Sovereign Wealth Funds: Their Operation and the Economic, Political and Legal Responses

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PhD

I, Georges Kratsas, confirm that the work presented in this thesis is my own. Where information has been derived from other sources, I confirm that this has been indicated in the thesis.
Abstract

This thesis deals with the investment behaviour of government-led investment vehicles, widely known as Sovereign Wealth Funds (SWFs), and the implications that arise from their investments in Europe and the western world.

In the last 10 to 15 years SWFs have grown in size and number and have drawn the attention of many government officials because of their non-transparent nature and their expansionary investment policies. Although SWFs have been a valuable source of foreign investment in the past, their non-transparent nature, combined with their government-controlled status, raises fears that their investments might be politically, rather than economically, motivated. Specific examples of those concerns are the risk that SWFs use their economic influence in order to obtain critical information, to transfer jobs abroad or compromise the operation of strategically important companies such as telecommunications or energy companies.

The above concerns have led many western governments to take active measure to regulate sovereign investors. Such regulation comes in the form of legislation establishing procedures to control the impact of their investments. Additionally, various forms of regulation have been established at the international level, through the adoption of Codes of Conduct. The main case studies used in this thesis are those of France, Germany, the USA as well as instruments promulgated by international bodies, such as the Organisation for Economic Cooperation and Development, the International Monetary Fund and the European Union.

In this thesis, it is argued that the majority of the legislative measures adopted at the national level are overly protectionist and go far beyond what is necessary to respond to the potential concerns associated with SWFs, while they seriously risk damaging their positive effects. It is also argued that international instruments are better placed to address the potential negative impact of SWFs while preserving the benefits of their operation.
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1. Subject and Focus

This thesis deals with the investment activities of Sovereign Wealth Funds (SWFs) in the European Union (EU) and the legal responses adopted by EU Member States to address them. The definition of SWFs given by the European Commission is ‘state-owned investment vehicles, which manage a diversified portfolio of domestic and international financial assets’. These are typically found in developing nations that manage natural resources, such as Qatar and Russia, or simply enjoy significant positive trade balances, such as China and Singapore. More recently, SWFs have appeared in western nations with budget deficits, such as France. It is common for a SWF to invest its capital internationally in search of opportunities to diversify its country’s income or simply to achieve better returns than those provided in its home market.

Recipient countries, meaning countries receiving SWF investments, usually consider SWFs as a separate type of investor, mainly due to their state-owned nature and their unusually large size, and often have concerns about their investment motives. While private investors are normally profit-driven, the same cannot be guaranteed for SWFs, which are state-owned and therefore may hide political agendas. Such motives may include using financial investments in order to obtain political benefits to the detriment of recipient economies by, for

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4 As western countries, for the purposes of this thesis, are taken, the Member State countries of the European Economic Area (Ireland, United Kingdom, France, Portugal, Spain, Belgium, Luxemburg, the Netherlands, Austria, Germany, Denmark, Finland, Sweden, Norway, Iceland, Lichtenstein, Switzerland, Greece, Italy, Slovenia, Cyprus, Malta, Estonia, Lithuania, Latvia, the Czech Republic, Hungary, Poland, Bulgaria, Romania, Slovakia), the EU candidate members (Croatia, Serbia, Montenegro and Turkey), Albania, Bosnia Herzegovina, Kosovo, the United States of America, Canada, Australia, New Zealand and Israel.
5 Also called ‘host’ or ‘target countries’. By analogy, the terms ‘host’, ‘target’ and ‘recipient companies’ are also used to describe those individual companies that receive the investments of SWFs.
example, gaining access to confidential national security or critical technological information. The opacity of those institutions means that external observers cannot easily verify if there is or is not any basis for those concerns. The problem is exacerbated when investments originate from geopolitical rival countries or when they are directed towards public providers (such as energy or transport companies). Other threats posed by SWFs relate to their potential impact on the financial stability of recipient economies. The large size of their investments may have destabilising effects if SWFs were to collectively enter or exit a specific market. These issues have been raised both in the discourse of governments and in the academic literature. As a result, a number of countries have passed regulation targeting state-owned funds in order to prevent compromise of national security or negative economic effects caused by their investments. It is possible to argue, however, that these regulations have no rational basis but are driven by unsubstantiated prejudices against foreign economic actors. If so, they run the risk of deterring Foreign Direct Investment (FDI) without addressing any real and existing threats.

This thesis aims to contribute to the debate on SWFs by examining their operation, i.e. the investment activity, from a holistic point of view, taking into account economic and political considerations as well as legal ones. Thus, policy proposals made at the end of the thesis are based on conclusions drawn in previous chapters on the economic and political impact of SWFs.

The main focus of the thesis is the EU. Thus, primarily, the thesis examines sovereign investments targeting EU markets and the respective reactions of EU Member States and the relevant EU law. For comparative and analytical purposes, regulations and investment activity in third countries, such as the

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6 Chapter 3, at 119.
7 Meaning the secrecy surrounding their structure and investment portfolio, see at 46 onwards.
8 Such as when Russia invests in Europe, or China invests in the USA.
9 Chapter 3, at 129.
10 For instance, Chapter 5, at 210.
11 Such as chapter 5, at 212, 221.
12 Definition provided n 742.
13 In particular Article 63(1) of the Treaty for the Functioning of the European Union (previously 56(1) EC) on free movement of capital.
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United States of America (USA), and those established at the international level are also examined in depth.

It must be noted that sovereign entities make foreign private investments using a variety of vectors, such as state-owned enterprises (SOEs) or public pension funds. Although not the primary focus of this thesis, these entities are studied for exemplary purposes where their manner of operation is sufficiently similar to SWFs and can cause similar concerns.

2. The Background

Recent developments in the area of global economic imbalances and the rise of direct investment from third countries into the EU make the subject and focus of this thesis timely. These developments relate to the economic performances of SWFs’ managing countries, but also to the financial state of Western countries, the traditional recipients of SWF investments.

Since 2000 SWFs have grown considerably in size and importance, reflecting the high growth rates of their countries’ economies. Countries such as China and Russia have recently demonstrated great economic growth which has enabled them to establish large SWFs and conduct aggressive investment policies throughout the world. At the same time, rising energy prices have resulted in large revenues for commodity-exporting countries, mainly from the Middle East (such as Saudi Arabia, the UAE and Qatar).

An additional development connected to the place and role of SWFs relates to recent financial crises. The first Global Financial Crisis (GFC) began with the bursting of the housing bubble in the USA in 2007 and affected all financial institutions that had invested heavily in housing related securities. The immediate threat of the crisis was addressed with government action in those

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14 See below, at 232.
15 DPW at 230, and Lenovo Group, at 61.
16 Chapter 1, at 35-36.
17 Chapter 1, n 105.
18 Chapter 1, n 104.
19 Chapter 2, at 86 onwards.
countries concerned, but the long-term effects continued to distress the economies of western developed nations. These effects, combined with a number of national and EU-level structural deficiencies, resulted in a subsequent crisis, this time affecting Eurozone countries that had accumulated excessive debt.\footnote{As it is known as a ‘Eurozone debt crisis’, for instance, see Chapter 5 at 225.}

All those recent developments are of direct interest to the study of SWFs: the rapid growth of many developing countries accounted for the creation of numerous new SWFs and increased the reserves available to them, thus expanding their size. The urgent need for capital in Europe and America caused by the crises prepared the ground for an increased presence of SWFs in those countries. As a result, SWFs today control stakes in some of the west’s most valuable corporations,\footnote{Chapter 2, at 61 onwards.} a fact that, however beneficial to the west, may introduce a new round of protectionism against foreign state investors in the future.\footnote{Chapter 2 at 135.}

### 3. Formulation of the Research Question

In light of the above considerations, it becomes relevant to consider whether SWFs should be regulated and, if so, under which form. This issue is the core research question in this thesis. The ultimate aim of this inquiry is to draw policy lessons and give recommendations on how to deal with SWFs for the purpose of achieving the most efficient outcome from the point of view of both investors and host countries. This end necessitates a focus on all aspects of the operation of SWFs.

First, it should be determined which entities are classified as SWFs and what their main characteristics are.\footnote{Chapter 1.} Next, their investment behaviour must be analysed.\footnote{Chapter 2.} This analysis, which must also take into account different economic environments (such as times of growth and times of economic crisis), may allow the determination of common investment patterns among SWFs. The next issue...
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deriving from the main research question relates to the impact of SWFs on host economies. Specifically, it is essential to assess the various benefits and costs brought by SWFs to their recipient countries before establishing the need for regulation. These effects are examined at both a micro (individual companies) and macro level (economy-wide effects).

With the conclusions reached, it is possible to frame a regulatory rationale for SWFs: one that would take into account the actual impact and characteristics of those investment funds. Numerous academic regulatory proposals for SWFs that have appeared in the literature can be usefully analysed. More importantly, this framework of analysis can also serve to assess the regulatory instruments that have been adopted by various EU Member States and third countries. The examples used in this thesis are those of France, Germany, Greece and the USA. Finally, to address all matters flowing from the principal research question it is necessary to consider whether the best solution might be one at the supranational level.

4. Assessment Method and Challenges

The aim of this thesis is to establish what constitutes a proportionate response to the risks brought by SWFs, justify the restrictions that meet the actual risks and identify those cases that use SWFs as a pretext to raise protective barriers. This research will necessitate, first, a close scrutiny of the commercial operations of SWFs and, second, a scrutiny of the views of various commentators on the impact of SWFs on the EU and global economies.

Because of the secrecy of SWFs, only a limited amount of information necessary to carry out this research is publicly available. Therefore extensive use is made of web resources – reliable media sources specialising in the field of

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25 Chapter 3.
26 Chapter 4.
27 Chapter 5.
28 Chapter 6.
Introduction

finance – which provide news about SWF commercial operations.\textsuperscript{29} In addition, reports issued by financial institutions, such as commercial and investment banks,\textsuperscript{30} can reveal useful information. Furthermore, a number of informal personal correspondences are made with persons with relevant specialities. The purpose of this close scrutiny and collection of news is to offer a holistic view on the benefits and costs arising from SWF investment in western, and, in particular, EU economies.

The following analysis of regulatory proposals\textsuperscript{31} requires an examination of papers published by academics and news commentators offering suggestions for regulatory frameworks. Some of those proposals are more detailed than others and those are chosen for more extensive analysis.

Next, an examination of actual legal instruments dealing with SWFs is required. As far as the laws of EU Member States are concerned (France, Germany and Greece), these must also be examined in the light of the EU law on free movement of capital.\textsuperscript{32} A similar examination is carried out as regards a third jurisdiction, namely the USA. The study of each jurisdiction is preceded by an overview of its history and general relation to SWFs, which require the use of further news articles and reports. The same method is used to examine regulatory instruments put in place at the supranational level.\textsuperscript{33} To this end, numerous documents published by the Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF) and the European Commission will be used.

Therefore, the methodological approach and discussion of this thesis moves between the study of economic and political factors, the analysis of national law, EU case law and international regulatory instruments. The economic aspect is mainly in the first half of the thesis, while the legal part occupies most of the second half.

\textsuperscript{29} Such as Financial Times, Guardian, Reuters, NY Times and various Gulf based sources, such as Arabian Business and Business 24/7.
\textsuperscript{30} Such as Deutschebank and Morgan Stanley.
\textsuperscript{31} Chapter 4, at 162-185.
\textsuperscript{32} Chapter 5, at 188-198.
\textsuperscript{33} Chapter 6.
Introduction

The problems encountered in the preparation of this thesis are twofold: the opacity of SWFs and the volatility of modern financial markets. Firstly, SWFs are notorious for secrecy. The great majority of them make no information available as to their ownership portfolio, business plans, internal governance or names of executive officials. More importantly, it is impossible to ascertain the extent of government influence on their management decisions. This limitation inevitably constrains the available field of research and the conclusions drawn therefrom. A similar limitation applies to the public institutions charged with overseeing SWF investments in certain jurisdictions due to the confidential nature of their work.\textsuperscript{34} To minimise this problem, this thesis uses numerous examples of transparent SWFs that disseminate the required information (for example, equity portfolio constitution) to make broad conclusions.\textsuperscript{35} For the remainder more secretive SWFs, some limited information that appears in the news or in financial reports (for example, regarding individual transactions or investment strategies) is used. These sources can be a helpful, if imperfect, source of information.

Secondly, as seen in the following chapters, the place and role of SWFs evolves in parallel with the latest events and developments in global financial markets. At times of economic volatility, especially pertinent now, observing the behaviour of SWFs and the attitudes of western countries towards them, let alone drawing safe conclusions about them, can be particularly challenging. This can have the effect of slowing down the process of collecting needed material and lengthening the time required to draw robust conclusions about, or evaluate the place and role of, SWFs in modern markets from a long-term perspective.\textsuperscript{36} This thesis has sought to take into account all available information about the behaviour of SWFs and recipient countries in different environments. It has taken the time necessary for appropriate scrutiny and comment.

It is noted that in this thesis, the terms ‘company’ and ‘corporation’ are used interchangeably. In addition, ‘company’ is sometimes also used in the literature referred to describe SWFs.

\textsuperscript{34} Such as the USA one discussed in Chapter 5, at 232-235.
\textsuperscript{35} Such as Singapore’s Temasek or Norways’ GPFG.
\textsuperscript{36} For example, evaluating SWFs’ behaviour or future western attitudes towards them.
5. Structure

The structure of the thesis is as follows:

Chapter 1 delineates the subject by providing an analysis of various definitions and categories of SWFs but also specifies state-owned investment entities that will not be the subject of the thesis, such as public pension funds. The main characteristics of SWFs are described: their unusually large size and their general lack of transparency. A suggestion is made that because many SWFs originate from non-democratic countries this might account for their opacity and general structure.

Chapter 2 focuses on the investment behaviour of SWFs and attempts to discover common patterns in this behaviour. It shows SWFs to be predominantly conservative investors with a long-term and largely passive investment outlook. It also shows that, when SWFs do participate actively as investors they may contribute positively to the operation of their recipient companies. The chapter also offers a comparison between SWFs and other investment entities; namely hedge funds and institutional investors.

Chapter 3 uses the conclusions from the earlier chapters to assess the benefits and costs posed by the operation of SWFs with a particular focus on EU and western countries. This assessment will later form the basis of a rationale for regulation. This chapter shows that SWFs bring substantial benefits to the recipient economies, primarily in the form of reliable and stable foreign investment. In addition, SWFs can contribute to the stability of their target countries by providing capital at times of crisis. Arguments emphasising the costs/risks caused by SWFs are challenged. Potential costs, framed in the language of national security threats or risks to financial stability are shown as often based on theoretical scenarios lacking realism. Moreover, such arguments have failed to take into account the frame of operation of SWFs, the scrutiny applied on them by national governments and the press, as well as their general
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willingness to remain low key (in the large majority of cases). It is argued that SWFs can bring minor indirect costs, such as increasing the overall political influence of their home countries and sometimes sparking protectionist backlashes in their target countries. However, based on these considerations, it appears that SWFs bring significant benefits, while potential detriments are often theoretical, unrealistic or indirect.

Chapter 4 establishes a rationale for regulating SWFs as well as the principles that should underlie this rationale. It is held that the reality of SWFs does not call for particular hard regulatory instruments; rather a limited form of regulation may be needed to address certain costs, such as to suppress protectionist backlashes and to increase investor confidence in the markets where they operate. To achieve this purpose, regulation should aim to increase the transparency and global accountability of SWFs without, however, compromising their competitive position in relation to other international investors, notably hedge funds. At the same time, it is accepted that the growing acquisition of political leverage by developing countries (to which SWFs also contribute) is not something that can necessarily be addressed by regulation. Rather, this occurrence is a result of the growing phenomenon of global imbalances that is best tackled by foreign diplomacy and macroeconomic policy. The chapter concludes by analysing various regulatory proposals categorised under ‘limiting SWF acquisitions’, ‘command and control’ and ‘incentive-type’ regulation as well as ‘self-regulation’. It is argued that most of them are overly protectionist and do not reflect the real implications of the operation of SWFs.

