

A Study on the Upgrade of the Investment Dispute Settlement Mechanism in the China-ASEAN Free Trade Area 3.0

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Abstract: Against the backdrop of the China-ASEAN Free Trade Area 3.0, the investment dispute settlement mechanism under CAFTA 3.0 faces multiple practical challenges: at the regional level, the ambiguous hierarchy of application under the RCEP and the diverging stances of ASEAN member states complicate efforts to harmonize rules; at the level of the rules themselves, the ISDS mechanism—which has not undergone substantive revisions—struggles to address the specific requirements of new chapters such as those on the digital economy and the green economy. Resolving these challenges requires a dual-pronged approach: Externally, CAFTA 3.0 should serve as a “regulatory anchor” to coordinate its relationship with RCEP; Internally, specialized procedures should be established in different sectors to address the new chapters—such as involving technical experts in the digital economy and establishing a “climate change exception” mechanism in the green economy—to facilitate a paradigm shift in the ISDS mechanism from a “generic tool” to a “sector-specific toolkit,” thereby providing institutional safeguards for optimizing the regional investment environment and advancing economic integration.

1. The Evolution of the CAFTA Investment Dispute Settlement Mechanism

The evolution of CAFTA is a key manifestation of the deepening mutually beneficial cooperation between China and ASEAN. Its investor-state dispute settlement mechanism has progressed from the foundational framework of Version 1.0 to the partial adjustments of Version 2.0, forming a development path characterized by gradual advancement and continuous optimization. The period from 2002 to 2010 marked the Version 1.0 phase of CAFTA, which centered on the liberalization of trade in goods. During this period, the CAFTA 1.0 investment dispute settlement mechanism, centered on the Investment Agreement under the China-ASEAN Framework Agreement on Comprehensive Economic Cooperation, established arbitration as the primary method of dispute resolution, thereby laying the foundational framework for regional investment dispute settlement.^[1] However, it faced issues such as a narrow scope of application—limited to traditional investment sectors—and insufficient transparency due to limited public access to arbitration proceedings and awards. The period from 2015 to 2019 marked the 2.0 phase of CAFTA, focusing on the facilitation of investment

in services. However, the changes to the investment dispute settlement mechanism in CAFTA 2.0 were not significant; it only introduced minor optimizations based on Version 1.0, primarily involving slight adjustments to the scope of jurisdiction and preliminary improvements to procedural coordination. It did not address the core structural framework of the mechanism or resolve the fundamental issues present in Version 1.0, thereby leaving room for a comprehensive upgrade in Version 3.0.

As China-ASEAN cooperation deepens and the international community advances reforms to the Investor-State Dispute Settlement (ISDS) system, the investment dispute settlement mechanism under CAFTA 3.0 is guided primarily by the principles of “inclusivity and adaptability,” aiming to establish a modern investment dispute settlement system that meets the new demands of regional economic cooperation. As evident from the text of CAFTA 3.0 published on the official website, the provisions on dispute settlement—which do not require re-confirmation by the contracting parties—indicate that CAFTA 3.0 incorporates emerging areas such as digital investment and green investment. However, in practice, CAFTA 3.0 has not made any upgrades to the ISDS mechanism; it continues to use the dispute settlement mechanism that took effect in 2009. Therefore, it can be said that the investment dispute settlement mechanism in CAFTA 3.0 is no different from that in CAFTA 2.0, and the investment dispute settlement mechanism in CAFTA 3.0 still suffers from the same issues as the 2.0 version. There are gaps in the alignment between the existing mechanisms of CAFTA 3.0 and bilateral investment treaties—agreements between two countries that provide mutual protection for investors and investments originating from the other party within their respective territories^[2]—as well as the rules of the RCEP^[3]. There is a lack of targeted dispute resolution pathways for investment disputes in new sectors, which urgently requires theoretical and institutional responses.

2. Practical Issues Regarding the Upgrade of the Investment Dispute Settlement Mechanism in CAFTA 3.0

2.1. The Challenge of Harmonization with Relevant Regional Agreements

The issues regarding the transition between the 2009 CAFTA Investment Agreement and the RCEP, which entered into force in 2022, in terms of investment dispute settlement mechanisms are primarily reflected in three key areas: generational differences between the old and new rules, overlapping scopes of application and conflicts in exclusion clauses, and varying levels of detail in procedural rules. The 2009 CAFTA mechanism represents a previous generation of ISDS rules, with provisions that are relatively general and concise.^[4] The RCEP’s ISDS mechanism, by contrast, reflects more recent practices and reform priorities, incorporating more detailed rules.^[5] There is a clear “generational gap” between the two in key provisions, such as the prevention of forum shopping regarding most-favored-nation (MFN) treatment [Article 10.4.3 of the RCEP explicitly excludes the application of MFN clauses in dispute settlement proceedings]. While the RCEP mechanism explicitly excludes such forum shopping, the CAFTA mechanism does not make this explicit exclusion, leaving room for broader interpretation. Furthermore, neither agreement establishes an explicit “conflict of laws” provision specifying which takes precedence. Harmonization primarily relies on general principles of international law: the principle of the later treaty taking precedence—according to Article 30 of the Vienna Convention on the Law of Treaties, among the same contracting parties, a later treaty prevails to the extent that it does not conflict with earlier treaties. However, for matters explicitly excluded by RCEP, CAFTA, as the earlier treaty, may still remain in force. Yet, when addressing purely China-ASEAN investment disputes, CAFTA may be regarded as a more “specialized” set of rules. Nevertheless, the more specific and recent provisions in RCEP may take precedence due to their greater precision, leaving the arbitral tribunal with significant discretion and increasing the uncertainty of the outcome.

