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SCOPE AND DEFINITIONS: "INVESTMENT" AND "INVESTOR"

Note by the Secretariat

EXECUTIVE SUMMARY

The Scope of an international commercial treaty, such as the GATT, the GATS, and international investment agreements (IIAs), is set by a combination of three things: the definitions of key terms in the treaty; the treaty's substantive provisions (its rules and disciplines, development provisions, and exceptions); and the specific commitments made by individual member governments. Together, these determine the treaty's coverage.

A treaty's definitions therefore need to be read in conjunction with its other provisions. On their own, they represent only a normative point of reference for understanding and interpreting the treaty's 0substantive obligations.

The GATT does not contain any definitions, as such. To the extent there has been a need to interpret the meaning of specific terms, such as "like product", this has been handled case-by-case, typically by dispute settlement panels. The GATS, on the other hand, does define many of the terms it uses.

So do most IIAs, in particular the key terms "Investment" and "Investor". These are the subject of this Secretariat Note, which reviews how the terms have been defined in different IIAs, and takes stock of the Working Group's discussion on this issue.

IIAs generally aim to serve one, or both, of two purposes: to control and/or liberalize access for foreign investment to a host country, and to protect it after it is established in a host country.

The Note suggests that most IIAs take as their starting point a broad, asset-based definition of the term "Investment". It covers both direct and indirect forms of foreign investment (i.e., FDI and portfolio investment), and the whole range of assets that can be associated with a foreign investment, from factories, to stocks and shares and loans to a company, to business contracts and concessions.

Breadth of coverage is particularly important in the context of guaranteeing a high level of protection to foreign investment after it has been established in a host country. Even so, a host country government may wish to limit the protection it offers to certain types of investment. There has been frequent mention in the Working Group, for example, of the need for host countries to maintain the right to regulate speculative, short-term capital flows, because of concerns about their potentially destabilizing effects. One way of dealing with this is through the definitions themselves. Certain assets can be excluded from the definition of covered "Investment" – in this case, for example, capital with a maturity of less than, say, six months. More usually, however, IIAs limit their coverage through their substantive provisions rather than through their definitions – in this case again, for example, by allowing host governments to regulate investment for balance-of-payments purposes.

Introducing more significant limitations on the coverage of an IIA has been discussed in the Working Group, especially in IIAs that aim to liberalize foreign investment since these are often more sensitive from the point of view of a host country's economic, industrial, and development policies. In this context, the possibility of limiting the coverage of an IIA to FDI only has been put forward. This can be done by restricting the assets that are covered by the asset-based definition, although not without some methodological difficulty. Some IIAs use alternative approaches to define the investments that they cover, notably the enterprise-based definition or the transactions-based definition, so as to focus on FDI and treat it differently from other forms of investment.

Generally, the term "Investor" only needs to be defined in an IIA for one or other of two reasons; either to help restrict an IIA's coverage to FDI, in which case the terms "control" and "ownership" of an investment are important and need to be defined; or to prevent third-country investors from benefiting from an IIA's provisions, in which case it is the association with the investor's home country that is important and that needs to be defined. The relevance of this second case diminishes as the number of countries that are members of an IIA increases.

I. INTRODUCTION

1. The definitions of an international commercial treaty frame the treaty's substantive obligations and its specific commitments; together, these three elements set a treaty's scope. Read in conjunction with a treaty's other provisions, the definitions determine which specific commercial transactions the treaty covers, which government policies are subject to its obligations, who enjoys rights under the treaty, and in what respects those rights can be exercised. They need, therefore, to be taken up at an early stage in designing or understanding a treaty.

2. This Note focuses on the definitions used in international investment agreements (IIAs) for the terms "investment" and "investor", and the nature of the relationship that exists between the two as regards "ownership" or "control". It takes stock of the Working Group's discussions on these issues[1], and draws on other sources of analysis, particularly UNCTAD.[2] Other terms used in IIAs can also be unfamiliar from the point of view of WTO Agreements; supplementary Notes on them will be prepared at the request of the Working Group.

3. The discussion in the Working Group has centred predominantly on the definition of the term "investment". The main themes taken up have been:

- the merits of a broad, asset-based definition of investment that covers all types of foreign investment (direct investment (FDI) and indirect investment) and all forms of investment assets, relative to other definitions that are narrower in scope, such as the enterprise-based definition which is associated primarily with FDI, or the transactions-based definition which focuses on the cross-border movement of capital;

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[1] Accounts of the Working Group's discussions on the topic of Scope and Definitions can be found in the following meeting Reports: WT/WGTI/M/5, paras. 52-62; M/6, paras. 85-94; M/7, paras. 47-52; M/8, paras. 73-81; M/9, paras. 74-75; M/12, paras. 50 and 56-57; M/14, para. 80; and M/15, para. 51. References to this topic in Members' submissions can be found in WT/WGTI/W/28, W/29, W/31, W/34, W/42, W/43, W/49, W/51, W/60, W/69, W/71, W/80, W/92, and W/104.

[2] See, in particular, UNCTAD, International Investment Instruments: A Compendium, 5 volumes (1996-2000); UNCTAD, Bilateral Investment Treaties in the Mid-1990s (1998); UNCTAD, Scope and Definition, Series on Issues in International Investment Agreements (1999).

