NOTE

From: Commission
To: Delegations
Subject: Investment in TTIP and beyond – the path for reform

Delegations will find in ANNEX a concept paper prepared by the Commission services to be discussed at the Foreign Affairs/Trade Council at its session on 7 May 2015.
CONCEPT PAPER

Investment in TTIP and beyond – the path for reform

Enhancing the right to regulate
and moving from current ad hoc arbitration towards an Investment Court

Investment is essential for growth and for job creation. It integrates the EU in global value chains to achieve a stronger economic recovery. EU policies are geared towards increasing investment as part of the recovery. The EU already is the world's largest source and destination of foreign direct investment (FDI), and therefore has a strong interest to facilitate and protect international investment and to support our investors. As the EU upholds a high standard in promoting and protecting investment in its territory, the EU has a natural interest in obtaining similarly credible and enforceable guarantees for EU investments and investors abroad.

The starting point

International investment rules were invented in Europe. Today, EU Member States are parties to almost half of the total number of international investment agreements that are currently in force worldwide (roughly to 1400 out of 3000). These agreements, almost all of which include both investment protection and investor-to-State dispute settlement (“ISDS”) (which allows disputes between an investor and a State when the latter is alleged to have breached its commitments under an international investment agreement to be resolved) - have played their part in encouraging and protecting the high volume of EU investment abroad and, reciprocally, the investments held by the rest of the world in the EU.

The need for a new EU approach

In 2009, the Lisbon Treaty conferred competence for the protection of investments to the EU. This creates an unprecedented opportunity not only for a comprehensive approach to trade and investment at EU level, but also for a profound reform of the traditional approach to investment protection and the associated ISDS system.
The key challenge for the EU's reformed investment policy is the need to ensure that the goal of protecting and encouraging investment does not affect the ability of the EU and its Member States to continue to pursue public policy objectives. A major part of that challenge is to make sure that any system for dispute settlement is fair and independent. The EU has already begun to address these challenges, through interactions with EU stakeholders and through the process of negotiation of the first generation of EU trade agreements that included investment protection and ISDS.

**What have we achieved so far?**

In 2014 the EU concluded the negotiations of the first two free trade agreements that include investment protection and ISDS, with Canada (CETA) and Singapore (EU Singapore FTA). These agreements introduce a new approach, innovating both in terms of substance (investment protection rules) and procedure (ISDS mechanism) and already incorporate many of the reform ideas that the Commission has discussed with the European Parliament, Member States, and stakeholders:

- We have reaffirmed the right to regulate. In CETA we have made clear in the preamble of the agreement that the EU and Canada preserve their right to regulate and to achieve legitimate policy objectives, such as public health, safety, environment, public morals and the promotion and protection of cultural diversity.

- We have defined key concepts like “fair and equitable treatment” and “indirect expropriation”, in order to prevent abuse. For the first time, CETA provides a definition of these terms. "Fair and equitable treatment" is defined through a clear, closed text which defines precisely the content of the standard without leaving unwelcome discretion to arbitrators. Moreover, detailed language has been agreed upon to clarify what constitutes indirect expropriation, particularly excluding claims against legitimate public policy measures.

- We have prevented practices by investors such as "forum shopping", that is trying to pick the most suitable agreement to bring an ISDS claim. For example, the making of an investment or business re-organisation for the purpose of bringing a case (as is alleged Philip Morris has done to bring its case against Australia) is explicitly prohibited in CETA. No other ISDS agreement contains such a provision. Moreover, "mailbox" companies will not be able to bring cases to arbitration. Only companies with real business operations in the territory of one of the Parties will be covered by the investment protection provisions.
We have introduced full, mandatory transparency of the arbitration process. CETA incorporates the UNCITRAL rules on transparency which will mean that all documents (submissions by the disputing parties, decisions of the tribunal) will be made publicly available. All hearings will be open to the public. Interested parties (NGOs, trade unions) will be able to make submissions.

We have given governments, not arbitrators, ultimate control over the interpretation of the rules. Under CETA, the EU and Canada can issue binding interpretations on how the provisions should be interpreted, and the ISDS Tribunal is obliged to respect those interpretations. These binding interpretations can also be made with respect to on-going ISDS cases. The ability for the Parties to the agreement to adopt binding interpretations is a safety valve in the event of errors by the tribunals (the likelihood of which is in any event eliminated by the clear drafting of the relevant investment protection standards).

