consequences on its ability to regulate than the requirement of regulatory stability under the FET standard.

Different types of stabilization clauses exist but, as regards the subject matter, a distinction may be made between freeze clauses and economic equilibrium clauses. The level of protection offered by the two types varies; the purpose of a freeze clause is to effectively exclude the investment project from any future changes in the legislation of the host state that would affect the investment. The economic equilibrium clauses, on the other hand, offer a somewhat less rigid protection by requiring the preservation of the economic equilibrium between the investor and the host state, rather than for the regulatory environment not to change at all. In the latter case, a regulatory change falling under the scope of the stabilization clause will result in the obligation of the host state to restore the economic equilibrium between the parties, normally by paying a certain sum to the investor.[15] This means that, while the host state will keep its right to regulate, effectively it will be discouraged to do so, particularly when its resources are scarce. This may mean that the effects of either type of stabilization clauses will be similar: particularly governments of countries with limited resources will have little incentive to pursue regulatory changes

[13] *EDF (Services) Limited v. Romania*, ICSID Case No. ARB/05/13, Award, 8 October 2009.

[14] *Saluka Investments BV v. Czech Republic*, Ad hoc UNCITRAL 1976, Partial Award, 17 March 2006, para 307.

[15] States and investors also often negotiate *hybrid clauses* which share some of their characteristics with both freeze clauses and the economic equilibrium clauses.

that would give rise to their liability as they might not be able to afford to compensate the investor for complying with the new regulations.[16]

3. Proposed Field of Research

The introduction of the study will consist of a detailed overview of the means of stabilization of foreign investment projects including an introduction to the various types of risks with the particular emphasis on the risks of regulatory changes. This will be followed by an overview of the means of stabilization of the regulatory environment, including a thorough presentation of the regulatory stability component of the FET standard as well as the stabilization clauses. Various types of stabilization clauses as well as their legal effects will be thoroughly presented.

A substantial part of the study will consist of presenting the interaction between the stabilization of international investment contracts and its impact on the ability of states to regulate in the field of protection of human rights and the environment after the investment has been made. Based on the assumption that such stabilization of the legislative framework may well cause a reluctance of the host state to implement more stringent standards of environment protection and human rights,[17] the study will address the issue whether stabilization clauses could be adequately replaced by relying on the stability and the legitimate expectations elements of the FET standard. This will be achieved by comparing the level of protection offered by each of the instruments and determining, whether an adequate level of protection is offered to the investors by relying on the FET standard.

Another aspect that will be dealt with is the possible conflict between the State's obligation towards the investor and its obligations under international law towards other subjects of international law. This may arise when a host state has assumed an obligation not to change certain leg-

[16] *See* H. MANN, Stabilization in investment contracts: Rethinking the context, reformulating the result, *Investment Treaty News*, International Institute for Sustainable Development, October 2011, pp. 6-8.

[17] Stabilization clauses have been considered to have a "chilling effect" to the state's ability to enact stricter standards of human rights and environment protection. *See* A. SHEPPARD and A. CROCKETT,'Chapter 14: Are Stabilization Clauses a Threat to Sustainable Development, IN M-C. CORDONIER SEGGER, M. W. GEHRING and A.P. NEWCOMBE (eds.), *Sustainable development in world investment law,* Alphen aan den Rijn, Frederick, MD: Kluwer Law International, 2011, p. 334.

islative framework but subsequently assumes various types of obligations under public international law (e.g. when the State subsequently becomes party to a treaty or when a treaty that the State has previously ratified enters into force).

4. Research question

The primary purpose of the study is to compare the level of protection offered by the stabilization clauses on one side and the regulatory stability component of the FET standard on the other. The research question will be whether stabilization clauses are still necessary to entice investors or whether an adequate level of protection of regulatory stability is offered by the FET standard while at the same time not discouraging the host State to make *"good faith"* regulatory changes in public interest relating to the investment.