- the various ways in which a broad asset-based definition of investment can be shaped to suit the objectives of the Parties to an IIA: for example, by excluding certain assets from the definition, or by treating different assets in different ways under the substantive obligations of an IIA, or on an *ad hoc* basis through reservations and limitations agreed to in the individual schedules of Parties to an IIA;

- the advantages and disadvantages of including portfolio investment in the definition of investment, and, if it is included, ways of differentiating and treating separately speculative, short-term capital flows that can be damaging to a host country's economy;

- the use of different definitions of investment at the post-establishment stage of an investment on the one hand, where the primary consideration is the protection of investment assets, and at the pre-establishment stage on the other hand, where the primary consideration is market access and the liberalization of cross-border investment. Generally speaking, the liberalization of investment flows is the more sensitive area of policy-making for host countries, so there is a tendency to approach the definition of investment in this context more conservatively.

II. DEFINITIONS OF "INVESTMENT" AND LIMITATIONS ON THEIR SCOPE OF APPLICATION IN INTERNATIONAL INVESTMENT AGREEMENTS

4. The definition of "investment" in an IIA has important consequences for the extent and ways in which host countries are subject to the IIA's policy disciplines when regulating foreign investment and pursuing their economic and development objectives. By the same token, it affects the value that home countries will attach to an IIA in bringing about more transparent, stable and predictable conditions for foreign investment to take place.

5. Several different approaches are used in IIAs to define the term "investment". By far the most widely used is the asset-based definition, which typically covers all types of foreign investment and all forms of investment assets. The enterprise-based definition is narrower, and is used typically in conjunction with conditions on ownership and control of investment assets so as to focus on FDI. The transactions-based definition focuses on investment as the cross-border flow of capital and related assets.

6. In the past, the choice between these approaches has often been linked to the character and objective of an IIA. IIAs aimed at the protection and guarantee of an investment after it has crossed the border and been established in a host country have tended to use a broad definition, which allows them to provide a high level of investment protection. IIAs aimed at the regulation and/or liberalization of cross-border investment have tended to use a narrower definition, focused either on FDI or on investment as a flow rather than a stock concept, in part from an industrial policy perspective, and in part because of host-country concerns about the balance-of-payments and macroeconomic effects of removing restrictions on foreign portfolio investment, especially short-term capital flows.

7. Recently, most IIAs, without distinction to their main purpose, are tending to take as their starting-point a broad definition of investment.[3] Where there is a need to limit the IIA's focus in order to take into account a host country's domestic economic and development policy objectives, this is achieved by narrowing down the range of assets that are covered through an IIA's definitions, or varying the ways in which different assets are treated under the IIA's operational provisions.

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[3] UNCTAD, Scope and Definition, (1999), p. 17.

A. THE ASSET-BASED APPROACH TO DEFINING INVESTMENT

8. The majority of existing IIAs use as their starting point a broad, open-ended approach to define what is covered by the term "investment". This is referred to as the asset-based approach, since it treats investment as a collection of assets. It covers both the assets that an investor brings into the host country, as well as those acquired locally. This approach is particularly common in IIAs dealing with the protection of investment after it has been admitted to and established in a host country; the breadth of its coverage allows for a high level of protection to be provided to an investment through the substantive obligations of an IIA.

1. The Standard Asset-Based Model

9. Typically, "investment" is defined to cover "every kind of asset". It is not confined to financial assets, nor is it linked only to the economic concept of "capital", in the sense of tangible or intangible assets that lead to the creation of productive capacity. Typically also, this broad reference is accompanied by an illustrative (non-exhaustive) list of the categories of assets that are covered by the IIA. The list usually includes: tangible and intangible property; interests in companies (both direct and portfolio investment); other financial assets and contractual rights; intellectual property rights; and business concessions.

10. Standard language on the asset-based definition of investment has been developed, particularly for use in bilateral investment treaties (BITs). An example is the following:

A Standard "Asset-Based" Definition of Investment[4]

"Investment" means every kind of asset and in particular, though not exclusively, includes:

(a) movable and immovable property and other property rights such as mortgages, liens and pledges;

(b) shares, stock and debentures and any other kind of participation in companies;

(c) claims to money or to any other performance having a financial value;

(d) intellectual property rights;

(e) concessions conferred by law or under contract, including concessions to search for or exploit natural resources.

11. Since the standard, asset-based definition of investment typically covers "all assets", an asset is covered by the terms of an IIA even if it does not fall obviously into one of the categories in the illustrative list (Annex 1).

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[4] This language is the basis for the model bilateral investment treaties of Chile, China, Egypt, France, Germany, Indonesia, Jamaica, Malaysia, the Netherlands, Sri Lanka, Switzerland, the United Kingdom, and the United States (UNCTAD, International Investment Instruments: A Compendium, Volume III, pp. 115-206, and Volume V, pp. 293-346), as well as Argentina (WT/WGTI/M/8, para. 78), Costa Rica (WT/WGTI/W/31), Japan (WT/WGTI/W/92), Korea (WT/WGTI/W/49), and Turkey (WT/WGTI/W/51), India's Bilateral Investment Promotion and Protection Agreements (WT/WGTI/W/71), Australia's model Investment Protection and Promotion Agreement (WT/WGTI/W/80), and regional treaties such as the ASEAN Agreement for the Promotion and Protection of Investment (UNCTAD, *Ibid*, Volume II, p. 293).

2. Limiting the Asset-Based Definition

12. While using this broad, asset-based approach as a starting-point to define what investment is to be covered by an IIA, Parties may wish nonetheless to restrict the scope of the agreement in one way or another. They may not wish to cover all investment assets under the provisions of the IIA in the same way, or to the same extent.