Chapter 5 focuses on national measures, in particular those of France, Germany, Greece and the USA. The analysis of EU member countries is preceded by an examination of the EU case law on the free movement of capital and how this may apply to the case of SWFs. Each of those jurisdictions constitutes a unique example. France and Germany make up large and efficient markets that attract SWF investment, although each has responded in a considerably different

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37 Ibid.
38 at 153.
manner. As a result, their legal provisions have also had differing success under the scrutiny of the European Commission. For example, the German law was found to comply with EU law, while France was obliged to amend its provisions. Greece, on the other hand, has no significant SWF presence, although its legal response is of particular interest due to the manner of its speedy adoption in response to one single threat. The USA, finally, is the most attractive investment destination for SWFs and has long dealt with issues of foreign investment and national security. Moreover, it is not constrained by a supranational regulator to the same degree as EU Member States are. Therefore, it constitutes an excellent example to compare with EU jurisdictions. It is argued that those legal instruments largely disregard the reality of SWFs and, therefore create inefficient investment structures which impose costs on their economies by distorting the efficient allocation of capital. Moreover, as far as the laws of EU Member States are concerned, these often fall foul of established EU laws which state that all restrictions to free movement of capital between Member States and between Member States and third countries are prohibited. In short, most laws at the national level are misconceived as a response to the SWF phenomenon.

Finally, Chapter 6 deals with measures taken at a supranational level. While the hard law option might be unworkable at the supranational level, a form of voluntary self-regulation might bring the desired results without compromising the financial operation of SWFs and the efficient allocation of capital. Such initiatives have already been undertaken by various international institutions, with the most important being the one carried out by the International Working Group (IWG) under the auspices of the IMF in 2008. Although supranational instruments, as they currently stand, could be further improved to better address the issues of transparency and accountability of SWFs, it is submitted that, to date, they offer the best alternative to hard regulation. Moreover,

39 Chapter 5, at 228.
40 Chapter 5, at 248-249.
41 Article 56 TFEU;
42 ibid.
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financial regulations already in place in Europe and America, such as hedge fund regulation, can further contribute to raising the benchmark of transparency in the wider financial sector, thus encouraging SWFs to follow suit.

A list of abbreviations used in the body of the thesis is also attached.
INTRODUCTION

This chapter examines the definition of SWFs and identifies their specific characteristics. To this end, first, various definitions of SWFs are provided, followed by an analysis of their two most fundamental characteristics, namely their size and lack of transparency.

The difficulty of defining SWFs consists mainly in their large number and diverse nature. Although all SWFs share a number of common features (such as government control), at the same time, there is no consensus as to how far this definition should stretch. For instance, it is not certain whether SOEs should also be included in the definition. An additional question relates to the inclusion of the purpose of a SWF in the definition (such as ‘government revenue stabilisation’ or ‘the guarantee of future state pension liabilities’). While some definitions are based entirely on a fund’s investment behaviour, others focus solely on the purpose behind the constitution of the fund.

The size and transparency of SWFs is examined next. An understanding of those two features is crucial to the analysis of their investment behaviour and for the discussion on various issues that arise from their operation. The question of size is strongly linked to the issue of definition. The collective size attributed to SWFs depends on the width of the definition and the number of funds included in it. The collective size of assets held by SWFs changes dramatically if stabilisation funds, public pension funds and/or central bank reserves are included in the definition. Next, the discussion on transparency is crucial to understand the various criticisms made against SWFs. As SWFs differ greatly between them, their levels of transparency can also vary or change over time. All in all, it can be said that there is a pattern towards increased transparency.
A. DEFINITION AND PURPOSE

1. Definition of SWFs

   i. Broad and narrow definitions

Defining SWFs is a necessary first step for all the authorities that seek to regulate them. However, there is no universally accepted definition for SWFs until this day. A number of sources have attempted to define SWFs (see below) based on their investment behaviour or the source of their funding but there remains disagreement about the types of state-owned funds that are included in it. Furthermore, it is not uncommon for SWFs to argue that they do not come under any definition and, therefore, they should not be regarded as ‘SWFs’. One example of such case is Saudi Arabia whose government denies possessing a SWF, thus contradicting many published studies that consider the Saudi Arabian Monetary Authority (SAMA) or the Public Investment Fund (PIF) to be a SWF.

   43 Another example is China’s State Administration of Foreign Exchange
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(SAFE) which claimed that it did not fall under the definition of SWFs and therefore it should not be covered by any measures intending to regulate the behaviour of SWFs.44 Singapore’s Temasek Holdings45 has also made similar claims. All of these state funds, however, are classified as SWFs by the SWF Institute and other organisations.46 This stance could possibly be explained, in part, by the fact that the term ‘SWF’ in the west has acquired a negative connotation, which discourages many states from openly admitting that they manage one.47

The term ‘SWFs’ was first evoked by Rozanov in 2005,48 and no consensus has yet been reached on its exact meaning. Most definitions suggest these are state-owned investment funds (not operating companies) that make long-term domestic and international investments in search of commercial returns. In his article Rozanov lists the major SWFs and attempts to estimate the size of each. In a subsequent article, the author claims that the most important step in designing a fund is defining its liability profile.49 Accordingly, he classifies SWFs in five

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45 Straits Times Staff, ‘Temasek Says it Is Not a Sovereign Wealth Fund’ Straits Times (Singapore, 23 March 2008)
46 SWF Institute, ‘List of Sovereign Wealth Funds’ (SWF Institute, 2012) <www.swfinstitute.org> accessed 4 November 2012;
47 One example being the government owned Sanabil al-Saudia fund in Saudi Arabia, which is named ‘investment company’ to avoid being labelled as an SWF,
48 Rozanov’s definition of SWFs is ‘neither traditional public-pension funds nor reserve assets supporting national currencies, but funds set up with one or more of the following objectives: insulate the budget and economy from excess volatility in revenues, help monetary authorities sterilize unwanted liquidity, build up savings for future generations, or use the money for economic and social development’,
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categories: stabilisation buffer funds, endowment funds, pension reserve funds, development funds and government holding funds.50

Some definitions are much narrower, such as Truman’s, who defines a SWF as ‘a pool of domestic and international assets owned and managed by governments to achieve a variety of economic and financial objectives, including the accumulation and management of reserve assets, the stabilisation of macroeconomic effects and the transfer of wealth across generations’.51 If one follows this definition, it would include forty-four of the world’s most significant SWFs, including eight funds from the United Arab Emirates (UAE), three from the USA, two from Venezuela, Russia, China and Singapore and including the Algerian Revenue Regulation Fund.52

The definition offered by the SWF Institute is more inclusive than Truman’s. SWFs are defined as ‘state-owned investment funds composed of financial assets such as stocks, bond, real estate, or other financial instruments funded by foreign exchange assets’.53 According to this definition we would include forty-seven of the world’s largest SWFs. In particular, this definition would also include funds from Angola, Australia, Bahrain, East Timor, and New Zealand and Ireland’s pension funds that would be missing from Truman’s list. Moreover, the Chinese SAFE, which as seen above avoids being labeled as a ‘SWF’, would also appear only under the second definition, while SAMA would surface under both.

As far as national and international institutions are concerned, according to the IMF, SWFs can generally be defined as ‘special investment funds created or

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52 Ibid Table 1 Panel A.

Definition and Characteristics of SWFs

owned by governments to hold foreign assets for long-term purposes’.\(^{54}\) The OECD defines them as ‘government-owned investment vehicles funded by foreign exchange assets’.\(^{55}\) The two definitions reflect the two trends apparent in the academic definitions above to define SWFs either according to their investment objectives (as the IMF does) or based on the origin of their funds (as the OECD). Moreover, both definitions appear to be quite broad and they encompass a variety of state funds. The OECD’s definition, however, appears somewhat narrower since it would exclude all pension funds that receive their funds from social security contributions.

The definition given by the EU Commission in a 2008 Communication on SWFs is ‘state-owned investment vehicles, which manage a diversified portfolio of domestic and international financial assets’,\(^{56}\) while the USA Treasury defines them as ‘government vehicles funded by foreign exchange earnings but managed separately from foreign reserves’.\(^{57}\) Whereas the Commission’s definition is clearly inspired by the one offered by the IMF, the USA Treasury’s appears much like the OECD’s. Their differences consist in that the Commission’s definition also includes the management of domestic assets while the IMF only mentions foreign ones,\(^{58}\) and that the USA Treasury’s definition, as opposed to the OECD’s, includes a mention of how the assets are managed: ‘separately from foreign exchange reserves’. In any event, both the EU and USA definitions are quite broad, which is to be expected as those bodies may seek to expand their regulatory net in case they decide to regulate such funds in the future. However, the American definition may be held to be broader than the EU’s as it may

\(^{56}\) Commission, ‘A Common European Approach’ (n 1) 4.
\(^{58}\) And as a result is wider than the IMF’s.
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encompass some stabilisation funds that escape the EU’s list.\(^59\)

In this thesis, given that for a large part SWFs are examined from an EU law perspective, the definition offered by the Commission is adopted. Since the Commission does not provide any further details on the classification of SWFs, Rozanov’s classification, which is largely compatible with the above definition, can also be accepted. At the same time, it must be stressed that the research ambit of this thesis is not necessarily confined within the limits of this definition. In fact, there may be other entities that, albeit not SWFs \textit{stricto sensu}, are also worth considering and analysing. To better clarify this point, three fund classes are analysed next: stabilisation funds, SOEs and public pension funds.

\textit{ii. Stabilisation funds}

Stabilisation funds are national investment funds whose main purpose is to offset revenue declines due to falling commodity prices or production levels; most such funds are created by countries whose budgets are highly dependent on natural resources, such as oil, copper, diamonds or others.\(^60\)

As seen earlier, Rozanov did include stabilisation funds in the definition of SWFs but recognised that they ‘are a class of their own and stand out compared to all other fund types’.\(^61\) The reason is that, ‘while all other funds are managed primarily for long-term return and wealth maximisation, stabilisation funds have as their primary objective risk management’.\(^62\) Since a formal definition of SWFs does not yet exist, it is difficult to state with certainty whether stabilisation funds are included in the broad SWF category.

Morgan Stanley writer, Jen addressed this topic in 2006 where he accepted Rozanov’s definition, but noted that with the permanent rise in oil prices, most

\(^{59}\) This is because certain stabilisation funds do not focus at managing a diversified portfolio of domestic and foreign assets but rather on fixed income, Rachel Ziemba, ‘Responses to Sovereign Wealth Funds: Are Draconian Measures on the Way?’ \textit{RGE Monitor’s Economic Analysis} (New York, 18 October 2007) <www.economonitor.com/analysts/2007/10/17/responses-to-sovereign-wealth-funds-are-draconian-measures-on-the-way/> accessed 19 December 2012; and see below in the discussion on stabilisation funds n 61 onwards.

\(^{60}\) Fotak, Bortolotti and Megginson (n 51) 24.

\(^{61}\) Rozanov (n 49) 2.

\(^{62}\) ibid.
Definition and Characteristics of SWFs

Oil stabilisation funds have evolved into ‘wealth-accumulation’ funds. He notes that several Asian currency stabilisation funds have outgrown their liquidity needs and thus Jen predicts that many Asian stabilisation funds will change priorities and emphasise on wealth appreciation.

Truman, in 2007, distinguished between stabilisation funds, aiming at providing liquidity and characterised by low-risk investments, and SWFs, which, he claimed, have longer-term investment objectives and are invested in a broader array of instruments. But the author did emphasise that the distinction is not always clear and that most funds share characteristics of both stabilisation and wealth-appreciation funds.

This thesis aims to examine, not only SWFs themselves, but also various responses by regulators and the general public towards them. Since a wide array of commentators perceive stabilisation funds to be SWFs, these will also be taken into account further below. Paraphrasing Jen, the issue is that they manage a diversified portfolio of foreign assets, regardless of whether they, strictly speaking, fall in the definition.

**iii. State-owned Enterprises**

Another way through which countries invest in foreign entities is through purchases by SOEs. The first time that an international investment by a SOE aroused controversy in the USA was in 2005, when the Chinese National Overseas Oil Company (CNOOC) attempted to purchase Unocal, only to be blocked by opposition from the USA Congress. One year later, popular

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64 ibid.


66 What Jen noted in 2006 was that SWFs started to look more like private mutual funds, rather than official reserves, Jen (n 63).

67 n 196.
Definition and Characteristics of SWFs

Opposition expressed through Congress again scuttled the acquisition of a major American operating company by a foreign state-owned enterprise, this time Dubai Ports World’s (DPW) purchase of operating rights to six key port facilities.68 Other examples include the purchase of IBM’s computing business by the Chinese government-controlled Lenovo Group;69 Russia’s Gazprom buying pipelines and other energy infrastructures in Europe70 and the attempted huge investment by China’s Chinalco into Anglo-Australian mining company Rio-Tinto in 2009.71

Notably, neither of these foreign companies was a SWF, yet their actions fueled the popular backlash against acquisitions of western companies by state-owned entities. More importantly, it was the backlash to such actions that in many instances triggered the adoption of protective national laws.72 It must therefore be understood that although national laws protecting vital industries often target SWFs, in reality most of them were implemented as a result of the actions of SOEs.

As a consequence, today SOEs are sometimes put in the same category as SWF and similar criticisms are used against both types of state companies.73 This tendency of confusing SWFs with SOEs prompted the annoyance on the part of SWFs, since they profess purely economic motivations and argue that no significant example of politically motivated investment by SWFs has ever been recorded.74

68 n 197.
69 n 195.
70 n 201.
74 Statement by unnamed SWF officer (personal communication 24 February 2009).
iv. Public Pension Funds

Public Pension Reserve Funds (PPRFs) could be defined as funds set up by governments or social security institutions with the objective of contributing to financing the relevant pay-as-you-go pension plans. Based on this definition, two sub-categories of pension reserve funds can be identified: firstly, social security reserve funds, set up as part of the overall social security system, where the inflows are mainly surpluses of employee and/or employer contributions over current payouts, as well as, in some cases, top-up contributions from the government via fiscal transfers and other sources. Secondly, sovereign pension reserve funds, referring to those funds which are established directly by the government (completely separated from the social security system), and its financial inflows are mainly from direct fiscal transfers from the government. Unlike the first type of reserve fund, those within this category have been set up by governments to meet future deficits of the social security system.

SWFs and PPRFs share some similarities: both are large in terms of assets under management, and are autonomous and accountable only to governments or public sector institutions. Like SWFs, PPRFs are also increasingly investing abroad and moving into alternative assets (for example, property, private equity and hedge funds). However, there are also considerable differences. First, PPRFs manage assets to meet clearly defined liabilities, while SWFs tend to have broad objectives and are rarely assigned to meet specific government expenditures. Second, PPRFs often face strong pressures to invest their resources domestically, as opposed to SWFs, which are, by construction, mainly or solely invested in foreign assets. Third, SWFs are mainly financed by foreign exchange revenues on commodity exports and/or transfers of foreign reserves from the Central Bank. PPRFs, on the other hand are more often financed via

76 ibid.
77 ibid 9.
78 ibid.
79 ibid 10.
Definition and Characteristics of SWFs

social security contributions or direct fiscal transfers from the government.\textsuperscript{80} Finally PPRFs also raise issues concerning fiduciaries’ responsibilities and trustees may require what these funds can do and require greater transparency than is the case for SWFs.\textsuperscript{81}

As opposed to most commentators, Truman includes government pension funds in the SWF category.\textsuperscript{82} Most others exclude government pension plans, with the unique exception of Norway’s Government Pension Fund – Global (GPFG), which is shoe-horned into the definition because of its size, its unusual global asset allocation, and its focus on profitability make it more similar to other SWFs rather than to other government pension plans.\textsuperscript{83}

With the exception of the Norwegian pension fund, PPRFs, due to their structural differences with SWFs and because of the different issues raised by each type of investments, they do not make the subject of this thesis.

2. Purpose Behind the Creation of SWFs

In order to effectively address the issue of definition of SWFs, it is crucial to examine the purposes behind their creation. However, as said before, SWFs are large in number and their objectives may be multiple, overlapping or changing over time.