The FET standard, namely its element of required stability and the protection of investor's legitimate expectations, requires the host state to ensure the stability of the regulatory environment. In *CMS Gas Transmission Company v Argentina* the tribunal pointed out that "[t]here can be no doubt […] that a stable legal and business environment is an essential element of fair and equitable treatment."[18] The tribunal in *LG&E v. Argentina* pointed out that the FET standard consists "of the host State's consistent and transparent behavior, free of ambiguity that involves the obligation to grant and maintain a stable and predictable legal framework necessary to fulfil the justified expectations of the foreign investor."[19] These decisions suggest that the investor should be entitled to expect a stable and predictable legal framework under the State's obligation to comply with the FET standard.

Another alternative on which an investor might base its claim is an indirect or "creeping" expropriation of the investment. This will be the case when the legislation change by the host state was "a measure tantamount to expropriation" or "measure with a similar effect to expropriation". Such expropriation of the investment by the host state would normally require a compensation to

[18] *CMS Gas Transmission Company v. The Argentine Republic,* fn. 11, para. 274.

[19] *LG&E v Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, para. 131.

be paid by the host state.[20] Similarly, the consequence of a breach of a stabilization clause would be the liability of the host state to reimburse the investor. The preliminary assumption is therefore that stabilization clauses do not offer additional protection against regulatory changes that would amount to indirect expropriation of the investment.

The study will compare these situations with those where the changes of legislation were made by the host state in a non-arbitrary and non-discriminatory manner (in good faith) – especially legitimate changes that follow new technological and social standards of protection of the environment or human rights. Based on an assumption that such changes should not be subject to restrictions by stabilization, the study will then focus on the question whether adequate protection to the investment is offered by the FET standard.

Furthermore, the study will examine whether stabilization clauses are the appropriate means of protection of the investment even when they relate solely to the fiscal stabilization of the project, ensuring its economic viability. In most developed countries, changes in the legislative framework of the state, which are done in a fair and equitable manner (and as such would not constitute a violation of the FET standard), would normally mean a business risk assumed by the investor.[21] In *Too v. Greater Modesto Insurance Associates*, the tribunal noted that "[a] State is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation or any other action that is commonly accepted as within the police power of States, provided it is not discriminatory and is not designed to cause the alien to abandon the property to the State or to sell it at a distress price…"[22]

[20] Compensation under the Hull formula should be "prompt, adequate and effective". See, *e.g.*, F. G. DAWSON and B. H. WESTON, "Prompt, Adequate and Effective": A Universal Standard of Compensation? *30 Fordham L. Rev. 727*, 1962, available at: http://ir.lawnet.fordham.edu/flr/vol30/iss4/4.

[21] Stabilization clauses in investment contracts have been described as unconstitutional in most developed countries. *See* H. MANN, 'Stabilization in investment contracts: Rethinking the context, reformulating the result', *Investment Treaty News, International Institute for Sustainable Development,* October 2011, p. 6.

[22] *Emmanuel Too v. Greater Modesto Insurance Associates and the United States of America*, 29 December 1989, Iran-US CTR, vol 23, 1989-II, p.378.

5. Proposed Methods of Research

The study will examine the various types of means of stabilization and their effects on the host state's right to regulate issues in public interest, in particular the protection of human rights and the environment. It will make a thorough overview of the two kinds of the overlapping obligations of the host states. This will be achieved by first laying out the state's right to regulate as a part of the principle of sovereignty. Thereafter, a detailed overview of the means of stabilization will be made by describing the different types and their individual properties and purposes, including the state obligation to accord fair and equitable treatment to the investor and an overview of stabilization clauses. This will be followed by an analysis of state obligations under international law in protecting the human rights and the environment.