13. The most important and most usual way of limiting the scope of an IIA through its provisions on definition is to exclude certain assets from coverage of the IIA. This can be applied flexibly, to exclude whole categories or sub-categories of assets. Limitations reflect host-country concerns about applying the substantive obligations of an IIA to the cross-border movement or subsequent legal protection of certain kinds of investment assets. Practice, in this regard, varies considerably among IIAs. Some that aim to encourage the long-term commitment of resources to the host country include only capital flows with a particular maturity (e.g., three years or more) as falling within the definition of "investment". The investment chapter of the NAFTA does not include intellectual property rights in its definition of an "investment", since this is covered elsewhere in the Agreement, and it excludes explicitly various "claims to money", including trade financing (Annex 2). An example which addresses concerns about the potentially volatile nature and destabilizing effects of short-term capital flows is the definition of "investment" contained in Costa Rica's free trade agreement with Mexico; it specifies that the agreement does not cover capital movements that are mere financial transactions for speculative purposes, commercial contracts for the sale of goods or services, credits granted to a State, or loans that are not directly related to an investment.[5]

14. In this way, the asset-based approach can be used in principle as a starting-point for defining investment in an IIA that aims to focus primarily on FDI. Assets that are not considered to be associated directly with FDI activity can be excluded from the definition. An approximation to FDI, for example, could in principle be made by excluding from the standard asset-based definition of investment everything except paragraph (b): *shares, stock and debentures and any other kind of participation in companies*. In practice, however, this exclusion line is not easy to draw. First, the element of ownership or control is missing from the asset-based definition. Second, FDI activity in a host country often relies on assets contained in other parts of the standard definition, such as certain kinds of international capital flows, including short-term capital, often between a parent company and its subsidiary.

15. Alternatively, therefore, and more usually in IIAs that use the asset-based definition of investment, the differentiation between FDI and other forms of foreign investment is made through the ways in which different assets are treated under an IIA's substantive provisions (see paragraph 23 below).

16. The scope of an IIA can be limited through its definitions also by defining what characteristics an "asset" must have if it is to be considered an "investment". Typically, the aim of IIAs is to capture the idea that an investment involves a commitment of resources that has an element of risk and on which the investor expects a return, so that some IIAs define an investment as an asset that is used in activities susceptible of "generating a profit". This could exclude, for example, assets such as real estate property that is owned by a foreign investor but is not used for productive purposes. However, use of this approach would appear to be relatively minor in practice, and offers only very limited scope to narrow down the coverage of an IIA.

B. Other Approaches to Defining Investment

17. Some IIAs that are concerned primarily with FDI have taken a different approach to defining their scope, by focusing on foreign investment in an enterprise rather than as a menu of various assets

[5] Cited in WT/WGTI/W/60, Communication by Costa Rica.

invested in a host country. This is referred to as the enterprise-based definition of investment. Typically, its point of departure is the investor's objective of taking a lasting, or long-term, controlling interest in an enterprise through foreign ownership and/or management control. One example was the 1988 Canada-United States Free-Trade Agreement (superceded in 1992 by the NAFTA), which defined investment as follows:

> *(a) the establishment of a new business enterprise, or (b) the acquisition of a business enterprise; and includes: (c) as carried on, the business enterprise so established or the business enterprise so acquired, and controlled by the investor who has made the investment; and (d) the share or other investment interest in such business enterprise owned by the investor provided that such business enterprise continues to be controlled by such investor.*

Another example is the bilateral investment treaty between Denmark and Poland, which defines "investment" as: *all investments in companies made for the purpose of establishing lasting economic relations between the investor and the company and giving the investor the possibility of exercising significant influence on the management of the company concerned*.[6]

18. The notion of "foreign control" is the key to limiting the scope of application of IIAs based on an enterprise-based definition of investment, in particular to differentiating FDI from portfolio foreign investment. In the case of the Canada-United States Free Trade Agreement, for example, "control" is defined in terms of the ownership of all or substantially all of the assets used in carrying on the business enterprise. This issue is described further in Section IV, below.

19. One point of reference in the Working Group for differentiating FDI from foreign portfolio investment has been the IMF definition of direct investment. This is based on a third approach to defining investment, the transactions-based approach.[7] It focuses on foreign investment as the cross-border movement of capital and related assets – the cross-border transactions involved in establishing or liquidating a foreign investment – and it is used primarily in IIAs that are concerned with a host country's policies towards international capital movements rather than investment per se. It is used by the IMF for balance-of-payments statistics purposes, and also by the OECD as its Benchmark Definition of FDI, to provide operational guidance to its member governments on the compilation of FDI data.

20. The IMF definition of direct investment is:

> *Direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy. (The resident entity is the direct investor and the enterprise is the direct investment enterprise). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. Direct investment comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated.*
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> *Direct investment capital is capital provided by a direct investor to a direct investment enterprise or received by a direct investor from a direct investment enterprise. The*

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[6] Cited in UNCTAD, Scope and Definition, (1999), p. 26.

[7] An early version of this approach is the definition of direct investment in the 1961 OECD Code of Liberalization of Capital Movements: "Investment for the purpose of establishing lasting economic relations with an undertaking such as, in particular, investments which give the possibility of exercising an effective influence on the management thereof". (UNCTAD, International Investment Instruments: A Compendium, Volume II, p. 3).

components of direct investment capital transactions are equity capital, reinvested earnings, and other capital associated with various inter-company debt transactions.[8]

21. In its presentation to the Working Group, the IMF noted that the concept of lasting interest was not defined in terms of a specific time-frame, and that the more pertinent criterion was that of the degree of ownership in an enterprise. A share of 10 per cent or above was often deemed to reflect a lasting interest, although countries could choose to allow for further qualifications that involved a degree of subjective judgement. Thus, if a direct investor owned less than 10 per cent of the ordinary shares or voting power in an enterprise, but had an effective voice in the management of that enterprise, a host country could decide to treat it as FDI.

C. GENERAL LIMITATIONS

22. Various ways exist of limiting the scope of application of an IIA other than through the language used in the definitions themselves.