We have included, for the first time, a code of conduct for arbitrators, ensuring the respect of high ethical and professional standards. CETA sets out precise and clearly defined procedures to follow to ensure full impartiality of arbitrators, for instance by requiring full disclosure of any situation which could give rise to real or perceived conflicts of interest (for instance previous work or links to law firms). CETA also includes concrete steps to allow to determine whether a conflict could arise or has arisen. In case an arbitrator is found not to comply with the code, he/she will be replaced.

We have created rules ensuring the early dismissal of unfounded claims. Under CETA we have introduced a fast track system that will allow to reject unfounded or frivolous claims in just a matter of weeks.

We are making investors who bring a case and lose, pay for all the costs of the legal proceedings. This "loser pays principle", introduced for the first time ever in CETA, will not only discourage frivolous or unfounded claims but will also mean that the investor must pay the litigation costs of the state he has challenged (at present, even if a government successfully defends itself, it often has to bear its litigation costs). Given the financial risk, an investor will think twice before bringing any ISDS claim.
• We have had our negotiating partners agree to work towards a future appeals mechanism. The Commission has said already back in 2010 that an appellate mechanism has clear added value in ensuring consistency and predictability of the system and the idea of putting in place such a mechanism has broad support amongst EU stakeholders. CETA is the first agreement to which the US is not a party which contains a clear commitment to the possible creation of an appeal mechanism.

• And we oblige investors to drop cases in national courts if they want to pursue ISDS. CETA prohibits parallel proceedings: investors cannot seek remedies in domestic courts and through ISDS at the same time. The aim is to avoid double compensation and divergent verdicts. Most of the over 3,000 existing investment treaties with ISDS do not have this prohibition.

*What can we further improve?*

The TTIP negotiations, which concern the world's two largest economies, have attracted a significant interest from the public and civil society organizations, with much of the attention focusing on the provisions on investment protection and ISDS. For that reason, the Commission last year decided to hold a public consultation on investment protection and ISDS in TTIP, in order to gather views from the public on how the EU could develop further its approach. The Commission intends to use the outcome of these consultations in developing the negotiating position it will propose to adopt in the TTIP negotiations on this question.

The report on the results of the consultation, released on 13 January 2015, identified four areas where particular concerns were raised and where further improvements to the EU’s approach should be explored: i) the protection of the right to regulate; ii) the establishment and functioning of arbitral tribunals; iii) the review of ISDS decisions through an appellate mechanism; iv) the relationship between domestic judicial systems and ISDS.

The following sections of this paper set out such concrete ideas on the four areas where improvements could be made. They explain the concrete solution for improvement as compared to the status quo, the rationale behind the proposed solutions and how they relate to the approach the EU has followed so far in CETA and in the EU-Singapore FTA.
The following sections contain a possible way forward for each of the four policy areas. For the right to regulate, they provide for a further and clearer, legal provision to ensure that investment protection rules do not undermine the right to regulate.

They contain new proposals on the functioning of the ISDS system. They suggest steps that can be taken to transform the system towards one which functions more like traditional courts systems, by making their appointment to serve as arbitrators permanent, to move towards assimilating their qualifications to those of national judges, and to introduce an appeal system.

The sections below suggest that in parallel the EU should work towards the establishment of an international investment court and appellate mechanism with tenured judges with the vocation to replace the bilateral mechanism which would be established. This would be a more operational solution in the sense of applying to multiple agreements with multiple partners but it will require a level of international consensus that will need to be built. It is suggested to pursue this in parallel with establishing bilateral appeal mechanisms. These changes are intended to be the stepping stones towards a permanent multilateral system for investment disputes.

Eventually, what will be proposed in the TTIP context will set the standard for the further development of investment protection provisions and investment arbitration in EU investment negotiations. TTIP provides a unique opportunity for reforming and improving the system.

This paper is intended to serve as a basis for discussion with the European Parliament, the Council and reflects the substance and elaborates on the ideas presented by EU Trade Commissioner Cecilia Malmström to the INTA Committee (18 March) and to the informal Foreign Affairs Council (25 March). It also links in with views expressed by stakeholders. It is without prejudice to the final position of the European Commission on the matters described within.