The rationale for setting up government funds steams from two challenges faced by governments that accumulate substantial wealth. First, natural resources are exhaustible, and their consumption and export leads to their depletion. Second, superior international competitiveness of domestic industries can be a transitory phenomenon and it may change over time. Governments

\textsuperscript{80} ibid.
\textsuperscript{81} ibid.
\textsuperscript{83} It may also be argued that the Norwegian fund is not a PPF in the first place because its revenues finance the state budget, rather than pensions and, as such, the term ‘pension fund’ in the definition is misleading.
Definition and Characteristics of SWFs

therefore face the challenge of 'inter-generational equity' as well as of transforming the present-day revenue streams from the sale of the resources or other export successes into sustainable income.\footnote{84}{Kern (n 43) 4.}

\subsection*{i. The first SWFs}

National governments in the middle and towards the end of the 20\textsuperscript{th} century gradually acknowledged the importance of managing revenue from natural resources. According to Truman, the first SWF was established in 1956 by Kiribati, a tiny pacific island, to manage the revenue from phosphate deposits.\footnote{85}{Truman (n 82) 2.} However, it is more widely accepted that the first SWF was the Kuwait Investment Authority (KIA) set up in 1953. The Kuwait Investment Board was set up on that year with the aim of investing its surplus oil revenues to reduce the country's reliance on its finite oil resources. Replaced in 1965 by the Kuwait Investment Office (KIO), a subsidiary of the KIA, the organisation today manages a substantial part of the Future Generation Fund, which by law receives funds from the state’s oil revenue.\footnote{86}{Law decree No 106 1976 ‘Concerning the Reserves for Future Generations’, see: Kuwait Investment Authority, ‘Overview of Funds’ (KIA, 2008) <www.kia.gov.kw/En/About_KIA/Overview_of_Funds/Pages/default.aspx> accessed 4 November 2012.}

Since the creation of these two funds, the number of SWFs has grown in two major waves: First, in the 1970s, for example, the creation of Singapore’s Temasek Holdings in 1974 and the Abu Dhabi Investment Authority (ADIA) in 1976. Second, since the 1990s with the Iran Oil Stabilisation Fund (1999), the Qatar Investment Authority (QIA) in 2000, and other notable funds.

As mentioned earlier, the term ‘SWFs’ dates only from 2005. Before that, such funds were called ‘stabilisation funds’ i.e. funds whose purpose was revenue stabilisation. According to Fotak and others, ‘governments whose revenue streams are dependent on the value of one underlying commodity have engaged in diversification of investments with the goal of stabilising revenues’.\footnote{87}{Fotak, Bortolotti and Megginson (n 51) 4.}

As a result, most SWFs have been established in countries rich in natural resources.
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resource, with oil-related SWFs being the most common ones (in the case of Arab Gulf countries, ex-Soviet republics and Norway).

ii. Common objectives

Balin states three principal reasons why states chose to establish SWFs: Firstly, as an intergenerational transfer mechanism, where future government pensions, asset liquidity, and fiscal revenues are guaranteed by today's export earnings. Thus, when the country's natural resources are exhausted future generations can continue to live prosperously using the earnings of their forefathers.

Secondly, to diversify a country’s income so that it can respond to shocks, for example when the country suffers from low competitiveness. By outsourcing funds to a SWF an economy can also shield itself from the high-level price volatility of the commodities market. The low levels of oil prices recorded in 2008 can be seen as an extreme example of such price volatility. As argued by Deutschebank author, Kern 'in this case, the fund serves as a liquidity pool which is replenished at times of favourable commodity price conditions or reserve inflows, and which can be drawn upon in cases of low asset prices or shortage of reserves'. In this category fall most cases of the stabilisation funds discussed above, which are established in countries rich in natural resources, such as Chile, Iran, Mexico, Sudan, Venezuela and Russia.

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89 ibid; An example is what is often referred to as the 'Dutch disease': the danger of misallocation of capital if the sale of natural resources in turn leads to an appreciation of the real exchange rate and thereby diminishes the competitiveness of other sectors in the economy, Rietveld Malan and Robert Pringle, 'The Evolution of Sovereign Wealth Management' in Jennifer Johnson-Calari and Malan Rietveld (eds), Sovereign Wealth Management (Central Banking Publications 2007).
91 Kern (n 43) 4.
92 In the case of stabilisation funds, it becomes apparent that the 'objectives' of setting up a fund become a critical part of the definition. According to the definitions suggested by Rozanov and
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A third reason is to increase the return on assets held in their central bank reserves. By investing in securities other than USA or European sovereign bonds, they can raise returns above the 3-5% annual returns garnered by most foreign exchange reserve holdings. With rapidly expanding foreign exchange stocks in many emerging markets and the decline of the USA dollar—and thus lower returns on dollar-denominated debt—this desire has become increasingly prevalent in recent times.

An additional motivation behind the setting up of a fund may be to increase transparency. This may seem like an unlikely reason since SWFs generally make the targets of accusations for opacity. However, Malan and Pringle argue that allocating assets to SWFs can help increase transparency and accountability in the government sector by increasing public scrutiny of public finances. Depending on the organisational form and the reporting requirements that the fund is obliged to fulfill, managing national assets via a separate entity can, in theory, contribute to a less opaque management of national wealth.

Finally, some funds are set up and used typically to help fund socio-economic projects or promote industrial policies that might raise a country's potential output growth. These are also known as 'development funds'.

**iii. Political motivations?**

Some SWFs also seek to promote investment and technological transfer from large foreign corporations to their domestic industries. To achieve this goal, a fund would have to acquire a majority stake in a company or form a coalition with other shareholders. Using its voting power, the SWF can appoint board members in corporations that could direct a company to invest in the SWF’s home country, and especially, establish research and development facilities.

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Truman the distinctive feature between stabilisation funds and other government funds is the objectives pursued by the former.

93 Balin (n 88) 4.
94 ibid.
95 ibid.
96 Malan and Pringle (n 89).
97 ibid;
This is certainly the case for the Norwegian, Australian, Canadian and USA SWFs.
98 ibid.
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there.

However, because of the political ramifications of such a strategy, this practice is rather exceptional. Only those countries seen as ‘allies’ of the USA—Taiwan, South Korea and Singapore—have invested in foreign companies to promote technological innovation in their local industries. Furthermore, only Singapore’s fund has actually acquired corporations for this purpose.

B. CHARACTERISTICS OF SWFs

1. Size

The rapidly growing size of SWFs is a matter that after the middle and towards the end of the 2000s attracted much attention. This section discusses the source of wealth of SWFs, as well as their previous, current and future size estimates.

i. Where does their wealth come from?

The funds received by SWFs are derived from excess liquidity in the public sector stemming from official reserves at central banks, which throughout the 2000s have been rising faster in the developing than the industrialised world. In other words, they are a ‘by-product’ of national budget surpluses. Such reserves are accumulated from the sale of natural resources, from rapid growth,

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99 Balin (n 88) 5.
100 ibid;
It has also been reported that some of Singapore’s investments in China and India were interpreted as forging strategic ties with the city-state’s larger and more powerful neighbors rather than seeking financial returns,
102 Rozanov (n 48) 52.
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Current account surpluses or government fiscal surpluses.

Kuwait’s KIO, for example, is responsible for managing a substantial part of the Future Generation Fund and, as such, manages 10% of the country’s oil revenues allocated to the fund annually by the State of Kuwait.\(^1\) China, on the other hand, manages the world’s largest foreign exchange reserves (see table 1.1), mainly thanks to its dynamic export activity. It is those reserves that it uses to fuel its sovereign funds.

\textit{Table 1.1: Largest holders of foreign exchange reserves 2008}

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country/Monetary Authority</th>
<th>Forex Reserves ($ bn)</th>
<th>Figures (as of)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Mainland China</td>
<td>1905</td>
<td>September 2008</td>
</tr>
<tr>
<td>2</td>
<td>Japan</td>
<td>995</td>
<td>September 2008</td>
</tr>
<tr>
<td>3</td>
<td>Russia</td>
<td>546</td>
<td>October 2008</td>
</tr>
<tr>
<td>4</td>
<td>Eurozone</td>
<td>563</td>
<td>March 2008</td>
</tr>
<tr>
<td>5</td>
<td>India</td>
<td>283</td>
<td>October 2008</td>
</tr>
<tr>
<td>6</td>
<td>Taiwan</td>
<td>281</td>
<td>September 2008</td>
</tr>
<tr>
<td>7</td>
<td>South Korea</td>
<td>239</td>
<td>September 2008</td>
</tr>
<tr>
<td>8</td>
<td>Brazil</td>
<td>205</td>
<td>October 2008</td>
</tr>
<tr>
<td>9</td>
<td>Singapore</td>
<td>172</td>
<td>August 2008</td>
</tr>
<tr>
<td>10</td>
<td>Hong Kong</td>
<td>153</td>
<td>August 2008</td>
</tr>
<tr>
<td></td>
<td>Algeria</td>
<td>149</td>
<td>September 2008</td>
</tr>
</tbody>
</table>

(Kavaljit Singh, ‘Frequently Asked Questions about SWFs’ Cornerhouse 2008, 15)

Other types of funds, such as public pension funds are more often financed via social security contributions, according to the rules of each social security system.

\textit{ii. Their size and growth projections until the middle of 2008}

SWFs demonstrated impressive growth between 2000 and the middle of 2008. The reasons for this development were mainly high oil prices\(^2\) and rapid growth rates of China and Russia.\(^3\) The same reasons led also to an increase in

\(^1\) Law decree No 106 1976 (n 87).
\(^3\) For China, see:
the number of SWFs around the world, beginning in the 1990s but more extensively during the 2000s.\textsuperscript{106}

As explained above, the question of size is directly linked to the definition of SWFs. Size estimates differ according to the funds included in the definition. Morgan Stanley author Jen, who accepted Rozanov’s definition, estimated the total value of SWFs’ global assets to be $1.4 trillion in 2006\textsuperscript{107} and $2.3 trillion in 2007,\textsuperscript{108} while Kern made an estimate of 3.422 trillion in 2007\textsuperscript{109} and of 3.645 in 2008.\textsuperscript{110} Based on Truman’s definition\textsuperscript{111} SWFs totaled US$2.97 trillion in 2008, whereas based on the definition of the SWF Institute,\textsuperscript{112} this amount would reach $3.78 trillion the same period. Moreover, International Financial Services London gave an early-2008 figure of $3.3 trillion.\textsuperscript{113} The IMF avoided a precise figure but estimated the size of SWFs in 2008 between $2.093 and $2.968 trillion.

The size of SWFs can also be calculated with relation to other funds, such as hedge funds, mutual funds, insurance funds and pension funds (see table 1.2). In early 2007 according to Gerald Lyons, the aggregate size of SWFs ($2.1 trillion) was still much smaller than the aggregate assets of either pension funds (\textit{circa} $21 trillion) or mutual funds (\textit{circa} $17 trillion), but larger than the aggregate


\textsuperscript{107} Jen (n 63).


\textsuperscript{109} Kern (n 43) 3.

\textsuperscript{110} Kern (n 101) 3.

\textsuperscript{111} n 51.

\textsuperscript{112} n 53.

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In January 2009, Teslik of the Council on Foreign Relations (CFR) gave an overall figure of $3 trillion for SWFs which surpassed the $1.5 trillion managed by hedge funds worldwide but ‘were dwarfed by the $53 trillion managed by institutional investors like pension funds and endowments’.\footnote{Teslik Lee Hudson, ‘Sovereign Wealth Funds’ (2009) Council on Foreign Relations \texttt{<www.cfr.org/publication/15251/#5>} accessed 4 May 2013.}

At the same time, Johnson of the IMF, says that the answer to the question whether $3 trillion is a lot of money depends on the point of reference. As he affirms, USA GDP is $12 trillion, the total value of traded securities (debt and equity) denominated in USA dollars is estimated to be more than $50 trillion, and the global value of traded securities is about $165 trillion. In that context, he concludes, ‘$3 trillion is significant but not huge’.\footnote{Simon Johnson, ‘Straight Talk: Sovereign Wealth Funds’ (2007) Volume 44, Number 3, IMF - Finance and Development \texttt{<www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm>} accessed 6 November 2012.} This can also be ascertained from the figures provided in table 1.2 below.

| Table 1.2: Comparison of SWFs to other investor classes in USD tr. |
|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Private Equity Funds        | Hedge Funds                 | Sovereign Wealth Funds      |
| Reserves (ex gold)          | Insurance Companies         | Mutual Funds                |
| Pension Funds               | World GDP                   | Stock Market Capitalization |
| Bank Assets                 | Stock Market Capitalization |


The projected growth prospects of SWFs were equally impressive. In 2007
Definition and Characteristics of SWFs

Jen estimated that SWFs would grow in the next decade at around $40 billion per year,\(^{117}\) concluding that the pool of assets managed by SWFs could reach $12 trillion by 2015.\(^{118}\) In the same year Kern also stated that SWFs assets could grow to ‘over $5 trillion within the next five years and more than $10 trillion within the next ten years’.\(^{119}\) It becomes, therefore, clear why until the middle of 2008 many commentators and government officials were becoming alarmed by the sudden growth and proliferation of SWFs. If those projections were to materialise, SWFs would simply acquire, perhaps, significant influence in global financial and political affairs. Things, however, took a different turn towards the middle of 2008.

iii. Their size in the wake of the Global Financial Crisis (mid 2008 – middle of 2009)

Chapter 2 below offers a more detailed account of the meaning of ‘crisis’ and its effects on SWFs. However, since this section only purports to give size estimates, it suffices for now to establish that, for the purposes of this thesis, GFC is taken to mean the period following the 2\(^{nd}\) quarter of 2008. This period does not necessarily coincide with the recession in the USA and other parts of the world but is aimed to target the time when SWFs were most affected by the economic downturn. It should also be kept in mind that the losses suffered by SWFs did not all materialise at the beginning of this period, as most occurred progressively.

At the beginning of the recession experienced in the USA and much of Europe (beginning and middle of 2008), when prices of commodities where still high and world growth was still persisting, SWFs seemed to survive the crisis unaffected.\(^{120}\) With the deepening of the recession, however, and the slowdown

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\(^{118}\) Jen (n 43).

\(^{119}\) Kern (n 43) 1.

\(^{120}\) For example, see a May 2008 Arabian Business article that makes an optimistic estimate about Middle East SWFs:
Definition and Characteristics of SWFs

in world growth, demand for oil fell which led to a sever drop in oil prices and other commodities (chart 1.1).

**Chart 1.1: Spot oil price, Brent, USD (left) and monthly change (right)**

(Steffan Kern, ‘State Investments During the Financial Crisis’ (2009) Deutschebank 7)

As a result, economies that relied on oil sales declined\(^1\) and some of them even recorded deficits.\(^2\) At the same time, due to the fall in global demand and, thus, world trade,\(^3\) export-driven economies such as China where equally

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Definition and Characteristics of SWFs

harmed.\textsuperscript{124} The fall in the reserves of all those countries (see chart 1.2) led, naturally, to a drop in the size of their SWFs.

\textit{Chart 1.2: Foreign exchange reserves excl. gold in SDR tr. (left) and monthly change in % (right)}

As expected, the GFC affected in various ways both the investment behaviour of SWFs and the relative value of their assets. On one level, many SWFs reportedly halted all foreign investments and focused on reviving/bailing out their local economies. At the same time, part of their retained stocks and other assets lost part of their value. Exceptionally there were also reported cases of sale of assets.\textsuperscript{125}

The first reports predicting the shrinking of SWFs appeared as early as September 2007 foreseeing lower prices of oil affecting Gulf economies in the

\textsuperscript{124} According to the WTO 2009 report, ‘exports of Chinese manufactured goods to the [USA] increased just 1 per cent over the previous year, after growth of 14 per cent in the third quarter’, ibid 4.

\textsuperscript{125} Of the most known cases where:
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future as well as an ‘overheating’ of China’s economy.\textsuperscript{126} Nearly a year later, the governor of the UAE Central Bank, Al-Suweidi publicly acknowledged for the first time that the Gulf economies are not immune to the global slowdown.\textsuperscript{127} By November 2008 the first reports recording severe falls in the assets of SWFs surfaced: the CEO of Dubai International Capital Al-Ansari, announced that his fund’s assets dropped as much as $3 billion due to the GFC pushing down asset prices world wide.\textsuperscript{128}

As the recession deepened, in the beginning of 2009, CFR analysts Setser and Ziemba announced that, according to their estimates, ADIA may have lost $125 billion in the global crush.\textsuperscript{129} Soon after, in February, sources in Kuwait revealed that KIA’s assets fell $31 billion in nine months, while official sources in Singapore announced an $81 billion fall for Temasek Holdings\textsuperscript{130} and in Abu Dhabi $3.2 billion losses were reported for Mubadala in 2008.\textsuperscript{131} There was no doubt that SWFs were feeling the pinch of the global recession.\textsuperscript{132}

\textsuperscript{126} The overheating of the Chinese economy was likely to occur through, a sharp appreciation of the remnibi (which would lead to fewer exports), or a rise in manufacturing goods prices or a protectionist backlash (or a combination of all those factors), Diana Choyleva, ‘View of the Day, Sovereign Wealth Funds’ Financial Times (London, 10 September 2007) <www.ft.com/cms/s/0/3cfb20cc-5fd4-11dc-b0fe-0000779fd2ac.html> accessed 19 December 2012.