The core of the dissertation will consist of a comparison of the level of protection awarded by a particular means of stabilization and its interaction with the protection of the environment and human rights. To achieve this, a study of authorities as well as case law of various courts and tribunals dealing with investor-state, state-to-state and commercial disputes will be made. This analysis will focus on cases relating to investment protection; however, it will include cases from other areas that have considered relevant issues relating to human rights and environmental concerns or the issue of stabilization.[23] Furthermore, the research will focus on relevant provisions contained in certain international treaties such as Article III(3) of the ASEAN Investment Agreement, Article 1114 of the NAFTA Agreement, Part III, Article 10 of the Energy Charter Treaty, Chapter XX of the EU-Canada Comprehensive Economic and Trade Agreement (CETA), the upcoming text of the Transatlantic Trade and Investment Partnership (TTIP) as well as the OECD Multilateral Agreement on Investment.[24] Additionally, the study will consider models of various bilateral investment treaties by certain states. Finally, the study will examine various model direct investment agreements proposed by different sector organisations. Although these model agreements do not have by themselves a legal standing, they provide an important insight

[23] E.g. *Kuwait v. The American Independent Oil Company (AMINOIL), Texaco Overseas Petroleum Company v. The Government of the Libyan Arab Republic, AGIP S.p.A. v. People's Republic of the Congo* (ICSID Case No. ARB/77/1), *CMS Gas Transmission Company v. Argentine Republic* (ICSID Case No. ARB/01/8), *Methanex Corp. v. United States of America*.

[24] Not all of the listed treaties have entered into force.

into the investment practice as most of the actually concluded agreements between investors and states are at the time not publicly accessible. My research of legal sources will also take into consideration the relevant national laws of the host states and states of the investor, which may provide for jurisdiction over the investor's actions abroad under the nationality principle.

Finally, I will perform interviews with practitioners in the field of international investment law and investor-state arbitration to obtain an understanding as to the extent to which stabilization clauses are still included into individual contracts. I will attempt to acquire information by contacting international organisations and NGOs dealing with the subject of sustainable development in international investment as well as party counsels and arbitrators directly.

6. State of Research, Research Materials and Data

A fierce public debate is currently taking place, particularly in the context of the negotiations of the TTIP, which calls into question the necessity of the ISDS and criticizes its effects on the host state's right to regulate. As to the effects of the means of stabilization, the scholarly debate focuses mainly on the question whether they affect the right of the host state to regulate issues in public interest and, if so, the ways in which this is done. A very useful research project in the field has been drafted by Andrea Shemberg for the mandate of the United Nations Special Representative on Business and Human Rights, Professor John Ruggie, in which the author examined 76 investment contracts obtained from law firms and 12 modern contract models.[25] Stabilization clauses were found primarily in contracts where the host state was a developing country with 36.40 per cent of contracts containing full stabilization clauses involving host states from Sub-Saharan Africa.[26] In comparing the usage of stabilization clauses between different industries in the study found that 83 per cent of full freeze clauses came from contracts in the extractive sector.[27] Although comprehensive in its content, the document (intentionally) does not address the issue whether stabilization clauses are indeed still necessary to achieve an adequate

[25] A. SHEMBERG, *Stabilization clauses and human rights*: *A research project conducted for IFC and the United Nations Special Representative of the Secretary-General on Business and Human Rights*, International Finance Corporation, Washington, D.C., 2009.

[26] *Ibid.*, p. 21.

[27] *Ibid.*, p. 17.

level of investment protection. The subject has also been dealt with in a number of articles, however, the author is not aware of a comprehensive study addressing the question of necessity and researching possible alternatives to the stabilization clauses.