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I. **RIGHT TO REGULATE**

I.1. **Why further improve the EU approach in this area?**

In the public debate about investment protection and ISDS, concerns have been expressed about potential limitations to the right of governments to regulate in the public interest. In particular, it has been argued that ISDS offers to investors the right to sue governments whenever new legislation negatively affects their profits.

In the past, investment agreements have often been drafted more with the protection of investments in mind than the state’s right to regulate. Certain investment agreements have even explicitly included a reference to the rights of investors to a “stable business environment”. Concerns have been raised by the fact that such an explicit reference to a stable business environment has been interpreted by some arbitral tribunals as offering a general guarantee against repeated legislative changes. A reform on this point should address these concerns by making clear that EU investment protection standards do not offer such guarantee.

It has also been argued in the public debate that arbitral tribunals, in interpreting the investment agreements, have only considered the objective of protecting the economic interests of the investors and have not balanced it against the sovereign right of States to legislate in the public interest. This concern is based, *inter alia*, on the fact that an explicit reference to the right to regulate has been only rarely included in investment agreements. The EU and the countries with whom it has negotiated (Canada and Singapore) have considered that the right to regulate is part and parcel of their agreement, and have recalled this in the preamble to those agreements. Nevertheless greater clarity in relation specifically to investment protection and arbitration could be helpful. A reform on this point should reaffirm the right to regulate in a legal provision in the body of the relevant chapter.

Disputes involving state aid have raised specific problems. In a recent case under an intra-EU BIT in a pre-accession situation, the Tribunal found that a Member State's decision to discontinue the granting of a measure involving prohibited State aid was in breach of the Fair and Equitable Treatment (FET) clause. The Commission views this decision as an incorrect application of the FET clause given that EU law consistently denies legitimate expectations to investors as regards state aid. It has also taken the view that the compensation ordered by the Tribunal amounts *de facto* to the reinstatement of the prohibited state aid.
In order to ensure that these types of problems cannot arise, it should be considered, for greater certainty, to clarify that the investment protection standards are not to be construed as preventing from discontinuing the granting of state aid, and/or requesting the reimbursement of state aid already paid, when such state aid has been declared prohibited by its competent authorities.

1.2. **What has been achieved already?**

CETA and the EU Singapore FTA already set a very high benchmark insofar as the protection of the right to regulate is concerned, notably when measured against the approach traditionally followed by Member States in their BITs.

In these agreements, the EU has:

- Clarified and improved the drafting of the standards of protection, in order to leave less room for unwarranted interpretations. Notably: a) the "fair and equitable treatment" has been limited to a closed list of types of behaviour consistent with consolidated judicial views in the EU (like denial of justice, arbitrary conduct and breach of due process) and b) the notion of “indirect expropriation” has been explained in an annex which clarifies that for indirect expropriation to occur there must be a substantial taking away from the investor of the attributes of property (i.e. the right to use, enjoy and dispose of the investment).

- Given the right to the Parties (EU and Canada/Singapore) to adopt binding interpretations in order to control the interpretation of the agreement, and correct possible errors by the tribunals (the likelihood of which is in any event quasi-eliminated by the clear drafting of the relevant investment protection standards).

Re-balancing the context in which investment protection standards are interpreted is an issue that has been addressed in CETA and EU Singapore FTA through a reference in the preamble of both agreements. This reference is already an innovation as compared to EU Member States’ traditional approach in their BITs, which is to refer exclusively in the preamble to the economic imperative of promoting and protecting investments. The reference in the preamble to the right to regulate already gives a very important interpretative guidance.
I.3. **What should be further improved?**

The EU proposal should enhance governments’ ability to regulate in the public interest through:

- An operational provision (an Article) which will refer to the right of Governments to take measures to achieve legitimate public policy objectives, on the basis of the level of protection that they deem appropriate. Such provision is recognition of the right of domestic authorities to regulate matters within their own borders which exists already under international law. It allows setting the right context in which investment protection standards are applied.

- A provision clarifying that the agreement shall not be construed as preventing a Party from discontinuing the granting of state aid, and/or requesting the reimbursement of state aid already paid, when such state aid has been declared prohibited by its competent authorities.