\textsuperscript{127} Sweidi, however noted that ‘as long as the price of oil did not drop below $60 to 80$ per barrel, the UAE economy would be in good shape to survive the economic uncertainty’ a claim that was later proved to be overly optimistic. Tom Arnold, ‘Gulf Not Immune to Global Slowdown’ Arabian Business (Dubai, 28 August 2008) <www.arabianbusiness.com/529276-uae-cenbank-head-sees-oil-price-falling-sharply> accessed 19 December 2012.

\textsuperscript{128} Tom Arnold, ‘DIC Assets Drop as Much as $3bn Amid Crisis’ Arabian Business (Dubai, 25 November 2008) <www.arabianbusiness.com/539508-al-ansari-crisis-creating-phenomenal-opportunities> accessed 19 December 2012; Note that DIC’s assets do not depend on oil-prices as Dubai is not a petroleum exporting Emirate.


\textsuperscript{132} In this respect, see also the plans for creating a Malaysian investment fund that was finally agreed to be set up using borrowed money and not existing capital:
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According to an early 2009 report by CFR, ADIA, once believed to manage close to $900 billion worth of assets,\textsuperscript{133} was then estimated to manage funds below $300 billion, while the accuracy of previous estimates was put into question.\textsuperscript{134} SAMA, with assets totaling $500 billion, according to the CFR was held to be the largest SWF in the Gulf, partly due to its more conservative portfolio that allowed it to avoid severe losses in the credit crunch.\textsuperscript{135} Concerning Gulf funds specifically, CFR calculated a total of $350 billion of losses (which translates into a 27% fall in their assets) and $111 billion of losses for the Norwegian SWF (30% fall), between December 2007 and December 2008.\textsuperscript{136} Russia's Reserve Fund fell $5.8 billion in May 2009 and according to Russian finance minister Alexei Kudrin, it could be 'exhausted by the end of [2009]'.\textsuperscript{137}

Overall, SWF portfolios contracted 18% between 2007 and 2009, mainly because of a 45% decline in the value of their equity portfolios (see chart 1.3).\textsuperscript{138} As a result of the above, SWFs could not be seen any more as institutions with very deep pockets, as they did until then.

Chart 1.3: Decline of SWF portfolio values in USD tr.

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Kern (n 43) 3.

Setser and Ziemba (n 43) 1.

ibid.


Despite the continuing market instability, assets under management of SWFs were estimated to have increased by 9% in 2011 to around $4.8 trillion, while another $7.2 trillion were held to be under the management of other sovereign investment vehicles, such as pension reserve funds and development funds. The SWF Institute made an estimate of $5,029 trillion in May 2012. The rise of assets under management was partly due to the number of new SWFs that were launched during 2011, such as the Nigerian Sovereign Investment Authority (established in May 2011) and the €4bn Italian Strategic Fund (launched in July 2011). The creation of new funds, however, does not suffice to explain this significant rise alone. Therefore, a part of it should be attributed to a return in global business activity and the rising price of oil in 2011 and 2012. In short, despite their dramatic fall during the GFC, SWFs verified a statement made during the worst part of the crisis by Ahmed, Director of the IMF’s Middle East

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140 SWF Institute, 'Fund Rankings' (n 43);
The disparity between the various estimates is also due to different definitions given to SWFs as discussed above.
141 Other funds launched in 2011 include the Papua New Guinea Sovereign Wealth Fund and Mongolia’s Fiscal Stability Fund, Maslakovic (n 409) 3.
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and Central Asia Department, that ‘SWFs [had] a long-term role to play’.143

iv. Future growth projections

The degree to which SWFs will retain their strength will depend on a multitude of factors. These are the price trends of oil and other commodities; growth of Asian and other developing economies; international exchange rate policies as well as the effects of the global crisis and economic downturn. Regarding commodity-based SWFs, it is possible to make projections based on future oil prices. A 2009 CFR study, for example, evaluated a number of different scenarios for SWFs by reference to the estimated average oil prices for the next five years. It was reported that even if oil stabilises at $75 a barrel until 2014, the pace of foreign asset accumulation in the Gulf would slow substantially.144 Moreover, it was estimated that ‘if oil averages $100 or more over the next five years, the GCC’s assets will resume their rapid expansion and expand to $2.2trn by 2012’.145 Based on the data available for 2012, this scenario appears to have been significantly surpassed.146

Chart 1.4: Estimated stock of GCC foreign assets depending on oil prices

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144 Setser and Ziemba (n 43) 13.

145 ibid 18.

146 TheCityUK projections made in February 2012, for example, are for SWFs’ assets to increase to around $5.2 trillion by the end of 2012, Maslakovic (n 139) 3.
Definition and Characteristics of SWFs

According to estimates made in 2012 by Castelli and Scacciavillani, by 2016 the assets managed by SWFs will be between USD 8.6 trillion and USD 10.8 trillion (reflecting three different return scenarios).\textsuperscript{147} The growth in the assets managed by SWFs is determined by three factors: the return on the wealth accumulated, the fiscal policy framework adopted by the countries concerned and the new funds transferred from the current account surpluses.\textsuperscript{148} Deutsche Bank’s analysts, on the other hand, have shaved estimates for SWF growth to $7 trillion by 2019 compared with forecasts of $10 trillion by 2016 in a survey two years before.\textsuperscript{149}

\textit{Chart 1.5: SWF asset growth, based on past foreign exchange reserve growth}

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\textsuperscript{147} Massimiliano Castelli and Fabio Scacciavillani, \textit{The New Economics of Sovereign Wealth Funds}, Wiley Finance, 2012, 67–74.

\textsuperscript{148} Their estimates are made at country level and one important observation concerns the increasing concentration of the assets managed by SWFs in a relatively small number of countries: Norway, UAE, Saudi Arabia (which does not formally have a SWF), China, Kuwait, Qatar, Hong Kong and Singapore will account for 85 per of the total.

\textsuperscript{149} Kern (n 138) 10.
Definition and Characteristics of SWFs

(Kern, 'State Investments' 2009, 10)

2. Transparency

Transparency, or the lack of it, for the past few years has been the primary cause of debate around SWFs. The issues arising from the opacity of SWFs is discussed in chapter 3. This section examines the meaning of ‘opacity’, while chapter 3 analyses in what circumstances this becomes a matter of concern.

i. Most SWFs typically reveal little if any information

Lack of transparency is a relatively straightforward matter. As opposed to the majority of large market investors (such as commercial banks, pension and mutual funds), most SWFs do not issue public reports on their size and holdings, management personnel and management structures. In addition, SWFs rarely reveal their business plans or future intentions. More importantly, very little is known about how much governments intervene in the SWFs’ decisions or the distinction between the rulers’ private wealth and the funds held by each investment fund.150

150 See, for example Law No 47 of 1972 in Kuwait ‘Prohibiting and providing penalties for the disclosure of information’ on the KIA, see:
Definition and Characteristics of SWFs

SWFs adapt their transparency levels based on the legal requirements of the jurisdictions where they invest in. Certain jurisdictions, for example, require the disclosure above a certain percentage of ownership and before a takeover. These rules are usually designed to allow shareholders to better observe the progress of the company and to make informed decisions critical to corporate events such as takeovers. The USA is a prime example, where the Securities Exchange Act of 1968 requires disclosure of important information by anyone seeking to acquire more than 5% of a company’s securities by direct purchase or tender offer. Such an offer often is extended in an effort to gain control of the company. In addition, in the USA, the Securities and Exchange Commission (SEC), requires any institutional investors holding over $100 million in USA-listed securities to submit some sort of 13F filing which later becomes public.

To this day there is no comprehensive list of what SWFs own, nor any mandatory reporting of their investment policies. For this reason the California-based ‘SWF Institute’ established a ranking of SWFs’ transparency level named the ‘Linaburg-Maudell Transparency Index’ (see below table 1.3). This model uses a variety of criteria, such as the publication of audited annual reports, the application of ethical standards and the fund's investment policies to rank a fund’s transparency from 1 to 10.

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152 s 13(d). This information must be filled in what is known a Schedule 13D form.
153 Form 13F—Reports Filed by Institutional Investment Managers (SEC)
In early 2010, CIC was forced by the USA securities regulator to submit a similar filing which revealed a number of the fund’s strategic holdings, such as investments in American International Group, Apple and Citigroup, see:
154 As the situation continues since SWFs were first on the spotlight,
Knowledge@Wharton, ‘A Closer Look at Sovereign Wealth Funds: Secretive, Powerful, Unregulated and Huge’ (2007) Wharton School - University of Pennsylvania,
155 Each principle adds one point to the index, see,
SWF Institute, ‘Linaburg-Maudell Transparency Index’, (SWF Institute, 2008-2012)
Definition and Characteristics of SWFs

Today it is being agreed by nearly the entire literature on the subject that the opacity of SWFs is a negative phenomenon and must be corrected.\(^ {156}\) Although transparency and openness are, today, long established principles\(^ {157}\) and are applied today by the most part of market investors, SWFs’ lack of transparency allows them to invest without supervision and accountability (a more detailed discussion of the place and role of transparency in the debate about regulating SWFs takes place below in chapter 4). At the same time, it is recognised that SWFs are not the only type of opaque investors. Other investment entities, such as hedge funds, did not abide by the generally accepted standards of transparency for a long period. Although smaller in size than SWFs and privately owned, there is no rationale why hedge funds should be allowed to operate in obscurity while SWFs make the target of constant calls for more transparency.\(^ {159}\)

SWFs often argue that maintaining secrecy is a way of protecting themselves and their investments from undue scrutiny and a way to engage in better competition with hedge funds.\(^ {160}\) In short, SWFs present an efficiency argument. The rationale for this is that glass-like transparency could potentially prevent

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\(^{156}\) For a representative piece of literature see, Truman (n 65);
\(^{157}\) However, it has also been pointed out that SWF ‘lack of transparency cannot itself be the problem, and as a result of that greater transparency cannot itself be the solution’ see, Ronald Gilson and Curtis Milhaupt, ‘Sovereign Wealth Funds and Corporate Governance: a Minimalist Response to the New Mercantilism’ (2008) Vol 60(5) StanLRev <www.stanfordlawreview.org/print/article/sovereign-wealth-funds-and-corporate-governance-minimalist-solution-new-mercantilism> accessed 7 November 2012, 1361.

\(^{158}\) In this regard see, OECD Code of Liberalisation of Capital Movements, adopted in 1961; OECD Declaration on International Investment and Multinational Enterprises issued in 1976 and revised in 2000.

\(^{159}\) This thesis does not deal with the merits of using transparency as a regulatory technique for the wider financial sector. For more information, however, on this subject see Avgouleas, who argues that using disclosure as a regulatory technique contains difficulties, such as the lack of certainty that disclosed information will be used rationally by potential market participants so as to render market more efficient and decrease inherent market flaws. His argument is that greater disclosure requirements can be a strong supervisory tool only if it is used to supplement the impact of protective rules, Emilios Avgouleas, ‘What Future for Disclosure as a Regulatory Technique?: Lessons from Behavioural Decision Theory and the Global Financial Crisis’ in Iain MacNeil and Justin O’Brien (eds) The Future of Financial Regulation (Hart, 2010) 211-31.

\(^{160}\) This issue is further discussed in chapter 3, n 286 onwards.

‘SWFs need to preserve their competitive advantage against an array of competitors that include hedge funds and others who face less pressure for disclosure. Therefore, SWFs need to find the right balance between reassuring stakeholders of their purely financially motivated objectives and not being front-run by competitors’, Unnamed SWF officer (n 74).
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funds from taking greater risks and accumulate greater returns,\(^{161}\) or allow others to free ride on the investment strategies that they have adopted.\(^{162}\) It has also been argued, however, that lack of transparency puts heavy demands on the quality of fund administration. Even where fund administration is solid, greater transparency would enhance the likelihood that the fund serves its intended purposes and reduce the likelihood of future governance problems.\(^{163}\)

The experience of large corporations in the industrialised world demonstrates that potential for error and abuse exists even in apparently highly rated and well-managed organisations. In general terms, transparency facilitates the maintenance of openness to investment. As said by Lowery, ‘what may have been tenable in a world where SWFs manage only several hundred billion dollars may not be tenable in a world where [they] manage several trillion dollars’.\(^{164}\)

Table 1.3: 2nd Quarter 2009 Linaburg Maduell Transparency Index rating 1 - 10

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\(^{163}\) Lowery (n 58);

See above, n 97, where the argument was made by Malan and Pringle, that creating a SWFs may be for the very reason of enhancing transparency.

\(^{164}\) ibid.
ii. Democracy and accountability

There can be an argument that the level of transparency of a SWF depends, to a large extent, on the political system of the fund’s home country. As seen from table 1.3, while funds in democratic countries such as Norway, Canada, Australia and the USA, are very transparent and accountable, those run by authoritarian

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165 n 43; 
For a better view of the progress made by SWFs in the field of transparency see, Truman (n 82) tables 3-4 and the SWF Institute website (n 43).
Definition and Characteristics of SWFs

regimes such as the UAE, Saudi Arabia, and Qatar are not.

Norway, for example, publishes monthly return figures for its Government Pension Fund and reveals its holdings on a quarterly basis. Its managers are directly accountable to Norway’s legislature, and therefore, the Norwegian people.\(^{166}\) In a speech, the former finance Minister of Norway, Halvorsen explained the conditions that contributed to the adoption of such high level of transparency by the Norwegian fund: ‘the high level of openness in the management of our sovereign wealth is not the result of pressure from the international community. Instead, it is a prerequisite of the fund’s existence’.\(^{167}\)

More specifically, according to Halvorsen, a high degree of transparency is ‘essential to be able to build and maintain support for the government’s management of the petroleum wealth’, which entails running large budget surpluses and building up substantial and very visible financial assets in order to meet large unfunded pension liabilities in years to come.\(^{168}\) The Norwegian Minister emphasised in her speech that it would simply be ‘impossible’ for the Norwegian government to put aside the equivalent of 15% of GDP per year in a fund that is now 100% of GDP and growing, without giving an account of the rationale for building up such substantial financial assets, and also providing the public with information on the management of that wealth.\(^{169}\)

The ADIA, on the other hand, is one among the most secretive funds when it comes to its operations, and has never publicly announced its size, holdings, or even the names of its top managers. As argued by Balin, ‘because [ADIA] is only accountable to the unelected Sheikh of Abu Dhabi, it has significant leeway in both its investments and its transparency’.\(^{170}\) Balin concludes that, ‘viewing the list of the holders of SWFs—where approximately 65% are undemocratic—it can be seen that SWFs, on average, are highly opaque and have both loose oversight and lax domestic regulatory structures’. The same is also true of China, another

\(^{166}\) n 264.


\(^{168}\) ibid.

\(^{169}\) ibid.

\(^{170}\) Balin (n 88) 8.
Definition and Characteristics of SWFs

example of an undemocratic country. As stated by Sasso, the lack of transparency in Chinese corporate governance and the strong government influence on most Chinese investment vehicles ‘have already generated a reluctance in western countries, particularly the USA, to open up some of their markets’.171

Judging from table 1.3 with the transparency scores, it is no coincidence that democratic states rate better than non-democratic ones.172 This fact easily leads to the conclusion that transparency for SWFs is a matter strongly linked to the political circumstances of each country. In fact, it is safe to assume that the level of a SWF’s transparency and accountability is often determined by the degree to which those principles also reflect a country’s political structure.

iii. There is a clear trend towards openness

Regardless of their degree of openness, most SWFs admit that transparency and accountability are good governance principles and are eager to make proof of their commitment to them. In this context, many SWFs publicise their progress in moving towards greater transparency or demonstrate a willingness to do so. Overall, it can be said that there is a noticeable trend among SWFs to increase their transparency and abide by higher reporting standards.