23. The most important one is to provide policy flexibility for host countries to use in particular situations through the substantive provisions of an IIA. An example that has been discussed in the Working Group is to differentiate between categories of investment assets in terms of their post-establishment treatment and their pre-establishment treatment; many IIAs cover a broader range of investment assets at the post-establishment stage, in the context of providing investment protection, than at the pre-establishment stage where the issue is market access and liberalization of cross-border investment flows. Another is that even if an IIA uses a broad, asset-based definition of investment that covers all forms of portfolio investment, it may stipulate that its substantive provisions (such as National Treatment) apply only to certain assets, for example those that remain for one year or more in the host country. A third is to use exceptions: for example, controlling volatile short-term capital flows can be addressed through provisions allowing restrictions to be imposed for balance-of-payments purposes. This feature of limiting the scope of application of an IIA through its substantive provisions rather than through its definitions is common to many IIAs.

24. A second way is to limit the IIA's application only to certain sectors of the economy, or to exclude specific sectors or industries from its coverage. An example is the Canada-United States Free Trade Agreement, which excluded government procurement, transportation services, and most financial services. Many BITs exclude government procurement activities from their scope of application. To the extent that it can be qualified as a form of IIA, the most familiar example from the WTO's point of view is the GATS, which is limited to the services sector of the economy. Limits on the sectors or industries to which an IIA applies can also be achieved in a more *ad hoc* way, particularly at a disaggregated level through limitations or reservations placed by individual Parties on the commitments they undertake in their respective Schedules.

25. Other ways of limiting an IIA's scope include applying it only to investments made in accordance with the laws and regulations of the host country, or only to investments established on or after its date of entry in force, or by applying minimum thresholds, in terms of capital requirements, for the size of investments that an IIA covers. Various reasons can lie behind limitations such as these[9]; in many cases they are aimed at ensuring that foreign investment is consistent with a host country's economic, industrial and development policy objectives.

[8] WT/WGTI/W/61. In its contribution, the IMF indicates that, under the definitions and classifications of international accounts presented in the Balance-of-Payments Manual, foreign investment is classified in the following components: (i) direct investment; (ii) portfolio investment; and (iii) other investment.

[9] See UNCTAD, Scope and Definition, (1999), pp. 23-26 for an elaboration of these limitations.

III. DEFINITIONS OF "INVESTOR" IN INTERNATIONAL INVESTMENT AGREEMENTS

26. IIAs generally apply only to investment by investors who are associated legally with one of the Parties to the agreement. The IIA's provisions define what that association must be.

27. Practice with regard to the definition of "investor" in IIAs is more varied than in the case of "investment". Some IIAs avoid the term "investor" altogether, and instead define and use the term "covered investments" to fix the scope of application of their substantive provisions.[10] Others define and use the term "investor", to the same end. Whichever approach is taken, much the same considerations come into play in determining whose investments are covered by an IIA. These are well illustrated by reference to the Model Swiss investment agreement, which defines the term "investor" as follows:

Model Swiss Agreement on the Promotion and Reciprocal Protection of Investments

The term "investor" refers with regard to either Contracting Party to:

(a) natural persons who, according to the law of that Contracting Party, are considered to be its nationals;

(b) legal entities, including companies, corporations, business associations and other organizations, which are constituted or otherwise duly organized under the law of that Contracting Party and have their seat, together with real economic activities, in the territory of that same Contracting Party;

(c) legal entities established under the law of any country which are, directly or indirectly, controlled by nationals of that Contracting Party or by legal entities having their seat, together with real economic activities, in the territory of that Contracting Party. [11]

28. Most IIAs distinguish two broad categories of investor: "natural persons", and "legal entities".

29. "Natural persons" are individuals who invest directly in their own private business or through the placement of their own portfolio capital in a host country. Their association with a party to an IIA is generally straightforward, and is defined in terms of "nationality", by reference to the domestic law of the party concerned. Thus, investments by an investor who is a national of one of the parties to an IIA are covered by the provisions of the IIA. In some IIAs, this is broadened to include individuals who have permanent residence or domicile status in the party concerned (see the case of the GATS, below), but this is not a common feature of IIAs.[12]

30. "Legal entities" are sometimes referred to otherwise in IIAs as artificial or legal persons or juridical entities. Whatever the terminology used, it refers broadly speaking to companies. Most IIAs cover all forms of companies. Paragraph (b) of the Model Swiss Agreement reproduced above, for example, contains a short illustrative (non-exhaustive) list of covered companies. A more complete, but still open-ended list is contained in the Model US investment treaty: "company" means any entity constituted or organized under applicable law, whether or not for profit, and whether

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[10] This is the case, for example, of the Model US Treaty Concerning the Encouragement and Reciprocal Protection of Investment, the Model UK Agreement on the Promotion and Protection of Investments, and the Model French Agreement on the Encouragement and Reciprocal Protection of Investment. (UNCTAD, International Investment Instruments: A Compendium, Volume III, pp. 160, 186 and 196).

[11] WT/WGTI/W/28, Communication from Switzerland.

[12] E.g., Korea's standard Model investment treaty does not cover permanent residents (WT/WGTI/W/42).

privately or governmentally owned or controlled, and includes a corporation, trust, partnership, sole proprietorship, branch, joint venture, association, or other organization.

31. Some IIAs exclude certain forms of company from their coverage through the definition of "investor" for a variety of reasons: for example, the definition of a "company" may exclude partnerships or joint ventures, or not-for-profit organizations, or state-owned corporations. However, exclusions of this kind do not appear to be a common feature of IIAs.[13]

32. The most common condition necessary for a company to be recognized as formally associated with one or other of the parties to an IIA is reflected in Paragraph (b) of the Model Swiss Agreement: it is that a company is incorporated (constituted or otherwise duly organized) under the laws of its home country, which is itself a party to the IIA. This establishes a direct association between a company and one of the parties to an IIA.