II. **IMPROVING THE ESTABLISHMENT AND FUNCTIONING OF ARBITRAL TRIBUNALS IN ORDER TO INCREASE LEGITIMACY OF THE ISDS SYSTEM**

II.1. **Why further improve the EU approach in this area?**

Currently, arbitrators on ISDS tribunals are chosen by the disputing parties (i.e. the investor and the defending state) on a case-by-case basis. The current system does not preclude the same individuals from acting as lawyers (e.g. preparing the investor’s claims) in other ISDS cases. This situation can give rise to conflicts of interest – real or perceived - and thus concerns that these individuals are not acting with full impartiality when acting as arbitrators. The ad hoc nature of their appointment is perceived by the public as interfering in their ability to act independently and to properly balance investment protection against the right to regulate. It has also led to perceptions that this provides financial incentives to arbitrators to multiply ISDS cases.

II.2. **What has been achieved already?**

The approach taken to the selection process and ethics of arbitrators in the CETA and Singapore agreements is already by far the most advanced in existence.
First, it requires that the disputing parties nominate an arbitrator each, and then need to agree on the presiding arbitrator. If no agreement can be found an external actor - the Secretary General of the International Centre for the Settlement of Investment Disputes (ICSID) - is required to choose the presiding arbitrator from a pre-established “roster” (list) agreed by the Parties to the agreement (not to the dispute) in advance. The arbitrators, whoever selects them, are required to have expertise in international law. Second, they need to comply with a code of conduct (annexed to the agreement or via the incorporation of the functionally equivalent International Bar Association (IBA) rules on conflicts of interest). The ICSID Secretary General – not the other arbitrators as is currently the case – decides whether there had been a conflict.

This constitutes a deep reform of the system. First, existing agreements often permit the two arbitrators selected by the disputing parties to choose the presiding arbitrator. In CETA/EU Singapore FTA the agreement of both disputing parties to the choice of the presiding arbitrator is required. Some existing agreements provide for an “appointing authority” (normally the ICSID Secretary General) to appoint arbitrators, but leave this appointing authority relatively free in the choice – there is no requirement of expertise in international law for example nor that the arbitrators be chosen from a roster of arbitrators previously agreed (and vetted) by the parties to the agreement. Furthermore, no existing agreement actually has a code of conduct or incorporates the IBA rules on ethics. Finally, the decision on whether there is a conflict under the existing system often falls to the other two arbitrators – not an independent entity, like the ICSID Secretary General.

Currently CETA and the EU/Singapore FTA provide for the possibility that the arbitration tribunal "may" accept *amicus curiae* briefs from third parties under certain conditions, in line with recently agreed UNCITRAL Rules on Transparency. But they do not specifically provide for right to intervene to persons with a clear and concrete interest in the case.

**II.3. What should be further improved?**

The EU proposal should include:

- A requirement that all arbitrators are chosen from a roster pre-established by the Parties to the Agreement (they could then be chosen either by lot or by choice of the disputing parties). This option would not present technical difficulties, and would allow to “break the link” between the parties to the dispute and the arbitrators. It would mean that all arbitrators have been vetted by the Parties.
• This requirement could be accompanied by requiring certain qualifications of the arbitrators, in particular that they are qualified to hold judicial office in their home jurisdiction or a similar qualification. This would need to be complemented by the fact that they also need expert knowledge of how to apply international law as contained in the agreement – which would very precisely frame the exercise of their functions and reduce drastically the risk of unforeseen interpretation of the rules on investment protection. Thus, even the choice of the disputing parties would be limited to persons whom the Parties to the Agreement have decided in advance are competent, independent, impartial and can be trusted to decide in accordance with known and predictable legal principles.

• In addition to the possibility for the Tribunal to accept *amicus curiae* briefs, the EU proposal should confer a right to intervene to third parties with a direct and existing interest in the outcome of a dispute.

### III. APPELLATE MECHANISM

### III.1. Why an appellate mechanism?

One of the most persistent criticisms of the international investment arbitration process is that ISDS tribunals can get their decisions wrong, and there is no corrective mechanism via an appeal, as is found in almost all legal systems. This lack of appellate mechanism also makes the system less predictable for governments and investors alike.