A major step in this direction was made when, at the end of February 2008, the largest SWF in the world, ADIA, sent a letter to regulators in key countries specifying what its investment policies are and promising greater disclosure. Moreover, in March 2008, representatives from the USA, Abu Dhabi, and Singapore met and agreed to adopt rules for SWF governance that included

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171 As the author says about China’s State Foreign Exchange Investment Company (SFEIC), ‘relevant legislation needs to be put in place and a stricter management regime established to govern the fund. Considering the reserve fund’s enormous scale, China will have to clarify the fund’s different functions further and establish a rational fund allocation regime in the context of a system of transparent information disclosure in order to raise investment returns’. Lorenzo Sasso ‘New Trends in China’s Foreign Investment Strategy’ (2007) Vol 47(3) Int’l Spectator 399 <http://dx.doi.org/10.1080/03932720701567604> accessed 7 November 2012.

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greater disclosure and transparency.173 This was held to be a move similar to 
bilateral investment treaties, which are believed to have facilitated a reduction in 
trade barriers.174

In 2007, the Kuwaiti government repealed a law barring its SWF, KIA, from 
revealing its assets and the fund publicised its size for the first time in thirty 
years; its figure of $234 billion was only half the size of most analysts’ 
projections.175 In January 2009, the Libyan Investment Authority announced that 
it would start disclosing the details about its investment strategy to allay 
conterns in the USA and Europe about its intentions.176

In Singapore, Temasek Holdings publishes an annual report containing 
details of its investments and its corporate governance structure is known.177 On 
the other hand, another Singaporean fund, the GIC Singapore, does not publish 
y any information on its holdings. Amid mounting concerns about the secretive 
fund’s influence after high profile investments in UBS and Citigroup, in 2008 GIC 
promised greater disclosure about its activities.178 Nevertheless, the former 
deputy chairman of GIC, Tan, would not be drawn on what areas of disclosure 
GIC would move, arguing that this was a decision for the Singaporean 
government. For the time being, GIC has still to improve its transparency level 
and lags considerably behind Temasek.179

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173 WSJ Staff, ‘Code Set for State-Run Funds Guidelines Address Fears Over Motives Behind 
174 Nancy Brune, ‘SWFs: Passive Investors or National Security threat?’ in Al Meahaiza Myrna (ed), 
The Impact of the Growth of Sovereign Wealth Funds (Arab Financial Forum, 2009) 86;
It should, however, be mentioned that soon after this meeting, Temasek Holdings reported that it 
was not a SWF and as such it was not bound by any agreements. Temasek made this claim on the 
basis that it does not receive additional funding from the government and does not require 
government approval to sell assets. Former US Treasury Secretary Paulson replied that Temasek 
already provided more information that government-run funds and implied that it was the GIC 
(second largest Singaporean fund) that needed to make more disclosures,
Straits Times Staff, ‘Temasek Says it is Not’ (n 45).
175 Balin (n 88) 8.
176 Brune (n 174) 75.
177 Ananya Roy, ‘Temasek Gets Perfect 10 in Transparency’ Asiaone Business (Singapore, 9 May 
December 2012.
178 Peter Tahl Larsen and Martin Dickson, ‘Singapore Fund Pledges Greater Transparency’ 
000077b07658.html> accessed 19 December 2012.
179 GIC’s transparency score in the SWF Institute website between 2008 and 2009 remained at 
6/10, while Temasek received a clear 10/10,
In March 2009, as many as eleven SWFs of the oil-rich Gulf improved their transparency scores on the Linaburg-Maudell Transparency Index (displayed at table 1.3). A number of SWFs made considerable improvements, such as QIA, which increased its transparency score from one to five by the end of 2008 (and moved up in rank from 35 to 23). According to the same study, Mumtalakat Bahrain and Mubadala Development Company were voted the most transparent SWFs in the Gulf with a rating of 7 out of 10, being two of only 15 funds in that part of the world that achieved a score between 7 and 10.

Despite these improvements, transparency remains an important issue for SWFs as a whole and concerns relating to their opacity will not dissipate in the near future. Although certain funds in the study improved their positions considerably, the progress made by some others was small, nearly insignificant. One of those cases is the Emirates Investment Authority, which moved up from a score of one to two to be ranked 33rd among the 45 SWFs identified by the institute.

Furthermore, the scores of a number of high profile funds, such as the KIA, RAK Investment Authority and Saudi Arabian PIF remained unchanged in the year of the study (2007-2008). The head of China Investment Corporation (CIC), Xiqing, has raised the issue of transparency in the past but hinted that it is a process that might take considerable time. As he said, ‘our government has never been transparent for 5,000 years, now we are told we need to be transparent and we are trying’.

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Definition and Characteristics of SWFs

Judging from previous trends it is virtually certain that the creation of new funds will continue in the future. Given that most SWFs at the outset where considerably more opaque than today, there is no guarantee that newly created funds in the future will abide by transparency standards from the beginning. Presently, there are many countries contemplating the establishment of a SWF (including EU countries), while there are others that may be setting up smaller funds, additional to the ones they already operate.

In all, lack of transparency is today almost a synonym for SWFs and, although international pressure has forced some of them to make substantial progress, the overall image of SWFs remains rather obscure. Whether they originate from democratic or authoritarian regimes, SWFs are controlled by sovereign nations, and, as such, it is difficult to compel those nations to disclose information about their financial dealings. As a result, unless action is taken at an international level, opacity will always be associated with SWFs. This issue is reverted to at chapter 3 below whilst analysing issues of concern caused by SWFs’ operations.

CONCLUSION


Japan, Taiwan, Thailand, Bolivia, Nigeria, Scotland, UK and Canada have initiated a debate to set up similar funds;
About Nigeria, see a presentation of its newly created SWF, SWF Institute, ‘Nigerian Sovereign Investment Authority’ (SWF Institute, 2012) <www.swfinstitute.org/swfs/excess-crude-account/> accessed 19 December 2012;
and regarding Brazil see Bureau of Economic and Business Affairs, ‘2012 Investment Climate Statement - Brazil’ (USA Department of State, June 2012) <www.state.gov/e/eb/rls/othr/ics/2012/191115.htm> accessed 19 December 2012.

This first chapter touched upon the definition and the main characteristics of SWFs. It was established that there is no common definition for SWFs but that there are definitions provided by commentators and international regulatory bodies that can be widely used. For the purposes of this thesis, the accepted definition is the one provided by the EU Commission, as the main analysis is mainly carried out from an EU standpoint. However, where it is deemed necessary, other state-owned entities going beyond the strict EU definition of SWFs are used as examples, such as SOEs.

The rapidly growing size of SWFs was a matter that attracted much attention until the end of 2008. Although SWFs still manage an abundance of assets worldwide and have considerable reserves, their size as well as their growth prospects have been greatly reduced. Much of their future development will depend on the price of oil and, in the case of China, on world aggregate demand.

Lack of transparency is and will continue to be in the future one of the most important attributes of SWFs. While most SWFs acknowledge the importance of transparency in the investment business, nevertheless, the majority of them do not disclose their sizes nor their management structures and business plans. Although many concrete steps have been taken on the part of SWFs to enhance their transparency and openness, it is unlikely that this issue will be fully rectified in the future.
CHAPTER TWO

The Investment Behaviour of SWFs

INTRODUCTION

Chapter 1 explored various definitions and the basic characteristics of SWFs. It was seen that the investment behaviour and strategy of a SWFs depend to a large extent on its objectives. The present chapter offers a complementary understanding of SWFs by analysing their investment behaviour under normal circumstances as well as under economic crises. The rationale for examining this characteristic of SWFs is to help alleviate the concerns of recipient countries and reduce protectionist pressures and, at the same time, inform them on how SWFs should be regulated. Moreover, a better understanding of their role and practices could help countries managing SWFs to strengthen their domestic policy frameworks. The regulation of SWFs is the subject of analysis in the following chapters.

Chapter 2 is divided in two parts. Part I examines SWFs’ investment behaviour at times of economic growth, while Part II focuses on their behaviour at times of economic crisis. This is a necessary distinction as the investment behaviour and asset allocation of SWFs changes considerably depending on their home countries’ and the global investment climate. Part I concentrates on the presence of SWFs in western economies and provides some information on their sectoral and regional preferences. The sample period taken for this purpose is between 2000 and until the first quarter of 2008.

In this context, the distinctive features of SWFs’ investment behaviour is analysed, namely, their tendency for risk aversion, their passivity compared to

\footnote{The samples taken depend on the period where the relevant studies were conducted and do not always coincide.}
The Investment Behaviour of SWFs

institutional investors and the long-term character of their investments. Finally, a brief comparison between SWFs and other investment entities, namely hedge funds and institutional investors, is offered to address a number of common features between different categories of investors.

Part II analyses the behaviour of SWFs at times of global economic ‘crisis’. For the purpose of this thesis the start of the crisis is taken as the second quarter of 2008. The section concentrates on the effects of this crisis on the investment behaviour of SWFs. The conclusions of this chapter serve to explore below in chapter 3 the potential benefits and concerns posed by the operation of SWFs in recipient economies.

A. ASSET ALLOCATION AT TIMES OF ECONOMIC GROWTH

Asset allocation depends heavily on the purpose for which the fund was established. Since SWFs serve a variety of purposes, the investment strategies of SWFs vary as well. For example, stabilisation funds aim at offsetting government revenues at times of high price volatility of natural resources, therefore, it is to be expected that they would allocate their funds more conservatively. The same strategy characterises public pension funds. In fact, many pension funds, and to some extent SWFs, tend to regulate their asset allocation to prevent the management of those funds from taking excessive risks.¹⁸⁸

Other funds avoid taking risks for ethical or religious reasons. SAMA and other funds from Saudi Arabia purse only investment strategies that are compliant with Islamic principles. For example, in Islamic banking and finance the importance of risk sharing as part of raising capital and the avoidance of *riba*

The Investment Behaviour of SWFs

(/usury) and *gharar* (risk or uncertainty) are central. As a result those funds typically allocate their assets more conservatively and they avoid excessive risks. For example, as far as mortgage-backed securities are concerned, these would involve both an element of *riba*, since returns interest based, and *gharar* since they are issued by financial intermediaries, the holder of the security has no control over or knowledge of the origin of the returns and they involve excessive leverage and risk. Quite interestingly this policy is said to have shielded Saudi Arabia in the current financial crisis from suffering heavy losses. On the other hand, UAE funds invested heavily in financial instruments that promised higher returns or used higher leveraging, and were significantly more exposed to toxic assets, thus bearing greater losses during the financial crisis.

As seen in chapter 1, one of the main purposes of SWFs is to diversify a country’s economy. Therefore, it is understandable why SWFs invest in the entire spectrum of the economy. Indeed, today SWFs have penetrated in all economic sectors but demonstrate a clear preference in banking and the financial sector in general. Real estate also figures among SWFs’ preferred areas, but it is equally common for them to invest in companies operating in technology, aerospace, the car industry, telecommunications and even energy or

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189 Marc Ross, ‘Working with Islamic finance’ *(Investopedia, 2009)*
<www.investopedia.com/articles/07/islamic_investing.asp> accessed 7 November 2012; *Gharar* is defined as ‘An Islamic finance term describing a risky or hazardous sale, where details concerning the sale item are unknown or uncertain. *Gharar* is forbidden by the Qur’an, which explicitly forbids trades that are considered to have excessive risk due to uncertainty’, Investopedia, ‘Gharar’ *(Investopedia)* <www.investopedia.com/terms/g/gharar.asp> accessed 7 November 2012;

190 An extension of the prohibition of *Riba* and *Gharar* prohibits investments in companies with heavy debt.

191 Setser and Ziemba (n 43) 19.

192 By ‘toxic asset’ asset that becomes illiquid (cannot be sold) when its secondary market disappears. Such assets were mortgage-backed securities during the 2007-2009 crisis.

193 Setser and Ziemba (n 43) 20.
The Investment Behaviour of SWFs

defence. Sometimes cases of investments in food retail or British football clubs also make the news.

The first section involves a discussion of previously publicised cases of SWF investments as well as a presentation of actual stakes held. Then an analysis of their sectoral and regional preferences is provided, followed by a breakdown of the distinctive features of their investment behaviour.

1. The Presence of SWFs in the West

To understand the extent of the presence of SWFs in the west, it is essential to consider first a number of notorious transactions by SOEs in American or European companies. It is those transactions (whether completed or attempted) that ‘triggered’ the debate on SWFs in these countries.

Attention shifted to SOEs initially in 2004 when China’s Lenovo Group effectively took over IBM’s personal computer business. A few months later, in July 2005, CNOOC made an $18.5 billion bid to buy USA oil major Unocal Oil Company. In August 2005, CNOOC announced that it had withdrawn its bid for Unocal, citing political tension inside the USA. However, it was the so-called DPW deal in 2005 that sparked the greatest controversy around SWFs and SOEs. This case was an attempt on the part of DPW, a SOE owned by the government of Dubai, to acquire the Peninsular and Oriental Steam Navigation Company (P&O), domiciled in London, which was then the fourth largest port operator in the

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194 By ‘trigger’ in this thesis is meant a transaction that initiates the debate in a country about foreign investments and culminates in legal action been taken that tightens foreign investment.
The Investment Behaviour of SWFs

world, running major USA port facilities. The transaction was eventually blocked in March 2006 by the USA House Appropriations Committee.197

In the wake of these events, SOEs and other state investment entities came under close scrutiny. In this context, in May 2007 Chinese government-controlled CIC took the largest external stake (9.9%) in Blackstone Group LP in the form of non-voting units.198 The investment caused a stormy debate,199 among other reasons, because Blackstone, indirectly through its holdings, was one of the largest employers in the USA. Similar investments continued on the same pace stirring up the debate in the western world. In June 2007 Delta Two – an investment vehicle owned by the Royal Family of the Kingdom of Qatar – increased in the existing 7.6% stake of in J Sainsbury plc to a total of 25% by acquiring an additional $1.5 billion stake, making Delta Two the largest single shareholder.200 In addition, Gazprom, the Russian energy SOE has, at times, also caused concern over its tight grip of energy infrastructure across Europe. By the beginning of the 2000s Gazprom managed to own substantial equity stakes in energy transportation, storage and trade companies in Germany, Finland, Greece, Poland, the Baltic and other ex-Soviet countries201 and has made its intention clear in the past that it intends to take a share of Europe’s downstream gas

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200 The notification of the acquisition is available at,

201 Svetla Trifonova Marinova and Marin Alexandrov Marinov, Foreign Direct Investment in Central and Eastern Europe (Ashgate Publishing, Aldershot 2003) 139-140.
The Investment Behaviour of SWFs

The events described above have marked the debate on SWFs. Against this background, it would be interesting to offer an image of the presence of SWFs in western markets and provide an insight into their varying investment strategies (indicatively, see table 2.1 below). It ought to be stressed that these examples are only indicative. A significant part of SWFs’ investments are made through intermediaries, such as mutual funds or hedge funds, thus making it difficult to know the exact financial position of every fund.

