
# BALANCING INVESTOR PROTECTION AND STATE REGULATORY AUTONOMY: THE EVOLUTION OF THE FAIR AND EQUITABLE TREATMENT STANDARD

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**ABSTRACT**

*This paper examines the tension between investor protection and state regulatory autonomy under the Fair and Equitable Treatment (FET) standard in international investment arbitration. It argues that the FET standard has evolved from a narrow safeguard against egregious state conduct into a broad, unpredictable tool that increasingly encroaches upon legitimate state regulation. Using the example of a "regulatory adaptation scenario" – where a state modifies its environmental or tax legislation in response to changed circumstances without targeting specific foreign investors – the paper demonstrates how contemporary FET jurisprudence creates a "freezing effect" on state regulatory power. It further analyzes doctrinal inconsistencies across arbitral tribunals and the institutional limitations of the current investment arbitration system in reconciling these competing interests. The conclusion is that restoring balance requires not abolishing FET but transforming it through precise treaty drafting mechanisms, including an exhaustive illustrative list of violations, a regulatory carve-out for non-discriminatory public welfare measures, and a structured proportionality test. The paper offers specific drafting language for future bilateral investment treaties..*

In recent decades, the Fair and Equitable Treatment (FET) standard has become the most frequently invoked provision in investment treaty arbitration. Claimants rely on it in over 80% of cases, and tribunals have interpreted it to encompass legitimate expectations, due process, transparency, and non-arbitrariness. However, this expansion has come at a cost: states increasingly perceive FET as a threat to their sovereign right to regulate in the public interest. The tension is not merely academic. When a state raises environmental standards, modifies its tax regime, or adjusts public health policies, it risks facing multi-million dollar FET claims from investors who claim that their "legitimate expectations" have been frustrated.

The central problem is structural. FET clauses in most bilateral investment treaties (BITs) are notoriously vague – typically stating only that each party shall accord "fair and equitable treatment" to covered investments. This vagueness was originally intentional: it allowed states to agree on a standard without defining its precise contours. But it has also delegated enormous interpretive power to arbitral tribunals, which have filled the gap with divergent, sometimes contradictory, jurisprudence. The result is legal uncertainty for both investors and states.

Historically, FET was understood as synonymous with the minimum standard of treatment under customary international law, as articulated in the Neer v. Mexico claim (1926), which required "an outrage, bad faith, willful neglect of duty, or a manifest insufficiency of action" – a high threshold designed to protect states from frivolous claims. A decisive shift occurred with Tecmed v. Mexico (2003), where the tribunal held that FET requires the host state to provide "treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment". This decision elevated legitimate expectations to the center of FET analysis, introduced proportionality reasoning borrowed from European public law, and decoupled FET from the high threshold of customary international law. Subsequent tribunals followed, with Saluka v. Czech Republic (2006) explicitly stating that FET requires "a weighing of the investor's legitimate and reasonable expectations on the one hand and the State's legitimate regulatory interest on the other".

Consider a typical scenario, referred to here as a "regulatory adaptation". State A adopts a renewable energy law guaranteeing fixed feed-in tariffs for 20 years. Several foreign investors make substantial investments in reliance on this law. Ten years later, due to technological advances, solar energy becomes commercially viable without subsidies. State A reduces the tariffs to align with market prices, applying the change equally to all producers, domestic and foreign. The stated purpose is to reduce the burden on consumers. The foreign investors bring an FET claim, arguing that they had legitimate expectations based on the original law. The state argues that it has a sovereign right to adapt its regulatory framework to changed circumstances. Under Tecmed, the outcome depends on whether the state's conduct was "disproportionate to the need to protect the public interest". But proportionality is notoriously indeterminate. A tribunal could reasonably find for either party. The same facts produce opposite outcomes depending on the tribunal's weighting of factors. This is not a defect in adjudication, it is a consequence of FET's inherent indeterminacy.

The practical consequence is a "freezing effect". States anticipating potential FET claims may refrain from legitimate regulatory updates, even when those updates would serve the public interest. Empirical studies have documented this phenomenon in the context of environmental regulation, public health measures, and tax reform. The problem is acute for developing economies, which often lack the resources to litigate complex FET claims and face disproportionate reputational damage from being named in arbitration. Importantly, the freezing effect operates even when the state would ultimately prevail. The prospect of a multi-year, multi-million dollar arbitration is itself a deterrent, independent of the outcome.

Persistent inconsistencies in arbitral practice exacerbate the problem. Some tribunals treat legitimate expectations as the dominant element of FET (Saluka, Duke Energy v. Ecuador); others treat it as one factor among many (Parkerings v. Lithuania, Total v. Argentina). Some defer to state regulatory judgments, requiring clear evidence of bad faith, others actively scrutinize the proportionality of state measures, effectively second-guessing policy choices. Consider two cases involving the same Argentine emergency measures: CMS v.

Argentina (2005) found a breach of FET because the measures "entirely transformed" the legal framework; Continental Casualty v. Argentina (2008) found no breach because the state acted to protect the public interest. No appellate mechanism exists to resolve such inconsistencies. As a result, divergent interpretations persist indefinitely.

The institutional architecture of investment arbitration compounds these difficulties. The system was designed to protect investors, not to balance competing public interests. Arbitrators develop their professional reputations through expertise in investor protection, not regulatory policy. Empirical studies suggest that tribunal composition affects outcomes. Moreover, the absence of *stare decisis* means each tribunal conducts its own balancing exercise anew. For respondent states, especially developing economies, defending an FET claim imposes substantial costs – legal fees, expert witnesses, potential liability – regardless of the outcome. States may therefore choose to settle claims, or to avoid regulatory changes that might provoke claims, even when they believe their position is legally sound.

The solution is not to abolish FET – which would undermine investor confidence and disadvantage precisely those developing economies that seek to attract foreign investment – but to reform it through precise treaty drafting. States cannot rely on tribunals to consistently balance competing interests. They must embed the balance in the treaty text itself. Three concrete mechanisms are available. First, the exhaustive illustrative list approach (exemplified by the India Model BIT 2016) replaces the open-ended FET standard with a closed list of specific violations, notably excluding legitimate expectations. Second, the regulatory carve-out approach (exemplified by the Netherlands Model BIT 2019) excludes from FET's scope measures adopted to protect legitimate public welfare objectives, provided they are not arbitrary or discriminatory. Third, the structured proportionality test codifies the balancing exercise, allocating the burden of proof appropriately: the state proves the measure's public purpose, suitability, and necessity; the investor proves disproportionality of adverse effects.

A hybrid approach combining these elements is preferable. The following drafting language is proposed: a breach of FET occurs only through denial of justice, fundamental breach of due process, manifestly arbitrary or discriminatory treatment, or targeted harassment. Modifications to the legal framework for public welfare purposes do not constitute a breach, even if they negatively affect investor expectations. Legitimate expectations arise solely from specific written assurances provided directly to the investor, not from the mere existence of a stable legal framework.

The preliminary conclusion is that without transforming FET from a vague standard into a set of operational treaty provisions, the tension between investor protection and regulatory autonomy will persist. International investment law demands predictability for both investors and states. In its absence, states will increasingly resist investment arbitration, and the legitimacy of the FET standard – indeed, of the entire ISDS system – will remain in question. Bridging this gap requires not judicial self-restraint but disciplined treaty drafting

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