The possibility of including an appellate mechanism was one of the issues which gained broadest support in the public consultation from both business and NGOs. The guiding thought was that the right of appeal must be part of any functioning judicial or quasi-judicial system, including for investment protection, where issues pertaining to public policy may be at stake. Many respondents, however, underlined the importance of developing an institutional set up composed of permanent judges to ensure greater legitimacy. Many respondents also argued for a multilateral rather than a bilateral approach to avoid a multitude of appeal jurisdictions.
The TTIP negotiating directives from June 2013 are the first EU negotiating directives which explicitly mention an appellate mechanism. These state that “consideration should be given to the possibility of creating an appellate mechanism applicable to investor-to-state dispute settlement under the agreement”. The Parliament’s 2011 Resolution on the EU’s International Investment Policy also contained a reference to the need to create the possibility for appeals (as did the Commission’s Communication of 2010).

In addition to ensuring correctness and predictability, an appellate mechanism can respond to the legitimacy concerns as regards the current ISDS system. A key element in that regard is the design of an appellate mechanism, and in particular how its members are designated, the qualifications which they are required to hold and the form of their remuneration. The design of an appellate mechanism can also address other concerns which may arise. For instance, time limits may be imposed to ensure that an appellate mechanism does not lead to delays in proceedings (it should be recalled that the current ICSID system, for instance, provides for a two-step process and the second step is often relatively lengthy).

**III.2. What has been achieved already?**

For CETA and Singapore (and other agreements under negotiation), the EU has included a reference to a possible appellate mechanism in the form of *rendez-vous* clauses (i.e. a clause that commits the Parties to the agreement to look at setting up an appellate mechanism in the future).

Conversely, there is no appellate mechanism included in any existing investment treaties. Some of the most commonly referenced current ISDS arbitration rules (e.g. ICSID or UNCITRAL) only allow for “annulment” or “set aside” of the tribunal’s award (basically preventing enforcement of the award) on limited procedural grounds (for example, no jurisdiction, error in composition of the tribunal, breach of fundamental procedural rule).
III.3. What should be done now?

The EU proposal should include a bilateral appellate mechanism for ISDS. The EU text should lay out its role, its set-up and practical operation. The appellate mechanism would review awards as regards errors of law and manifest errors in the assessment of facts (this would include an incorrect factual treatment of domestic law as interpreted by domestic courts), ensure consistency in the interpretation of TTIP and increase legitimacy both on substance and through institutional design by strengthening independence, impartiality and predictability.

The bilateral appellate mechanism could be modelled largely on the institutional set-up of the WTO Appellate Body, with some adaptations both to make it specific for ISDS, and in light of experience in the WTO. There could be 7 permanent members (2 from each Party, 3 non-nationals) whose qualifications could be broadly similar to those of the WTO Appellate Body and/or the International Court of Justice. There would inevitably be certain costs associated with the establishment of the body including a possible secretariat to help the appellate members in their work. An appellate mechanism is a realistic possibility with the United States. The US has included a reference to the possible creation of an appellate mechanism in its agreements since 2002.

IV. Addressing the relationship between ISDS and domestic courts

IV.1. The relationship between ISDS and domestic courts

It is frequently claimed that ISDS gives investors a special and parallel track for settling investment disputes by which they can by-pass the ordinary jurisdiction of domestic courts. It is argued that domestic courts alone should resolve disputes with foreign investors, who should not be in a position to "appeal" the domestic courts' decisions before special ISDS tribunals.

Domestic courts are only competent to rule on investment disputes by application of domestic law. By contrast, ISDS tribunals - like other international courts - only decide on the compatibility of state actions (including all state actors) with international investment rules. This distinction is particularly relevant where the rules in the international agreement are not directly incorporated into domestic law, as is the case for most international trade and investment agreements in particular in the US, Canada and the EU. This puts ISDS tribunals on the same footing as other international judicial institutions in the sense that cases before them are not in legal terms appeals from domestic law, but rather application of international rules.
Nevertheless, it still makes sense to try and manage better the relationship between domestic (judicial) and international (arbitration) remedies. This should be done, for instance, to avoid the risk of double compensation (i.e. that investors could get compensation under domestic law and international law for the same damage).

In addition, concerns have been expressed with regard to the compatibility of ISDS with the principle of autonomy of the EU legal order. A risk of such incompatibility would exist especially if ISDS tribunals were to interpret EU law in a manner that would be binding on the EU institutions. Since ISDS tribunals only interpret the international agreement in question and would examine EU law only as a matter of fact, one may argue that concerns related to the autonomy of EU law are unfounded.