33. In some IIAs this is a sufficient condition.[14] In the Model Swiss Agreement and in other IIAs[15], it is not; the company must also have its headquarters (seat) there, and engage in real economic activities there, conditions that are aimed at least in part at preventing companies from setting up simple "mail-box" operations in one of the parties to an IIA in order to benefit from its provisions. However, it has been suggested in the Working Group that this problem can be approached in a different way, by including a "denial of benefits" provision in the IIA. An example of such a provision is contained in the Model US investment treaty:

> *Each Party reserves the right to deny to a company of the other Party the benefits of this Treaty if nationals of a third country own or control the company and (a) the denying Party does not maintain normal economic relations with the third country; or (b) the company has no substantial business activities in the territory of the Party under whose laws it is constituted or organized.*[16]

34. Paragraph (c) of the Model Swiss Agreement widens the definition of "investor" to include companies incorporated in a third country (non-party to the IIA) on condition that they are controlled, directly or indirectly, by individuals or companies in one of the parties to the IIA. This extends the coverage of an IIA to subsidiary companies incorporated in third countries: for example, in the case of a bilateral IIA between Country A and Country B, the provisions of the IIA would apply also to subsidiaries in Countries X, Y and Z of a parent company in Country A. However, this is not a standard feature of IIAs.[17]

IV. "OWNERSHIP" AND "CONTROL"

35. The issue of "ownership" and "control" of an investment by a company does not arise in all IIAs – many leave the issue to be decided on the basis of domestic company law in the parties to the IIA – but it is used in some IIAs to narrow down the definition of which "home-country investors" and which "investments in the host country" are covered by the IIA's provisions.

36. As was noted in the previous section, the definition of which companies are recognized as being home-country investors associated with one or other of the parties to an IIA is handled in most IIAs by reference to a company's place of incorporation, and/or the location of its headquarters (seat)

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[13] See UNCTAD, Scope and Definition, (1999), p. 33.

[14] E.g., the Model US and UK agreements cited in footnote 10, and the majority of Costa Rica's investment treaties (WT/WGTI/W/60).

[15] E.g., the Model French agreement cited in footnote 10, as well as Chile's Model Investment agreement.

[16] UNCTAD, International Investment Instruments: A Compendium, Volume III, p. 203.

[17] E.g., Chile's Model investment agreement and Korea's standard Model investment treaty do not cover investments by companies located in a third country (WT/WGTI/W/42).

and main place of business. Some IIAs combine this with a requirement that nationals of the party concerned own a majority of the company's shares, which can narrow down the coverage of an IIA considerably.[18] In practice, however, this can be difficult to ascertain in the case of companies whose stock is traded widely on international stock-markets, and even where it can be ascertained it may lead to companies moving in and out of the coverage of an IIA over time. Generally, this is not desirable when the aim of the IIA is to increase the stability and predictability of investment conditions. Furthermore, the need to define which investors belong to one or other of the parties to an IIA becomes far less relevant in the context of a multilateral IIA as opposed to a bilateral or regional IIA.

37. Most IIAs, particularly those that use the asset-based definition of investment, go no further than specifying the characteristics a company must have as a home-country investor in order to be covered by the IIA. Some, however, define also the relationship in terms of "ownership" and "control" that must exist between the investor and an investment in the host country if the investment is to fall under the coverage of an IIA. This crops up most obviously in the context of IIAs that use the "enterprise-based" and the "transactions-based" definitions of investment. For example, in the case of the Canada-United States Free Trade Agreement:[19]

> ***control or controlled****, with respect to:*
>
> *(a) a business enterprise carried on by an entity, means*
>
> > *(i) the ownership of all or substantially all of the assets used in carrying on the business enterprise, and*
> >
> > *(ii) includes, with respect to an entity that controls a business enterprise in the manner described in subparagraph (i), the ultimate direct or indirect control of such entity through the ownership of voting interests; and*
>
> *(b) a business enterprise other than a business enterprise carried on by an entity, means the ownership of all or substantially all of the assets used in carrying on the business enterprise.*

38. A few IIAs go further still and define "ownership" and "control" in quantitative terms; for example, in terms of a specific equity share or of voting rights. This, it was noted earlier, is a standard feature of the "transactions-based" approach to defining investment where it is necessary to create a clear line differentiating direct from indirect foreign investment, for example for statistical purposes; according to the IMF, the threshold for defining FDI is fixed typically at 10 per cent. It is also used in some IIAs based on the enterprise-based definition of investment, where according to UNCTAD it is typical to require 50 per cent ownership or majority control.[20]

V. THE CASE OF THE GATS

39. There has been reference and some discussion in the Working Group to the provisions on scope and definitions contained in the GATS (Articles I and XXVIII), in particular the definition of "trade in services" through commercial presence (or Mode 3) as:

> *the supply of a service … by a service supplier of one Member, through commercial presence in the territory of any other Member* (Article I:2(c))

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[18] UNCTAD, Scope and Definition, (1999), pp. 39-40.
[19] UNCTAD, International Investment Instruments: A Compendium, Volume V, pp. 8-9.
[20] UNCTAD, Scope and Definition, (1999) gives some examples, see pp. 41-43.