Inherently, a substantial obstacle to research in the field of international investment law field is posed by the fact that most investment contracts as well as many cases are confidential.[28] Therefore, the data and information for research will be collected primarily by reviewing existing literature and by conducting a review of available model contracts[29], bilateral and multilateral investment treaties along with performing interviews with practitioners and other researches of the subject, particularly to obtain state specific data on the existing level of stabilization of investment contracts. Priority will be given to available investment contracts in force as they best reflect the practice in negotiating international investment contracts.[30]

Another significant problem with the research is still the lack of transparency in many ISDS proceedings. However, some decisions regarding my proposed field of research have been published and substantial activities are taking place to enhance and promote transparency of international investment dispute resolution.[31]

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[28] It has been suggested, that "without public scrutiny of foreign investment contracts, it is impossible for citizens to judge whether or not their elected governments are acting in their best interests and effectively pursuing or meeting public policy goals" as well as to hold "their governments to account for consequences of foreign direct investment. *See* D. AYINE, H. BLANCO, L. COTULA, M. DJIRÉ, N.A. KOTEY, B. REYES, H. WARD, M. YUSUF, 'Lifting the Lid on Foreign Investment Contracts: The Real Deal for Sustainable Development', *Sustainable Markets, Briefing Paper*, International Institute for Environment and Development 1, September (2005). *See also* the very useful website of the Extractive Industries Transparency Initiative (EITI), available at: http://eiti.org.

[29] E.g. the Model Mining Development Agreement Project (MMDA) Initiative, available at: http://www.mmdaproject.org/.

[30] Some investors have made their investment contracts available to the public, *e.g.* The Production Sharing, Intergovernmental and Host Government Agreements related to BP operations in the Caspian region, available at: http://www.bp.com/sectiongenericarticle.do?categoryId=9029334&contentId=7053632 (last accessed: 1 October 2012). Furthermore, some investment contracts have been made accessible to the public by the host states.

[31] The United Nations Commission for International Trade Law (UNCITRAL) has recently adopted the UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration which, however, apply only to proceedings under investment treaties concluded on or after 1 April 2014 unless either the parties to the dispute or to the treaty (state of the claimant and respondent state) have agreed to their application (see Article 1(2) of the Transparency Rules). On

However, even with transparency in international investment arbitration gaining popularity, it is still difficult to establish current contract practice – the majority of the contracts were namely concluded years or even decades before the dispute arises, thus creating a time-lag for ressearching the current practice and the extent to which stabilization provisions are included into the contracts today.

In researching the issue, I will make use of online databases such as the very useful project implemented by the United Nations Conference on Trade and Development (UNCTAD), the Investment Policy Hub ad well as other databases such as The Investor-State Law Guide, Investment Claims, Kluwer Arbitration, Investment Treaty Arbitration, Transnational Dispute Management, International Investment Arbitration + Public Policy and the IAReporter[32].

7. Proposed Dissertation Outline

Due to new findings in the course of the project, the structure of the dissertation will most likely require subsequent amendments. However, at this initial stage, I propose the following preliminary dissertation outline:

1 INTRODUCTORY DEFINITIONS

1.1 Right of states to regulate

1.1.1 Right to regulate as a component of the principle of sovereignty

1.1.2 Regulating issues in public interest

1.2 Regulatory Stability requirement under the Fair and Equitable Treatment Standard

1.2.1 The Fair and Equitable Treatment Standard

1.2.2 The Minimum Standard of Treatment under international law

1.2.3 Legitimate expectations and regulatory stability

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10 December 2014, the United Nations General Assembly adopted the United Nations Convention on Transparency in Treaty-based Investor-State Arbitration, which has yet to enter into force. It will apply transparency provisions also to disputes filed under investment treaties concluded before 1 April 2014.

[32] Available at, respectively: http://investmentpolicyhub.unctad.org, http://www.investorstatelawguide.com, http://investmentclaims.com, http://www.italaw.com, http://www.transnational-dispute-management.com, http://www.iiapp.org and http://www.iareporter.com.

4.1 Analysis of Research Findings – Research Question

4.2 Other Findings of the Research Project

4.3 Proposed solutions

4.3.1 Claims under the FET Standard

4.3.2 Increasing transparency of international investment arbitrations (ICSID, UNCITRAL Transparency Rules, ICSID Transparency)

4.4 Closing remarks

8. Suggested Bibliography and Resources

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