2.2. Insufficient institutional responses to demands in new fields

The digital economy has become the primary driver of China-ASEAN economic and trade cooperation. However, the investment dispute settlement mechanism under CAFTA 3.0 fails to anticipate the unique characteristics of investment disputes in the digital sector or provide relevant rules, resulting in significant institutional gaps. The CAFTA mechanism completely overlooks core issues that could trigger investment disputes, such as data localization requirements, algorithm regulation, the expropriation of digital assets, and platform liability.^[6] This means that when such disputes arise, arbitral tribunals will face the dilemma of having “no law to rely on” or being forced to interpret traditional provisions in a strained manner. For instance, the current CAFTA mechanism provides no criteria for determining under what circumstances a host country’s data localization requirements constitute “indirect expropriation” under international investment law.

Both parties have set carbon neutrality targets. Policies introduced by host countries to reduce emissions—such as carbon tariffs, the elimination of fossil fuel subsidies, and mandatory coal phase-outs—are highly susceptible to being challenged by investors as “indirect taxation” or violations of the “fair and equitable treatment” principle. The CAFTA mechanism lacks explicit “environmental exceptions” or provisions stating that “necessary measures to protect the environment do not constitute expropriation,” and thus cannot provide a “safe harbor” for the host country’s well-intentioned environmental regulations. This is inconsistent with the growing trend in international investment agreements to emphasize “sustainable development.” Because traditional ISDS mechanisms generally lack explicit provisions for “environmental exceptions” or stipulations that “necessary measures to address climate change do not constitute expropriation,” arbitration tribunals often struggle to strike a balance between investors’ property rights and host countries’ authority to regulate the environment. This frequently leads to inconsistent rulings and a “chilling effect” on host countries’ “Green New Deal” initiatives.^[7]

3. Optimization Strategies for Upgrading the Investment Dispute Settlement Mechanism in CAFTA 3.0

3.1. Pathways for the Integration and Coordination of Regional Regulations

Pursuant to Article 30 of the Vienna Convention on the Law of Treaties regarding the principles of “later in time” and “special over general,” in investment disputes among CAFTA member states, CAFTA 3.0, as a more “special” regional agreement, should in principle take precedence; However, the more modern and specific provisions in the RCEP may be applied through reference to or incorporation into CAFTA 3.0. In cases where there is inconsistency between RCEP and CAFTA member states—such as when an ASEAN country is a member of both CAFTA and RCEP, but the two agreements contain differing provisions regarding ISDS obligations—it is recommended that the disputing parties prioritize the application of CAFTA if they cannot reach an agreement.^[8] At the same time, it should provide CAFTA member states with a necessary, flexible, and more equitable forum for resolving investment disputes between investors and host countries, balancing investor interests with host country sovereignty, and meeting the practical needs of the China-ASEAN Free Trade Area’s development.^[9]

3.2. A tailored response to the requirements of the new chapter

The chapter on the digital economy is a key highlight and significant institutional achievement of the CAFTA 3.0 Upgrade Protocol. The ISDS mechanism must provide the following specialized responses: First, establish a mechanism for the “participation of data technology experts.” This is

because issues such as the valuation of data assets, the determination of algorithmic discrimination, and the assessment of the trade impact of data localization measures involve complex technical judgments. In cases involving complex technical issues, parties should be permitted to nominate experts with a background in data technology to serve as arbitrators or expert witnesses; Second, clarify the regulatory scope and expropriation thresholds for data measures. Digital regulatory measures such as data localization and algorithmic review are highly susceptible to being alleged by investors as “indirect expropriation.” CAFTA 3.0 should draw on the rule design of the Digital Economy Chapter to clarify that non-discriminatory data measures adopted to protect public interests—such as national security, personal information, and cybersecurity—generally do not constitute indirect expropriation.

The green economy is another key new area introduced in CAFTA 3.0. The unique nature of green economy disputes lies in the fact that the core controversy often revolves around whether regulatory measures adopted by the host country to address climate change constitute “indirect taxation” or violate the principle of “fair and equitable treatment.” In response to this characteristic, regarding environmental protection, the agreement could draw on the experience of new-generation agreements such as the CPTPP by stipulating that bona fide, non-discriminatory regulatory measures adopted to address climate change and fulfill international environmental obligations do not constitute indirect taxation. Furthermore, when determining whether there has been a violation of fair and equitable treatment, due consideration should be given to the host country’s legitimate policy objectives in addressing climate change. This effectively provides a “safe harbor” for the host country’s “Green New Deal.”

4. Conclusion

The upgrade of the investment dispute settlement mechanism under the China-ASEAN Free Trade Area (CAFTA) 3.0 is, at its core, an institutional response to regional investment governance in the face of changing times.^[10] Faced with the fragmented landscape of regional rules and the specialized demands of new economic issues, the CAFTA 3.0 mechanism must pursue a path of incremental reform that addresses both internal and external dimensions—bridging the regulatory gaps between bilateral agreements and the RCEP through joint interpretations and capacity building, while establishing specialized procedures for the digital and green economies through a sector-specific approach. The vitality of law lies in experience rather than logic; the refinement of the CAFTA 3.0 mechanism will inevitably be a dynamic, continuously evolving process. Only by fostering regional consensus on rules with an inclusive mindset and responding to the demands of the times with an innovative spirit can we build a dispute settlement system that combines credibility with adaptability, thereby laying a solid institutional foundation for the steady and long-term development of China-ASEAN economic and trade cooperation.

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