40. The GATS is not an investment agreement in the same sense as most IIAs. Its focus is on the ability to supply a service rather than on investment *per se*, and one of its essential features is that the establishment of a commercial presence in a host country is to be "for the purpose of supplying a service"; the two cannot be separated. Nonetheless, it has been noted that "commercial presence" in the GATS approximates to the notion of "investment" in an IIA, and in that context "service supplier" approximates to the notion of "investor". Attention has been called, therefore, to the comparison of the definitions used in the GATS with standard features of the definitions used in IIAs.

41. "Commercial presence" is defined in the GATS as follows:

> *"commercial presence" means any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service.* (Article XVIII(d))

42. Clearly, this is narrower than the asset-based definition of investment used in most IIAs, but it is very similar to the enterprise-based definition (see paragraph 17 above). It covers both the establishment and the acquisition of a business enterprise in the host country, and the activities of the enterprise after its establishment in supplying a service.

43. Continuing from that basis, the scope of the "investments" that are covered by the GATS is limited in two ways.

44. First, and most obviously, its scope is limited to the service sectors of an economy, and as noted above the concept of "commercial presence" in the GATS is inseparable from its purpose, which is "supplying a service". The "supply of a service" is defined in the GATS to include the production, distribution, marketing, sale and delivery of a service.

45. Second, the scope of the GATS is limited by the ways in which "investments" are treated under its substantive provisions. Some of these limitations are general: for example, government procurement activities are exempted from having to meet the MFN provisions of the GATS (Article XIII). Some are specific to particular situations: for example, restrictions on payments and transfers associated with an investment can be imposed to safeguard the balance-of-payments (Article XI and XII). Others are ad hoc: for example, the National Treatment obligations of the GATS apply only in the service sectors inscribed in a Member's Schedule, and subject to any conditions and qualifications set out in that Schedule (Article XVII). In this respect, the GATS follows the model of IIAs that restrict the scope of their application through substantive obligations of the treaty rather than through the definitions that they use.

46. As regards the concept of "investor", the GATS follows the model of many IIAs that cover both individual investors and companies. "Service supplier" is defined in the GATS as *any person that supplies a service* (Article XXVIII(g)), and can include foreign individuals (*natural persons*) and foreign companies (*juridical persons*).

47. With respect to individuals, the GATS defines them in the same way as IIAs in terms of being nationals of the home country, but it covers also permanent residents, subject to certain conditions (Article XXVIII:(k)).

48. With respect to companies, the GATS defines "juridical person" as follows:

> *"juridical person" means any legal entity duly constituted or otherwise organized under applicable law, whether for profit or otherwise, and whether privately-owned or governmentally-owned, including any corporation, trust, partnership, joint venture, sole proprietorship or association* (Article XVIII:(l))

This language is very similar to the standard language used in IIAs to define legal entities (see paragraph 30, above). The GATS covers not-for-profit organizations and state-owned corporations, as well as an open-ended list of different forms of private commercial companies.

49. However, the GATS limits the scope of the companies that it covers by defining not only conditions of their association to their home country, but also conditions of "ownership" and "control" over their subsidiaries in host countries (see paragraphs 36 and 37, above).

> *"juridical person of another Member" means a juridicial person which is either:*
> *(i) constituted or otherwise organized under the law of that other Member, and is engaged in substantive business operations in the territory of that Member or any other Member; or*
> *(ii) in the case of the supply of a service through commercial presence, owned or controlled by: 1. natural persons of that Member; or 2. juridical persons of that other Member identified under subparagraph (i)* (Article XVIII:(m))
>
> *a juridical person is:*
> *(i) "owned" by persons of a Member if more than 50 per cent of the equity interest in it is beneficially owned by persons of that Member;*
> *(ii) "controlled" by persons of a Member if such persons have the power to name a majority of its directors or otherwise to legally direct its actions;*
> (iii) *"affiliated" with another person when it controls, or is controlled by, that other person; or when it and the other person are both controlled by the same person.* (Article XVIII:(n))

According to this definition, the origin of juridical persons of other Members can be determined not simply on the basis of quantitative criteria for ownership, but also on the basis of control. Thus, for example, in order to qualify as a service supplier of another Member, a parent company supplying services through commercial presence in a host country must be constituted under domestic law and engaged in substantive business operations in its home county, and its subsidiary in the host country must be either 50 per cent owned, or otherwise controlled, by the parent company.

VI. DISCUSSIONS IN THE WORKING GROUP

A. NARROW DEFINITION OF INVESTMENT

50. Support for defining the term "investment" narrowly, to cover essentially only FDI, has been expressed by some in the Working Group in terms of the view that "production-based" forms of investment contribute most directly and substantially to economic and technological development, employment and growth in host countries. It has been suggested, also, that account should be taken of different forms of FDI, with some taking the view that greenfield FDI is generally more beneficial to host country economies than FDI through merger and acquisition activity.

51. The value of FDI relative to other forms of foreign investment has been related, in addition, to the long-term commitment it involves on the part of foreign investors, and to host-country concerns about the potentially volatile nature of portfolio capital movements, particularly those of a short-term, speculative nature. The stability of FDI during the emerging-markets financial crisis of 1997-99 has been used to illustrate this point. Some of these concerns would appear to relate primarily to IIAs that focus on the pre-establishment treatment and liberalization of investment, but it has been noted that the stability of foreign investment can matter too at the post-establishment stage because of its link to incomes, jobs and exports in the host country.

52. The advantage of a narrow definition of investment has also been put forward in terms of there being a better level of understanding among WTO Members of the concept of FDI relative to other forms of foreign investment, and a definition that is readily available from the IMF. By narrowing the scope of a possible investment agreement, it has been suggested that any rule-making process would be easier and could be completed more quickly, and that it would facilitate the task in the WTO of harmonizing any eventual agreement on investment with the "commercial presence" provisions of the GATS.