Table 2.1: Concentration of shareholdings – major SWF investments in financial firms in 2009

<table>
<thead>
<tr>
<th>Funds</th>
<th>Target</th>
<th>Country</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China (CIC)</td>
<td>Blackstone Group</td>
<td>US</td>
<td>9.9</td>
</tr>
<tr>
<td></td>
<td>China Development Bank</td>
<td>CN</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td>Morgan Stanley</td>
<td>US</td>
<td>9.9</td>
</tr>
<tr>
<td></td>
<td>VISA Inc.</td>
<td>US</td>
<td>NA</td>
</tr>
<tr>
<td>Singapore (GIC, Temasek)</td>
<td>Bank of China</td>
<td>CN</td>
<td>15.5</td>
</tr>
<tr>
<td></td>
<td>Barclays Bank</td>
<td>GB</td>
<td>3.1</td>
</tr>
<tr>
<td></td>
<td>China Construction Bank</td>
<td>CN</td>
<td>5.1</td>
</tr>
<tr>
<td></td>
<td>Citigroup</td>
<td>US</td>
<td>11.1</td>
</tr>
<tr>
<td></td>
<td>ICICI Bank Ltd.</td>
<td>IN</td>
<td>9.6</td>
</tr>
<tr>
<td></td>
<td>Merrill Lynch</td>
<td>US</td>
<td>9.9</td>
</tr>
<tr>
<td></td>
<td>Standard Chartered Bank Ltd.</td>
<td>GB</td>
<td>20.0</td>
</tr>
<tr>
<td></td>
<td>UBS</td>
<td>CH</td>
<td>9.0</td>
</tr>
<tr>
<td>South Korea (KIO)</td>
<td>Merrill Lynch</td>
<td>US</td>
<td>7.4</td>
</tr>
<tr>
<td>Qatar (QIA)</td>
<td>Barclays Bank</td>
<td>GB</td>
<td>8.9</td>
</tr>
<tr>
<td></td>
<td>Credit Suisse</td>
<td>CH</td>
<td>10.0</td>
</tr>
<tr>
<td></td>
<td>London Stock Exchange</td>
<td>GB</td>
<td>15.1</td>
</tr>
</tbody>
</table>

The Investment Behaviour of SWFs

As seen in table 2.1, among western markets, the USA has been evidently the most preferred country for SWFs, followed by the UK, Australia and Switzerland. France, Germany and Italy, have also attracted considerable investments.

Regional strategies vary among SWFs. ADIA, for example, primarily holds large stakes in the USA, in companies such as Ares Management LLC, Apolo Management LP and Citigroup. The Libyan Investment Authority, with investments in Juventus Football Club and UniCredit, has historically chosen Italy as its target market. QIA, on the other hand, appears to target almost exclusively the UK market. Namely, QIA holds stakes in Sainsbury (a sizeable 27%), the London Stock Exchange, Chelsfield Partners and Barclays Bank.

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<www.sovereignwealthfundsnews.com/libyaninvestmentauthority.php> accessed 5 November 2012;  
The Investment Behaviour of SWFs

Sectoral strategies also vary. With large stakes in Morgan Stanley, Blackstone Group, and a minor stake in Visa (all of which in the USA)206 China’s CIC invest almost exclusively in finance, while another Chinese fund, SAFE, has favoured investments in energy (small stakes in French Total, Aviva, BP and Royal Dutch Shell Plc).207

Finally, the available evidence shows most funds prefer to control larger stakes in fewer companies, while others, such as SAFE and Norway's GPFG, choose to disperse their investments in small stakes across a larger number of companies. SAFE's known stakes average at around 1% while Norway reports stakes averaging at 1.5% in companies such as Alliant Techsystems, General Dynamics, Boeing, Honeywell, BAE Systems, EADS (Airbus), Finmeccanica, Safran, Thalys and Rio Tinto.208

As a rule, the larger the investment a SWF makes, the more it succumbs to pressure for disclosure. For example, soon after Mubadala's high profile investments in the USA, the Netherlands and Italy and after the sale of $1.75bn in bonds to international investors, securities regulations overseas required that it disclose its financials as part of that sale.209 For this reason, many SWFs prefer smaller investments that do not involve compulsory disclosure of their identity.210 As a result, for many funds the information available is extremely limited. Such funds are Saudi Arabia's PIF, the UAE's RAK Investment Authority, Iran's Oil Stabilisation Fund, Russia's National Wealth Fund, Algeria's Revenue Regulation fund and Malaysia's Khazanah Nasional.

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210 This sealing is generally as low as 5% (in the USA), below which companies are not compelled to reveal any information. This provision has allowed many SWFs to remain low profile, n 598,
One of the only funds that disclose small investments is the Norwegian fund, n 208.
The Investment Behaviour of SWFs

Having discussed the background of SWFs’ investments and the extend of their presence today in western markets, the next step is to offer an illustration of SWFs’ investment patterns based on sectoral and regional preferences as well as an analysis of their distinctive investment characteristics.

2. Characteristics of SWFs’ Investment Behaviour at Times of Economic Growth (period from 2000 including the first quarter of 2008)

When executing their asset allocation, some SWFs invest solely in publicly-listed financial assets,211 while others invest across all major asset classes, including alternative investments.212 Some SWFs take investment decisions based on market indices and sometimes they put additional caps on the maximum shareholding to ensure diversification. SWFs that aim to maximise absolute returns over longer time horizons may shift between different asset classes and acquire larger stakes in specific companies they deem profitable213 (see charts 2.1-2.2 below).

Chart 2.1: Holdings of the Government of Singapore Investment Corporation (representative of a ‘typical’ SWF portfolio)


211 For example, bonds and equities.
212 An alternative investment is an investment that is not one of the three traditional asset classes of stocks, bonds and cash. These may include hedge funds, managed futures, real estate, commodities and derivatives contracts. For more see chapter 6, n 1235.
SWFs traditionally held dollar denominated assets. Between 2002 and 2006 the dollar share of SWFs decreased slightly as many diversified away from USA assets into the euro, the pound and emerging market assets. However, the majority of the Gulf region’s purchases continued to be directed towards the dollar zone. For example, SAMA’s dollar share is about 80%, which is estimated to be the highest among the SWFs in the Gulf.

Fotak and others and Kotter and LeL undertook two separate studies to

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216 Fotak, Bortolotti and Megginson (n 51) 15,

The authors collected investment dates, announcement dates, name of the acquiring fund, name of the acquired target, country of incorporation of the target and acquired share of equity from multiple sources: the Securities Data Company database, direct disclosures by SWFs, the financial press and web sites. Their final sample contains 75 investments that originate from 16 SWFs and are related to 62 target companies in 23 countries. Investments in their sample span the period 1989-2008.

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examine the impact of SWFs’ investments in listed companies. In their conclusions they offer evidence on the mechanics of SWF investments. Kotter and Lel show that SWFs behave largely like institutional investors like Berkshire Hathaway with the objective of profit maximisation.219 Fotak and others find that SWFs purchase, on average, almost 19% of shares of the target company220 and that a large number of acquisitions are clustered in the finance and banking sector, many of which are carried out through privately negotiated transactions. In addition, they also document that SWFs tend to invest in firms whose stock price has appreciated over the past sixty trading days.221 Regarding the trading frequencies of SWFs, Fotak and others find that approximately half of their sample relates to the years 2004-2008,222 while Kern notes that two-thirds of all transactions reported have been undertaken between mid-2007 and 2008.223 This heightened activity reflects the growth of SWFs in size and number as well as a global increase in liquidity during the same period.

There are a number of studies presenting the global investment patterns of SWFs until the beginning of 2008. Kern in his 2008 study224 offers an account of the type of investments made by each type of fund (categorized by country of origin) as well as the regional preferences of each fund. Kern concludes, among other things that, (1) North American and EU firms are the prime targets of SWFs; (2) 2007 – 2008 has been their most active period to date worldwide; (3) in the EU, the UK is the prime investment target of such funds and that (4) while in the EU their investments are diversified, in the USA they focus mainly on

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Kotter and Lel’s sample consists of 163 SWF investment announcements that are hand collected from searching the Factiva database from 1980 to 2008. The announcement date is taken as the earliest press release in English. They collect information on both equity investments (145 announcements) and joint ventures (18 announcements) by SWFs. This search results in a total of 271 events.
219 ibid 3.
220 Fotak, Bortolotti and Megginson (n 51) 18,
Other studies, however, give much larger average shares, see below n 281, 282.
221 ibid.
222 ibid 15.
223 Kern (n 101) 7.
224 Kern presents a number of data and analyses based on transactions as reported by Dealogic in which at least one SWF participated as an acquirer of a minority, majority or 100% stake in a company between 1995 and July 31, 2008. The data do not reflect all transactions undertaken by all SWFs (for example, the Norwegian SWFs was not included in the analysis), ibid 6.
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financial products.\(^\text{225}\)

With regard to SWFs' regional preferences (see chart 2.3 below), SWFs primarily invest in North America and Europe. In particular, 37% of the total transaction volume during the period studied is related to North American enterprises and 32% to Europe-based firms.\(^\text{226}\) This tendency is largely due to the wider selection of investments offered as well as the higher rate of returns that characterise the North-American and European markets. Asia also figures among the most preferred target regions, absorbing 28% of the investments observed by Kern.\(^\text{227}\) Among EU markets it is the UK economy that has attracted the highest volumes of investments, totaling $26 billion between 1995 and 2008,\(^\text{228}\) with Germany as the second-best with $5.1 billion of SWF-related investments. This figure can be traced back to three major investments, namely by the Dubai cluster in car manufacturer Daimler in 2005 and in specialty alumina producer Almatis as well as in Deutsche Bank in 2007.\(^\text{229}\)

\textit{Chart 2.3: SWF regional distribution of assets}

\(^{225}\) ibid 6-9.
\(^{226}\) ibid 7;
\(^{227}\) This is also confirmed from the regional asset allocation of the Norwegian GPFG fund, for which there is sufficient information: among its equity holdings, 15% is invested in Asia and the Pacific, 50% in Europe and Central Asia, 32% in North America and the rest in Latin America, Africa and the Middle East, Allen and Caruana (n 213) 34.
\(^{228}\) Kern (n 101) 7.
\(^{229}\) ibid 8.
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Financial institutions are generally the main beneficiaries of SWFs (see charts 2.4-2.7 below). At $60 billion, investments in the financial sector have been the dominant theme in the USA market.\(^{230}\) There may be many reasons for this preference. Many countries operating SWFs, in the Middle East or Asia, tend to have largely developed banking sectors, and thus consider finance a natural choice for their investments.\(^{231}\) Real estate and other sectors follow, but at an extremely wide interval. Those are real estate\(^{232}\) and construction with $17 billion worth of investments, commodities and energy with $13 billion, services and retail with $11 billion, technology with $9 billion and infrastructure and transportation with $9 billion between 1995 and 2008.\(^{234}\)

*Chart 2.4: Investments with SWF participation in the EU by sector of recipient companies (1995 – 2008)*

(Simone Mezzacapo, ‘European Economy – The so-called SWFs’ (2009) European Commission 102)

\(^{230}\) ibid.
\(^{233}\) Kern (n 101) 8.
\(^{234}\) ibid;

It is also stated by Kern that Asian enterprises have been the most preferred targets of state investments, mainly reflecting intra-regional diversification.
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**Chart 2.5: Investments with SWF participation in the US by sector of recipient companies (1995 – 2008)**

![Pie chart showing the distribution of investments by sector.]

(Mezzacapo 103)

**Chart 2.6: Ten largest transactions: sector distribution – deal volume 2007 - 2008**

![Pie chart showing the distribution of deal volume by sector.]

(Mezzacapo 100)

**Chart 2.7: Ten largest transactions: sector distribution – deal value 2007 - 2008**
The Investment Behaviour of SWFs

Having made an introduction to the usual investment patterns of SWFs, the next step is to analyse the most distinctive features of their investment behaviour. These are in particular their tendency for risk aversion, their passive stance and their long-term investment outlook.

i. **SWFs are relatively risk averse investors**

Given their objectives to support their countries macroeconomic policies, most SWFs seek to maximise their returns in their investments by overall remaining largely risk averse. This usually means investing in low-risk holdings, such as USA government bonds, buying small stakes in a wide range of companies and using low leverage.\(^{235}\)

While SWF have, at times, exhibited an impressive sophistication, very often they engage in a simple form of ‘trend chasing’.\(^{236}\) Bernstein and others support this claim based on the fact that ‘they are more likely to invest at home when domestic equity prices are higher, and invest abroad when foreign prices are higher’.\(^{237}\)

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\(^{235}\) In the field of finance, leverage is normally defined by relating some measure of a firm’s indebtedness to the size of its overall asset base. As the term would suggest, leverage is viewed as a mechanism by which firms can magnify the results of the activities undertaken on behalf of their owners.


\(^{236}\) Bernstein and others (n 100) 28.

\(^{237}\) Ibid.
The Investment Behaviour of SWFs

According to Balin, to meet the objectives of stabilising pension fund obligations and government revenues, countries tend to invest ‘countercyclically’, i.e. taking stakes in industries and countries that perform best when the SWF holding county’s economy is performing poorly. For example, Norway and Saudi Arabia, invest primarily in banking, technology, and industrial companies, and avoid investments in natural resources. On the other hand, Singapore and Malaysia tend to invest more actively in natural resources.

Stabilisation funds also seek higher allocations of lower-risk equities and bonds. This is to be expected considering that, during times of worldwide economic slumps, low-risk securities are the only ones that hold their value. The same also applies to funds that aim at generating long-term savings (savings funds). KIA, for example, was for long known to run a very low risk portfolio due to the fact that it was responsible for Kuwait’s ‘Fund for Future Generations’.

Some countries, like Singapore and South Korea, aim at developing specific industries and encourage the transfer of technology to native firms. As a result, Singaporean and South Korean funds often target the equity of companies that can carry out their goals and tend to avoid risky assets and yield quick returns. Moreover, there is evidence that certain SWFs avoid high-risk investments because these do not conform with the ethical objectives of their governments. For example, Saudi Arabia avoids investment strategies that go against established Islamic principles. As a result SAMA has invested the heavy bulk of its assets in USA bonds and relied less on external borrowing, a fact that served it well during in the subsequent economic slump.

Other funds, however, did not follow equally low risk policies. Examples include ADIA and other Emirati funds. This is seen, first, in their asset allocation.

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238 Balin (n 88) 6.
239 Allen and Caruana (n 213) 11.
240 Since 2007, however, it was believed to have increased investments in risky assets such as equities, alternatives (e.g. hedge funds) and its general exposure to emerging markets, while reducing its USA fixed income portfolio, Setser and Ziemba (n 43) 23.
241 Balin (n 88) 4-5.
242 China’s CIC avoids, as a matter of policy to invest in sensitive foreign transportation, energy and telecommunications firms, Brune (n 174) 74.
243 See above, footnote 190.
244 Sfakianakis (n 216).
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With far less oil than the Saudis, Abu Dhabi had a larger and more dynamic external portfolio and ADIA’s wealth was invested in assets that were highly correlated with global growth. Secondly, although ADIA itself did not take on much debt, some of the smaller Abu Dhabi funds did, as well as many of Abu Dhabi private or semi-private firms. Dubai, without much oil to begin with, relied much more heavily on external borrowing. By the end of 2008, its government and ruling family-sponsored firms had accumulated $80 billion in debts. Investment vehicles such as Isthimar and DIC had invested abroad, mainly in global blue chips, which subsequently suffered significant losses. Furthermore, these vehicles were funded from the proceeds of Dubai’s other investments, including the domestic property market (where prices fell in 2008). Overall, Dubai entities had far more short-term external debts than liquid external assets.

In addition, although the examples of SWFs relying on debt remain exceptional, SWFs invest highly in hedge funds and other leveraged institutions. An IMF survey of global sovereign funds suggests that 20% (about five) of the twenty-six funds surveyed invest in leveraged funds. Setser and Ziemba assumed that these five include most of the Gulf funds as well as Singapore’s GIC.

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245 According to the CFR, ADIA viewed itself as a pure portfolio manager that seeks (not always successfully) the highest risk-adjusted return, Setser and Ziemba (n 43) 20.
246 While the UAE as a whole had racked up $100 billion of external debt, ibid.
250 Setser and Ziemba (n 43) n 22; Moreover, in June and July 2009 China’s CIC and Korea’s KIC respectively announced that they also aimed to invest in hedge funds, Tom Cahill, ‘China’s Sovereign Wealth Fund Aims to Invest in Hedge Funds’ Bloomberg (New York, 17 June 2009) <www.bloomberg.com/apps/news?pid=20601087&sid=ai5PLqcfRXWyc> accessed 20 December 2012;
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A survey by Norton Rose LLP on SWFs and the global private equity landscape shows that some 41% of non-SWF respondents saw the funds as more risk averse than private equity, while 36% saw them as less risk averse and 23% judged they had a similar risk profile. Of the SWF respondents a majority (71%) believed they had a similar risk profile to private equity.\(^{251}\)

**ii. SWFs are passive investors**

The available evidence on SWFs suggests that they generally have no desire to impact on company decisions, which would label them ‘passive’ investors.\(^{252}\) Firstly, most SWFs, even the largest ones, have outsourced the management of their assets and often vote by proxy. This may happen because, although public sector investment managers have significant experience in fixed-income markets, they often have limited capacity for investment in other asset classes, such as equities. Thus, the SWFs rely on external fund managers to implement their strategic asset allocation in areas where their capacity is limited.\(^{253}\)

This method is said to be very effective in heading off potential political backlash and concerns over their motives. ADIA has reportedly long outsourced the management of 70% - 80% of its assets to foreign money managers, while KIA outsources at least 50%.\(^{254}\) In addition, many SWFs – particularly the bigger

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\(^{251}\) It was also said by Sen, economist at Barclays Capital that in the wake of the financial crisis SWFs ‘will employ a variety of strategies to get to commodities, not just buying the commodities directly but going via hedge funds to gain exposure in commodities markets’, John Irish, ‘Qatar Sovereign Wealth Fund Delays Investments for Six Months’, *Arabian Times* (Dubai, 12 March 2009) <www.arabianbusiness.com/549441> accessed 20 December 2012.