IV.2. What has been achieved already?

Both under CETA and the EU/Singapore FTA, investors must withdraw from any domestic proceedings they may have started before submitting a claim to ISDS (this is the so-called “no u-turn” approach). Parallel claims are thus prohibited. However, investors may first seek to obtain redress in domestic courts, including by exhausting domestic court proceedings, before possibly turning to ISDS where the treatment afforded by the country [including by its domestic courts] still allegedly falls short of the basic guarantees contained in the investment protection provisions of an international agreement. The rationale of this approach is to encourage investors to primarily rely on domestic remedies thus minimizing the potential number of ISDS claims. The approach in CETA and the EU/Singapore FTA is very close to but not identical to the approach traditionally taken by the US and Canada in their own BITs.

The majority of Member States' BITs are silent on the relationship between domestic courts and ISDS, thus leaving it entirely up to the investor to choose between domestic and international remedies, and in which order. Parallel claims before domestic courts and ISDS tribunals on the same subject matter are therefore possible (whereas in CETA and the EU/Singapore FTA parallel claims are prohibited). A few Member States' BITs require the exhaustion of domestic remedies before ISDS proceedings, or request investors to make a definitive choice between domestic and international remedies ("fork-in-the-road").
CETA and the EU/Singapore FTA also clarify that ISDS tribunals should apply (only) the agreement and other rules and principles of international law applicable between the Parties to the agreement. This means that they cannot apply domestic law (whether of the EU or Member States). CETA and the EU/Singapore FTA, however, do not provide explicit guidance on how domestic law should be handled.

IV.3. What should be further improved?

Few investment agreements require the exhaustion of domestic remedies before submitting a claim to ISDS. Some even contain an explicit rejection of this idea, *inter alia* because it is considered to increase the cost and duration of litigation.

The EU proposal should ensure that parallel claims are prohibited, for example, so that investors cannot obtain double compensation.

There are different ways to achieve this result:

- A simple way would be to require investors to make a definitive choice between ISDS and domestic courts at the very beginning of any legal proceedings ("fork-in-the-road"). This would contribute to shortening the duration and the cost of litigation, by avoiding that a dispute is litigated first before domestic courts, and then before ISDS tribunals.

- Another approach would be to request investors to waive their right to go to domestic courts once they submit a claim to ISDS ("no u-turn"). This option has the advantage of not discouraging investors from seeking redress before national courts and hence of reducing the number of potential ISDS claims.

Either approach, or a combination of both, could be used, depending on the agreement being negotiated. In addition to the above, in order to ensure certainty with regard to the compatibility of ISDS with the principle of autonomy of the EU legal order, the EU proposal should clarify the relevance of the domestic law of each Party for the purposes of ISDS, by confirming that:

- The application of domestic law does not fall under the competence of ISDS tribunals;
- Domestic law can be taken into account by ISDS tribunals only as factual matter; and
- Any interpretations of domestic law made by ISDS tribunals are not binding on domestic courts.
The EU proposal should also clarify that, whenever a question of interpretation of domestic law of a Party arises, the Tribunal must base itself on the relevant case law of the domestic courts of that Party.

V. **TTIP AND BEYOND - STEPS TOWARDS A MULTILATERAL SYSTEM**

The proposals outlined above are intended as the stepping stones towards the establishment of a multilateral system. To achieve this, there are two areas where further development should be sought.

First, as indicated in section III above, a bilateral appellate mechanism should be included not only in TTIP, but should become a standard feature in all EU trade and investment agreements with other negotiating partners. Thus it should be considered to start working on an appellate mechanism with tenured judges, applying to multiple agreements and between different partners, for example on the basis of an opt-in system.

Second, the creation of a fixed list of arbitrators will already move ISDS procedures closer to a permanent court. A development that would institutionalise ISDS even further is to establish an actual permanent investment court with tenured judges. Pursuing such an investment court for each individual EU agreement that includes ISDS presents obvious, technical and organizational challenges.

Therefore, the EU should pursue the creation of one permanent court. This court would apply to multiple agreements and between different trading partners, also on the basis of an opt-in system. The objective would be to multilateralise the court either as a self-standing international body or by embedding it into an existing multilateral organization. Work has already begun on how to start this process, in particular on aspects such as architecture, organisation, costs and participation of other partners.