53. A related point has been that before use of a broad definition of investment covering also portfolio and short-term capital flows could be considered, further progress on reforming the international financial architecture would be needed in fora other than the WTO, in particular on the issues of capital account liberalization and prudential control. Excluding these forms of investment from further consideration in the WTO would spare the need to wait for progress to be made elsewhere on these matters.

54. The advantages of a narrow definition of investment, limited to traditional forms of FDI, have not been accepted by all. Another view has been that both FDI and foreign portfolio investment can generate economic benefits for host countries, and that in today's global economy the distinction between the two has become increasingly difficult to make (in the case of merger and acquisition activity, for example). Both portfolio and short-term capital can play important roles in providing foreign exchange and financing capital formation in a host country's economy. Excluding portfolio capital from coverage in an IIA would impede the growth of all international investment, including FDI, especially to developing countries, since successful FDI depends upon a range of associated capital flows, including some forms of short-term capital. Given this, and the substitutability of financial instruments in global capital markets, doubt has also been expressed about the practicality of trying to make a clear-cut differentiation between FDI and other forms of foreign investment. According to this view, the key distinction that needs to be made in the context of designing closer multilateral cooperation in this area is between foreign investment of a lasting nature on the one hand, and speculative capital flows on the other.

55. It has been suggested that the use of the IMF threshold of 10 per cent ownership to differentiate FDI from portfolio investment can be artificial, particularly in the context of modern corporate strategies and of volatile stock-markets and share prices. In the case of merger and acquisition activity, participation of less than 10 per cent ownership can still imply a lasting interest in an enterprise and a significant influence over its management, particularly if it is an initial step in a longer-term strategy aimed at building up a more significant stake. Also, treating FDI under the IMF definition simply in terms of cross-border transactions of capital and related resources, and failing to cover tangible and intangible assets associated with it (e.g., contractual rights and intellectual property rights), would significantly weaken the level of investment protection that could be provided to foreign investors. Consequently, it has been suggested that the concept of FDI, particularly when based on notions of “control” and “lasting interest”, is not sufficiently precise to allow for the development of clear and meaningful substantive provisions in an IIA. The point has also been made that developing countries that wish to limit foreign ownership of local assets might have an interest in encouraging portfolio investment rather than FDI that is foreign controlled.

B. Broad Definition of Investment

56. An advantage of the broad, assets-based approach as a starting-point for defining investment in IIAs, it has been suggested, is its flexibility. It provides protection to as wide a range of assets as possible, while at the same time giving host countries discretion in the way they treat certain, sensitive categories of assets. In this respect, it has been noted that UNCTAD concludes that development policy objectives and concerns are not necessarily incompatible with the broad approach to definition,

given the scope that exists to narrow the coverage of an IIA through its substantive obligations and the specific commitments of individual parties.[21]

57. Another advantage is that a broad approach would assist in ensuring that an IIA is compatible with existing bilateral investment agreements, and its provisions can be harmonized with theirs. However, in this context it has been suggested that the use of a broad, asset-based definition in many BITs should be seen in the light of the fact that they cover only the post-establishment stage of investment, and it would not necessarily be appropriate to use it at the pre-establishment stage.

58. A further advantage of this approach that has been put forward is that it is open-ended and forward-looking, and consequently it can be adapted to the evolution of new or hybrid forms of foreign investment. A definition covering "all kinds of assets" would cover new forms of foreign investment automatically, and avoid any need to renegotiate the definitions of an IIA in order to maintain its relevance. A narrow definition of investment would run the risk of becoming outdated by the emergence of new forms of assets and new modes of ownership, and hence would not offer the kind of protection to "lasting" economic interests that is intended. It has been pointed out, on the other hand, that such a forward-looking approach might result in protecting future business interests that go beyond the scope of what was intended at the time an IIA was concluded.

59. The use of a broad definition, including FDI and portfolio investment but excluding "transactions of a speculative nature", was suggested as a possible option. However, it was noted that identifying and differentiating short-term capital flows of a speculative nature could be conceptually and technically difficult. One criterion used for statistical purposes was the maturity of a financial asset, but this would not necessarily be appropriate since in practice businesses sometimes used short-term instruments for long-term financing purposes, and longer-term instruments for short-term financing purposes, such as forward sales of currencies.

60. It was suggested that host-country concerns about certain kinds of investment and capital movements could be addressed through the use of exceptions to substantive obligations in an IIA, rather than by limiting the scope of an IIA through its definitions. Reference was made in this respect to provisions in most IIAs on transfers of capital and funds. These could be formulated to allow for policy flexibility by permitting certain restrictions on transfers for macro-economic reasons or for the stability of financial systems, for example by prohibiting the repatriation of capital within less than a year after it had been invested.

61. It has been noted that the inclusion of intellectual property rights in the definition of investment did not require a particular level or nature of protection of intellectual property rights, and that the level of protection of specific forms of intellectual property rights was addressed in other contexts such as the TRIPS Agreement.

C. MIXED DEFINITION OF INVESTMENT, WITH SCOPE FOR LIMITING ITS APPLICATION

62. One suggestion was that there could be merit in distinguishing between narrow and broad definitions of investment on the basis of the nature of the substantive obligations to which they are applied. An example given, based on a Member's domestic legislation, was to use the concept of FDI in connection with provisions applicable to pre-establishment issues and the liberalization of investment, while reserving the broader, asset-based definition for purposes of protecting foreign investment at the post-establishment stage.

63. One view was that, on the one hand, using the option of changing the scope of the definition according to each element of a possible multilateral framework could facilitate a consensus. On the other hand, however, efforts should be made to avoid unclear and complex definitions that could

[21] UNCTAD, Scope and Definition, (1999), pp. 62-65.

cause problems of interpretation, and that could be difficult to understand for investors and to enforce for authorities.