\(^{253}\) Allen and Caruana (n 213) 9.

\(^{254}\) At the same time, ‘winning business from [SWFs] requires more work than for typical institutional clients. Training and educating the fund’s staff often is expected to come with managing the assets. The funds also expect more disclosure about the money manager’s own business’,
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ones – avoid taking active management roles. China’s CIC has a stated policy to take no seats or only non-voting seats on the boards of its purchases.255 It has also been mentioned before that CIC purchased in 2007 a stake in Blackstone without, however, acquiring voting rights, while in late 2007 it acquired a stake in Morgan Stanley pledging to be a passive investor.256 Another characteristic example is the case of KIA, which, in the late 1980s, attained a participation of nearly 22% in British Petroleum (BP). Subsequently, an inquiry by the British Monopolies and Mergers Commission called upon the KIA to divest below 9.9% by October 1989. Although it had communicated to the British government that it did not aim to take an active role in the management of BP, the KIA responded to the regulatory pressure by considerably lowering its interests in BP.257

Certain studies, such as those of Kotter and Lel and Fotak and others, show that SWFs do not improve firm value in the long run,258 which suggests that shareholder activism is not common among SWFs. This is not to say that SWFs investments are associated with deteriorating values, but rather, that their investments have no substantial effect on operational performance and

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**Jay Cooper**, ‘Sovereign Wealth Fund Hires No Cinch’ *Pensions and Investments* (London, 17 Mar. 2008), <www.pionline.com/apps/pbcs.dll/article?AID=/20080317/PRINTSUB/529010448&AssignSessionID=173359561655636> accessed 20 December 2012; Nevertheless, a modest tendency in favour of in-house asset management can be discerned. According to the IMF, ADIA, has now established in-house capacity and operate as highly professional investment managers and rely less on external managers than in its past. The same applies for other funds, such as the large Norwegian and Singaporean SWFs, while it is mostly the newest SWFs that rely on external managers, Allen and Caruana (n 213) 8.

255 However, it is stressed by critics that even if CIC’s international investments are genuinely based on commercial considerations alone, critics posit that China’s use of some portion of SWF assets for politically driven domestic investments undermines the country’s claim that the CIC is a passive global investor, Brune (n 174) 73.


258 ‘Long run’, for the purpose of the above studies is taken as 1 – 3 years after the investment, Kotter and Lel (n 218) 5.
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corporate governance outcomes.\footnote{ibid.} As Rose notes, while passivity reduces political and security risks it also comes with risks, namely it may 'lower overall shareholder monitoring, thereby increasing agency costs'.\footnote{Paul Rose, ‘Sovereign Wealth Funds: Active or Passive Investors?’ (2008) 118 Yale LJ <http://yalelawjournal.org/the-yale-law-journal-pocket-part/scholarship/sovereign-wealth-funds-active-or-passive-investors/> accessed 7 November 2012, 118; An agency relationship is defined through 'an explicit or implicit contract in which one or more persons (the principal[s]) engage another person (the agent) to take actions on behalf of the principal[s]. The contract involves a delegation of some decision-making authority to the agent. Agency costs are the total costs of structuring, administering and enforcing such contracts', Newman, Milgate and Eatwell (n 235) 27.}

At the same time, it has been argued that SWFs could be held to owe a fiduciary towards their beneficiaries. This argument, made by Rozanov, holds that in the event where the share price of a company invested drops dramatically and its management continues to underperform, then a domestic authority charged with overseeing the SWF (but also the media and the general public) would question the strategy of the fund.\footnote{Andrew Rozanov, ‘Sovereign Wealth Funds and Active Ownership’ in Miracky and Bortolotti (n 161) 39.} As a result, SWFs may feel compelled in the future to increase their activism as shareholders as a way of fulfilling their duties towards their beneficiaries. At a theoretical level this argument may have some basis. As opposed to other bodies, however (such as institutional investors), SWFs lack the express fiduciary contacts between them and their beneficiaries. The identity of the beneficiaries is not made clear in Rozanov’s paper, although it can be understood that a SWF’s ultimate beneficiary is the citizen of the sovereign. Nevertheless, in all known cases it is practically impossible for private citizens to challenge the voting record or the investment decisions of SWFs. It is stated, for example, in Norway’s Government Pension Fund Act of 2005\footnote{No. 123 of 21 December 2005.} that the GPFG itself ‘has no rights or obligations vis-à-vis private-sector entities or public authorities and may not institute legal proceedings or be subjected to legal proceedings’.\footnote{Section 6.} It is usually an official authority’s task to supervise the activities of a SWF and ensure that the fund respects its investment mandate and all other legal requirements.\footnote{See, for example, the supervisory framework applied to Norway’s GPFG: Norges, ‘Governance Model Supervision’ (Norges Bank Investment Management).}
event, it would still be difficult to envisage a scenario whereby a supervisory authority could intervene in the investment behaviour or the voting record of a SWF in company meetings, where the SWF in question respects its investment mandate and the general laws regulating its behaviour. For such a possibility to materialise, first, additional fiduciary ties should be applied to SWFs, such as in the kind of *The responsibilities of Institutional Shareholders and Agents – Statement of Principles*, and the Stewardship Code applied to institutional investors in the UK, or establishing some form of ‘prudent man’ standard, as it is required from pension funds in the USA.

Nonetheless, it is believed by Brune that the GFC might encourage SWFs to take on more active management roles to ensure higher returns. This is partly because, as a result of the crisis, the political leadership in their home states may be less willing to trust western management without any involvement on their part. Although many SWFs deny any likelihood of change in corporate strategies with regard to activism, Rozanov argues that it would be to the advantage of SWFs to establish relationships and develop a dialogue with institutional investors and activist hedge funds to promote their mutual interests.

In the next chapter the issue of shareholder activism is dealt with again in the context of analysing the benefits and concerns posed by the SWFs’ investment behaviour. It is argued that a stronger activism from SWFs can have a beneficial impact on companies that receive their investments in the sense of

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266 n 1163.


268 Brune (n 174) 86, Rozanov (n 261) 39.


270 Rozanov (n 261) 42.
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increasing takeover premiums and contributing with valuable know how and ideas.

iii. SWFs are long-term investors

SWFs are generally said to be long-term investors. However, what constitutes ‘long-term’ is subject to interpretation. The Oxford Dictionary of Finance and Banking provides different definitions to the term, depending on where it applies: while a ‘long-term bond’ may denote one that does not mature in less than 1 year, ‘long-term debt’ describes loans and debentures that are not due for repayment for at least 10 years. Long-term investment, however, may extend to a period of 30 years or more. This important point is picked up again in chapter 3 when examining the impact of SWFs on financial markets.

Whether a SWF chooses a long-term or medium-term strategy depends on the type of the fund. For example, savings funds and pension funds set more long-term goals because they are intended for future generations. Stabilisation funds, on the other hand, are intended for risk management and not for long-term purposes. As a result, most stabilisation funds have short to medium term goals. However, as said above, it is not always easy to determine which funds are purely ‘stabilisation funds’, let alone what counts as ‘long’ or ‘short-term’.

It is a widely accepted fact, however, that SWFs generally retain their assets despite short-term price fluctuations. One of the most prominent examples of the sort include KIA’s 7.1% stake in Daimler AG—making the KIA one of the single largest shareholders of the German car manufacturer—that dates back to an investment made in 1969.

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271 Fernandes and Bris (n 389) and the ‘MidAmerican case’ n 392, 438.
272 n 440.
274 As it is said, ‘the media frequently advises people to “invest for the long term”, but determining whether or not an investment is long term is very subjective. A day trader, for example, would define ‘long term’ much differently than a buy-and-hold investor, who would consider anything less than several years to be short-term trading.’ Investopedia, ‘Long Term’ (Investopedia) <www.investopedia.com/terms/l/longterm.asp> accessed 7 November 2012.
275 Behrendt (n 257) 6.
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During the abovementioned survey by Norton Rose, 71% of SWF respondents said they regarded themselves as longer-term investors than private equity firms.\textsuperscript{276} This is almost exactly the same percentage as all non-SWF respondents when they were asked directly if they thought SWF investments were longer-term than traditional private equity investments. When asked to explain their answer to this question, typical views included observations that SWFs had longer ‘time horizons’ and that they were not engaged in ‘active management’.\textsuperscript{277}

\textit{iv. Although they acquire large stakes, most SWFs do not pursue takeover policies in western countries}

Most of the transactions executed by SWFs involve large stakes.\textsuperscript{278} This, however, does not mean that SWFs typically follow outright takeover policies. Regarding the western world, in particular, takeovers are rare.\textsuperscript{279} Past experience shows that SOEs are more likely to attempt a takeover than SWFs themselves, but since popular perceptions, and sometimes policy makers, tend to link SOEs to SWFs, the later have also acquired a reputation for pursuing similar policies.\textsuperscript{280}

According to a study by Bernstein et al., the average acquisition stake of SWFs is substantial (56.59%). In more detail, the average stake of Middle Eastern funds is much larger (62.2%) than that of the western funds (25.7%), with Asia being between the two.\textsuperscript{281} Similarly, data collected by Monitor Group

\begin{itemize}
\item \textsuperscript{276} Moore and Choi (n 251).
\item ibid.
\item See above at Table 2.1.
\item Most of the transactions in which SWFs acquired a majority stake occurred in emerging markets, Nancy Brune, ‘Preliminary thoughts on SWFs’, in Myrna (n 174) 29; Miracky and Bortolotti (n 161) 19.
\item See Chapter 1, Traynor (n 73).
\item Bernstein and others (n 100) 15-16.
\item Although Fotak and others in their study give a much smaller average acquisition stake, Fotak, Bortolotti and Megginson (n 51) 18.
\end{itemize}
The Investment Behaviour of SWFs

indicates that since 2000, SWFs have acquired controlling stakes in half of their transactions.\textsuperscript{282}

The evidence submitted by Truman in 2007 before the USA Senate seems to confirm that Middle Eastern funds are more keen on making takeovers. As he said, ‘at present, the SWFs of only 8 of the 24 countries follow investment strategies involving the acquisition of significant or controlling stakes in companies: Brunei, Canada, China, Kuwait, Malaysia, Qatar, Singapore, and the UAE and, in the cases of Canada and Malaysia, the companies involved are domestic’.\textsuperscript{283}

Finally, the extent of SWFs’ investment policies also depends on the target sector. While companies in the financial sector rarely raise objections to the investments of SWFs,\textsuperscript{284} investments in manufacturing companies usually fuel a stronger backlash and national strategic companies (such as telecoms, energy etc.) often encounter strong governmental opposition.\textsuperscript{285} These different stances reflect the fact that some types of investments may have national security or political implications, but are also determined by other concurrent factors, such as the impact of public opinion or workers’ opposition etc.

3. SWFs compared

\textit{i. SWFs vs. Hedge Funds}

\textsuperscript{5}.

\textsuperscript{283} Truman (n 82) 7.

\textsuperscript{284} For example, in the USA, the passage of the Foreign Investment and National Security Act establishing a formal review process for foreign investments suspected of compromising national security (see below n 959) explicitly deleted financial services from the list of proscribed sectors.

\textsuperscript{285} For such examples see, OECD, ‘More Governments Invoke National Security to Restrict Foreign Investment. OECD adopts guidelines to avoid protectionist use of security measures’ 2009 OECD
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SWFs present differences and similarities to other investment vehicles, notably hedge funds. A hedge fund is a unit trust that is subject to minimum regulation, typically a partnership or mutual fund that attempts to obtain gains by exploiting market anomalies.286 These funds are often high-return and are regarded as speculative. Since hedge funds and SWFs today face similar calls for regulations, a brief comparison between SWFs and hedge funds can help us put SWFs more in perspective.287

SWFs, as mentioned in the first chapter, are considerably larger than all of the world's hedge funds combined. Specifically, until the beginning of 2009, they were estimated by Teslik to have twice the size of the world's hedge funds.288 However, hedge funds use excessive leverage while SWFs are relatively unleveraged therefore, the comparison is somewhat misleading.

SWFs are comparable to hedge funds because they give rise to similar issues, such as lack of transparency.289 Neither the size nor the exact investment positions of hedge funds are publically available, a fact that allows them to take additional risks in their investment strategies and compete more effectively with other investors. This feature creates concerns over the potential impact of hedge funds in the financial system.290 This was confirmed by a former Director at the SEC, Thomsen who said, SWFs, like hedge funds, are relatively opaque and they have, by virtue of their substantial assets, substantial power in financial markets.291 However, as she said, SWFs, unlike hedge funds, 'have power derived

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286 Smullen and Hand (n 273) 195.
287 This comparison, therefore, can be useful later when discussing the most appropriate regulatory response to SWFs.
288 Teslik (n 115).
289 And as a result, the discussion on additional regulation of hedge funds, raised during the financial crisis, has similarities with the SWFs debate.
290 See, for example, the 'De Larosiere Report' on financial supervision in the EU: 'hedge funds can add to the leverage of the system and, given the scale at which they can operate, should a problem arise, the concentrated unwinding of their positions can cause major dislocations', De Larosiere and others, 'High level Group on Financial Supervision in the EU' (2009) DG Internal Market, European Commission <http://ec.europa.eu/internal_market/facilities/docs/de_larosiere_report_en.pdf> accessed 7 November 2012, 24.
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from being governmental entities, which may give them access to government officials and information that is not available to other investors.\(^{292}\)

SWFs and hedge funds present some structural similarities: most SWFs are not subject to investment rules with respect to certain asset types or currency exposures, as they are known for pension or investment funds. In terms of the range of their investment options, SWFs are, therefore, more similar to hedge funds than to the regulated fund industry.\(^{293}\) On the other hand, SWFs and hedge funds differ as a result of their different ownership status. State ownership of SWFs makes them part of a country’s wider macroeconomic objectives and thus increases their responsibility but may also include non-commercial considerations behind their investments. Hedge funds, on the other hand, are driven by purely economic motivations and, therefore, aim at generating short-term profits. SWFs, on the other hand aim at medium to long-term returns. As a result, SWFs are long-term investors (also called 'buy-and-hold') while hedge funds are more volatile, short-term investors. As a result, when comparing their direct transactions, hedge funds, although smaller, have a much stronger impact on stock markets than SWFs and, therefore, are more likely to cause imbalances in the global financial system.\(^{294}\) However, as said above, SWFs invest frequently via hedge funds thus providing considerable liquidity for the transactions performed by hedge funds and other investment vehicles.\(^{295}\)

Overall then, although SWFs and hedge funds have similarities, their differences of ownership status, use of leverage and investment behaviour suffice to place them in different categories. However, both entities’ lack of transparency may give rise to similar considerations for regulators dealing with them. Those issues are dealt with below when analysing possible regulatory frameworks for SWFs.

\(\text{\(\textit{ii. SWFs vs. institutional investors}\)}\)
Institutional investors are often mentioned together with SWFs in a comparative approach. The term ‘institutional investors’ usually denotes a large pool of investment funds. These can be pension funds, mutual funds, money managers, insurance companies, investment banks, commercial trusts or endowment funds. It was reported by Davis that the assets held in 1998 by institutional investors in the UK amounted to $2.742 trillion (representing 197% of the country’s GDP) and in the USA to $14.967 trillion (176% of GDP). In 2000 claims by institutional investors amounted to 121% of the GDP of the G7 countries. The size of institutional investors’ holdings often draws comparisons with that of SWFs.