VII. OUTSTANDING ISSUES

A. DEFINITION OF INVESTMENT

64. A number of issues have been raised in the Working Group's discussions as warranting further consideration. With regard to the broad, asset-based definition of "Investment", they are:

- whether a broad definition can adequately take into account the development needs of all Members.

- how to identify, define and exclude capital transactions which are not investments but which are financial transactions of a speculative nature.

- whether branches and other unincorporated forms of enterprises should be covered as investments. It has been suggested that all types of entity should be included that are recognized by applicable law, even though formal registration might not be required.

- whether the treatment of loans as investments should be limited to loans of a long-term nature.

- the need to clarify the treatment of rights arising under contracts as investments, in particular, the need to make a distinction between contracts related to the sale of goods or services and contracts that involve the commitment of financial and/or human resources by an investor.

- whether the capital or other resources committed by an investor should be located in the host country.

- the implications of treating intellectual property rights as investment assets. The need to clarify the relationship between investment agreements and the TRIPS Agreement.

- the need to examine the conditions under which real estate should be considered as a form of investment.

- how to ensure flexibility and comprehensiveness so as to include new forms of investments.

65. With regard to the narrow, enterprise-based definition of "Investment", they are:

- whether differentiating FDI and portfolio foreign investment has any economic or operational relevance.

- how the notion of "lasting interest" in an enterprise can be clarified, and whether a 10 per cent threshold is relevant and practical.

- how to define the notion of "control" of an enterprise, in light of modern forms of FDI and of indirect forms of ownership or control through subsidiaries or other intermediate companies or persons, including those of third countries.

- what the implications are of differentiating greenfield FDI from other forms of FDI.

B. DEFINITION OF INVESTOR

66. A number of issues were raised regarding the categories of natural and juridical persons which should be considered as "investors", in particular:

- Regarding natural persons, whether permanent residents should be included among the natural persons considered to be investors.

- Regarding juridical persons, whether any enterprise formed under the law of a party should be considered as an investor of that party, regardless of the nationality of the ultimate ownership or control of the enterprise.

- Whether a combination of place of incorporation, administrative seat, and nationality of control or ownership should be used to determine whether an enterprise should be considered an investor of a party.

- The possible merits of a denial of benefits clause to prevent non-party nationals from establishing "mail-box" companies solely to gain benefits under an agreement.

- The treatment of investors of all types of business recognized by applicable law, including those requiring formal registration.

- The inclusion of governmental and non-profit organizations as investors.

ANNEX I

Main categories of investment covered by "asset-based" definitions

- *Moveable and immovable property* covers all merchandise (such as capital equipment and inventories), buildings (such as factories) and land, and legal interest in properties of this kind in which the investor may have less than full ownership (mortgages, liens and pledges).

- *Participation in companies* covers various forms of equity participation such as stocks and shares, as well as bonds, debentures, loans, and other forms of long-term debt interests. The investor is not required to exercise "ownership" or "control" of a company, so the definition covers all levels and percentage of participation, both FDI and portfolio investment. Debt instruments can include public sector debt; bonds issued by public enterprises or that are publicly-guaranteed.[22]

- *Contractual rights* cover rights for the performance of services such as construction and management contracts, contracts for accounting and other professional services, turnkey contracts, production and revenue-sharing rights. The contracts do not necessarily have to be long-term.

- *Intellectual property rights (IPR)* can cover not only "traditional" IPR such as trademarks, patents, copyrights and related rights, rights in plant varieties, industrial designs and trade secrets, but also in some cases "technical processes" and other forms of "know-how" that are not usually protected legally by international conventions or agreements on IPR as traditional forms of intellectual property. This category can also include "goodwill", such as the reputation of the company.

- *Concessions conferred by law or under contract* typically include rights and privileges conferred by public authorities by virtue of legislative and administrative decisions, or contracts, licenses and permits allowing the use and exploitation of natural or public resources. Business and public concessions fall under this category.[23]

[22] In some IIAs negotiable claims over the public sector are referred to explicitly in the definition.

[23] Australia's Model Investment Protection and Promotion Agreement defines this as "business concessions and any other rights required to conduct economic activity and having economic activity conferred by law or under a contract, including rights to engage in agriculture, forestry, fisheries, and animal husbandry, to search for, extract or exploit natural resources, and to manufacture, use and sell products" (WT/WGTI/W/80).

ANNEX 2

Definition of Investment in the North American Free-Trade Agreement

Investment means,

(a) an enterprise;

(b) an equity security of an enterprise;

(c) a debt security of an enterprise;

(d) a loan to an enterprise;

(e) an interest in an enterprise that entitles the owner to share in the income or profits of the enterprise;

(f) an interest in an enterprise that entitles the owner to share in the assets of that enterprise on dissolution, other than a debt security or a loan excluded from subparagraph (c) or (d);

(g) real estate or other property, tangible or intangible, acquired in the expectation, or used for the purpose of economic benefit, or other business purposes;

(h) interest arising from the commitment of capital or other resources in the territory of a Party to an economic activity in a such a territory, such as under

> (i) contracts involving the presence of an investor's property in the territory of the Party, including turnkey or construction contracts, or concessions, or
>
> (ii) contracts where remuneration depends substantially on the production, revenues, or profits of an enterprise;

but investment does not mean,

(i) claims to money that arise solely from

> (i) commercial contracts from the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party, or
>
> (ii) the extension of credit in connection with a commercial transaction, such as trade financing, other than a loan covered by subparagraph (d); or

(j) any other claim to money, that does not involve the kinds of interests set out in subparagraphs (a) through (h).

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