Their appearance in the 1960s brought changes to the notions of shareholding, the bulk of which until then was dispersed in the hands of individual investors. The effect of institutional investing was to lead to a re-concentration of shareholding in the hands of fewer investors. In this sense their impact presents similarities with that of SWFs, as the later also lead to a higher concentration of shareholding, although this time on behalf of governments.

Another similarity between the two entities is that they both manage large sums of money as intermediaries (i.e. they act as a middleman between investors and firms that raise funds). Institutional investors manage their funds for the

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296 See above n 286 onwards.
299 ibid 80, table 4.
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benefit of their contributors while SWFs manage their reserves for their ultimate beneficiaries, their home countries’ citizens. However, as it was explained above, while institutional investors are usually tied by concrete fiduciary duties, such ties are absent in the case of SWFs.

SWF and institutional investors, given their large stakes under their control, both have the ability as well as the incentive to impact on company decisions.303 However, while SWFs so far have chosen not to intervene in the management of companies, this is not the case with institutional investors. As Davies noted in 2003, ‘shareholder activism on the part of institutions is now a bigger part of the corporate scene than it was, say, 20 years ago, and it is an activity which is crucially underpinned by the rights of shareholders at general meetings’.304 Most intervention by individual investors is said to take place in private (and hence is difficult to detect) and only moves to the public arena if private pressure is unsuccessful.305

The second part now turns to SWFs’ investment behaviour at times of economic crisis. For this purpose, the sample taken is the economic crisis that began in the USA with the collapse of the real estate market in 2007 but its effects were felt globally. This part begins by describing the consequences of the global economic crisis and how it affected SWFs in particular. Later comes an analysis of various types of strategies deployed by SWFs during this period of crisis.

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B. ASSET ALLOCATION AT TIMES OF ECONOMIC ‘CRISIS’

1. The ‘Global Financial Crisis’

The origins of the GFC lied in the bubble formed in the housing markets as home prices across the country increased each year from the mid 1990s to 2006 moving out of line with fundamentals like household income. The rapid rise of lending by financial intermediaries to subprime borrowers was one of the factors that helped inflate the housing price bubble. In March 2007 a larger number of foreclosures in the USA caused a decline of house prices and a general collapse of the housing market, known as the ‘sub-prime mortgage crisis’.306 This development had a negative effect on investment banks and hedge funds that had invested heavily in mortgage backed securities.307 With the help of financial innovation these securities had been repackaged and resold to a wide array of investors, thus sending the effects of the crash across the entire financial sector.308 This outcome, in turn, caused a credit crunch309 primarily affecting highly leveraged financial institutions such as Bear Stearns and Lehman Brothers.310 As a result, a number of investment banks where either sold at fire-sale prices or became commercial banks.311 It was, however, the collapse of Lehman Brothers, the fourth largest American bank, in September 2008 that became the defining moment of the 2008 stock-market crash, as it led to

309 By credit crunch is meant a liquidity crisis.
311 Ibid.
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widespread losses to the global financial markets.\textsuperscript{312} The subsequent recession led to low consumer sentiment in the USA and other countries which, naturally, dropped the demand for imported goods, thus affecting export-driven Asian economies.\textsuperscript{313} In addition, it lowered demand for oil thus harming oil-exporting Gulf economies\textsuperscript{314} (see chart 1.1 above). Although the USA government, together with other governments, devised a bailout plan\textsuperscript{315} to assist the financial sector and help the credit system function properly, financial tremors continued.

SWFs were affected in multiple ways by the above developments. Because of the devaluation of listed companies’ shares SWFs immediately incurred serious paper losses on their investments.\textsuperscript{316} Losses in alternative investments such as real estate and hedge funds also hurt SWFs in which they had equally invested. Finally, the effects of the recession and the drop in demand for oil and Asian exports also reduced the reserves of the home countries of many SWFs (see chart 1.2 above).

Although the exact starting point of the GFC cannot be easily pinpointed, for the purposes of this thesis this is taken as the second quarter of 2008.\textsuperscript{317} It was during this period when publicly-reported collective SWF financial investments plummeted mainly because of the collapse of Bear Stearns in mid-March.\textsuperscript{318} As regards the end of the crisis, due to continued market instability it is difficult to

\begin{footnotesize}
\begin{enumerate}
\item Such as China and South Korea, Barbary and Chin (n 318) 37.
\item Oil prices fell from a high of $147 a barrel in July, to $60 a barrel three months later, and closed 2008 at only $38 a barrel, ibid.
\item In the case of the USA, this was the Troubled Assets Relief Program, USA Treasury, 'TroubledAsset Relief Program' (USA Department of the Treasury) <http://www.treasury.gov/initiatives/financial-stability/pages/default.aspx> accessed 6 November 2012.
\item The ten largest bank investments between September 2007 and January 2009, worth $56.9 billion, by March 2009 were collectively worth a mere $15.7 billion, implying an apparent loss of 73\% of initial value, in barely one year, Miracky and Bortolotti (n 161) 53.
\item Although as far as the USA is concerned, the National Bureau of Economic Research declared December of 2007 as the official start of the recession, Afyonoglu and others (n 269) 44.
\item Victoria Barbary and Edward Chin, 'The rise and Retreat of Sovereign Wealth Funds', in Myrna (n 174) 34.
\end{enumerate}
\end{footnotesize}
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establish. However, it is noteworthy that from the third quarter of 2009 an increase in the activity of SWFs was observed.\textsuperscript{319} Although their performance and investment behaviour had not returned to its pre-crisis levels, it was during this period that SWFs were largely considered to have ‘returned to the fray’.\textsuperscript{320} For these reasons, the sample used to analyse the behaviour of SWFs in times of crisis shall be the period between the second quarter of 2008 until (including) the third quarter of 2009 (see also chart 2.8 below).

*Chart 2.8: SWF investments by target sector in 2008 (billion USD)*

![Chart 2.8: SWF investments by target sector in 2008 (billion USD)](image)

(Myrna (n 174) 34)

Having established the meaning and the time frame of the GFC, the next step is to give a general background on the effect that this crisis had on the investment behaviour of SWFs.

2. The Effects of the GFC


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At times of economic downturn, the investment strategies of SWFs are put to the test, i.e. most SWFs are called to revive the local economies by drawing on the financial reserves they had accumulated in the past. Therefore, sovereign funds may be used to stimulate aggregate demand or to bail out the banking sector, while stabilisation-type funds are used to make up for the low prices of natural resources. Of course, as with normal times, the investment strategies of SWFs in recessions also vary greatly between them. Certain funds simply slow down or even halt all FDI activity and focus solely on domestic issues. Because, of the secrecy surrounding the behaviour of most SWFs there is no detailed account of the exact investment patterns for SWFs at times of crisis.

It should also be emphasised that since the large majority of SWFs are still new and the current financial crisis is the first to put SWFs under strain, there is no precedent on the strategies of SWFs at times of crisis. There is, however, sufficient information on their reaction to the deteriorating market conditions that followed the property bubble burst of 2007 which would allow us to draw valuable conclusions.

Until the second quarter of 2008, SWFs seemed to have survived the negative effects of the property bubble burst in the USA.321 The credit crunch that followed the collapse of the housing market towards the end of 2007 made it difficult for a number of high profile financial institutions to obtain credit and many fell in urgent need of capital.322 Under these circumstances, financial institutions normally draw capital from their shareholders. This time, however, they decided to address themselves to SWFs mainly because of their large available reserves to invest in the financial sector. Drawing funds from SWFs would also allow banks in the west to avoid the lengthy procedural requirements of convening an extraordinary meeting of shareholders.323

322 Such capital is also usually needed for reputational reasons, because investors needed to have the assurance that the companies they invest in are, and will continue to be, financially sound.
323 For the UK, these are found at sections 302-333 of the Companies Act 2006.
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Thus, in the course of a few months, by the first quarter of 2008 SWFs had substantially increased their presence in the USA and the EU through their high-profile investments in various financial institutions.324 In January 2008 Morgan Stanley analysts pointed out that 93% of $75 billion invested in western financial companies until then had come from five states: Singapore, China, Dubai, Abu Dhabi and Kuwait.325 Drezner estimated that between March 2007 and June 2008 SWFs injected a total of $59 billion in troubled western financial institutions,326 while figures from Dealogic put the value of cross-border equity investments by SWFs in 2009 until June at $21.1 billion.327

As the crisis deepened towards the second, but more intensely in the third and fourth quarters of 2008, more companies in the EU and the USA operating in all sectors of the economy, such as the car-making industry,328 experienced severe difficulties and began to seek capital from SWFs to keep themselves afloat. But by then, the price of oil as well as the growth rates of countries like China, Russia and Singapore had fallen sharply, thus reducing the inflows of cash into SWFs’ reserves. Moreover, most SWFs had already made serious paper losses on their previous investments.

324 Examples include,


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As demonstrated by the GFC, in global recessions the strategies of SWFs can generally be divided into three categories, sometimes applied separately and sometimes in combination: First, certain SWFs stop investing abroad (and in rare cases they even sell assets). Second, most funds apply their funds to bail out domestic economies, and third, a number of them seek opportunities for further investments abroad. Many SWFs followed a combination of the above strategies, either simultaneously or consecutively, depending on the financial situation of each individual SWF.

The first confirmation that SWFs were under strain came with the announcements of modification of their foreign investment plans, and for this reason, this type of behaviour is dealt with first.

i. **Interruption or modification of foreign investment plans**

Amid an uncertain economic environment caused by the declining share values of major investment banks such as Citigroup, and having endured severe losses, the majority of SWFs decided that FDI in western financial firms should be brought to a halt. Indeed, as the share values of major western financial companies were decreasing, it was reported that certain SWFs had been reviewing their earlier investments in those companies, while others became the targets of criticisms in their home countries for buying shares shortly before their values plummeted. For example, ADIA’s returns as a bondholder at Citigroup had been unaffected by continuing troubles in the company, but the dramatic fall in Citi’s share price had eroded the conversion value of the mandatory convertible bonds. In the original deal with ADIA, the Citi securities were to be converted into common stock at a price between $31.83 and $37.24 a share between March 2010 and September 2011. Citi, at the time, traded at $1.50 a share, Stanley Carvalho, ‘Abu Dhabi Reviewing Citigroup Investment: Sources’ Reuters (London, 1 March 2012) <www.reuters.com/article/newsOne/idUSTRE52012320090301?sp=true> accessed 20 December 2012; See also, John Burton, ‘Singapore Sovereign Fund invested “Too Early” in Citigroup and UBS’ Financial Times (London, 5 March 2012) <www.ft.com/cms/s/0/6bf45310-0926-11de-b8b0-0000779fd2ac.html> accessed 20 December 2012.


330 For example,
The Investment Behaviour of SWFs

As a result, SWFs gradually altered their investments policies. Funds from the Gulf or Asia gradually slowed down or completely stopped investing in the, once lucrative, western financial sector.\(^{331}\) Certain funds, such as GIC Singapore, which was estimated by analysts in late 2007 to have had an asset value of $300bn, in March 2009 according to Singapore’s Prime Minister, cut the equity position in its portfolio from 60% to about 45% in anticipation of a downturn in the global economy.\(^{332}\) It, moreover, announced that in the future it would be more cautious and take fewer risks.\(^{333}\)

The overall volumes of transactions confirm the above contention. During the second quarter 2008, following the collapse of Bear Sterns, only $3.6 billion were invested by SWFs globally, while it is indicative that the third quarter saw no investments in USA and EU financial companies at all.\(^{334}\) In the fourth quarter of 2008 SWFs gradually shifted away from western markets and moved towards emerging ones. The latter received over 70% of SWFs’ investments in the last quarter of 2008.\(^{335}\) As Monitor Group notes, from July to the end of September 2008, ‘twenty-one of the thirty-nine SWF transactions were in emerging markets, and these were spread across a range of sectors, including industrials and aerospace, in addition to their mainstays of financials and energy’.\(^{336}\) The downturn continued in the first quarter of 2009, during which only $6.8 billion were recorded in SWF investments\(^{337}\) (see charts 2.9 and 2.10 below).

*Chart 2.9: SWF cross border activity 2000 – 2008 (end of May)*

\(^{333}\) Burton (n 329).
\(^{334}\) Miracky and Bortolotti (n 161) 5.
\(^{335}\) ibid 15.
\(^{336}\) ibid.
Despite the general decline, a number of SWFs reportedly increased their exposure in the commodities market. The reason for this is because commodities prices have been low for some time but, as opposed to the stocks in

338 Such as energy, water and food,
It is also stated in the article that QIA intends to preserve its dollar denominated bonds in the short-term, but it could not guarantee that it would not shift towards the euro in the future.
financial companies, they were expected to gain more value quicker in the near future.\textsuperscript{339}

A final type of strategy that was applied in response to the crisis is that of asset sales. As seen earlier, SWFs typically invest with long-term prospects and early sales of assets are exceptional. Nevertheless, a few cases were observed. Such was the case of Temasek Holdings’ sale of its entire stake in Bank of America in March 2009 after the value of its holding in the investment bank fell when it was merged with Bank of America in January 2009.\textsuperscript{340} Temasek defended the sale stating that their ‘investment thesis had changed from Merrill’s specific businesses to a more diversified linkage to the broader USA economy’.\textsuperscript{341} Temasek said that its intention was to ‘rebalance its portfolio when the nature of the investment and risk environment had changed’.\textsuperscript{342}

Two further cases of QIA and Abu Dhabi’s International Petroleum Investment Co (IPIC) involved a sale of Barclays shares. In April 2009 Qatar Holding, the biggest shareholder in the Barclays, and an arm of QIA, said it sold 35 million shares in the British bank to cut its stake to 5.8% from just over 6%.\textsuperscript{343} The sale was ‘a part of a volatility-driven portfolio management strategy which it applies to a small part of its aggregate holding’.\textsuperscript{344} Qatar, however, stated that it would remain supportive of Barclays in the future.\textsuperscript{345} A few months later, in May-June 2009, PCP Gulf Invest, owned by Abu Dhabi’s IPIC sold more

\textsuperscript{342} ibid.
\textsuperscript{344} ibid.
than 1.3 billion Barclays shares, seven months after helping the British bank avoid a government bailout.\textsuperscript{346} As opposed to Qatar's sale, which incurred serious losses, IPIC had made a good profit from the rise in the share price and was 'cashing in'.\textsuperscript{347} The sale was said to have caused a 14\% drop in Barclay's share price.\textsuperscript{348}

These abovementioned instances of early sales are rare (see below, table 2.2). Taking 2008 as a benchmark, investments in the financial sector still dominated the overall picture. According to Monitor Group, in 2008 the financial sector accounted for 28\% of the SWFs deals, worth 75\% of the total value.\textsuperscript{349}

\textbf{Table 2.2: Major divestments by SWFs}

\begin{tabular}{|c|c|c|c|c|}
\hline
Date & Target & Divisor & Acquirer & Transaction value (USD m) \\ 
\hline
Aug 07 & Burgan Bank SAK & KW & Kuwait Investment Authority & KW & 158 \\ 
\hline
Jun 05 & Arab Malaysian Investment Bank & HS & Kuwait Investment Authority & KW & Market Purchase & NA & NA \\ 
\hline
Jun 05 & China Construction Bank Corp. & CN & Central Huijin Investment Co Ltd. & CN & Bank of America Corp & US & 3,000 \\ 
\hline
Jun 05 & China Construction Bank Corp. & CN & Central Huijin Investment Co Ltd. & CN & Tszalmak Holdings (Pte) Ltd & SG & 2,466 \\ 
\hline
Jun 05 & Vietnam Investment Fund Ltd. & VI & Abu Dhabi Investment Authority & AE & Keppel Corp Ltd & SG & 1,600 \\ 
\hline
Feb 05 & CIX AR & DE & Qatar Investment Authority & QA & Dose Duke Ltd & AE & 491 \\ 
\hline
Feb 05 & Merrill Lynch & & US & Tszalmak Holdings (Pte) Ltd & SG & Hana Bank & 2,466 \\ 
\hline
Feb 05 & London Stock Exchange plc & UK & Guitar Investment Authority & QA & Market Purchase & UK & 664 \\ 
\hline
Feb 05 & Bank of Communications Co Ltd. & CN & Central Huijin Investment Co Ltd. & CN & People's Republic of China & CN & NA \\ 
\hline
Feb 05 & China Construction Bank Corp. & CN & Central Huijin Investment Co Ltd. & CN & Bank of America Corp & US & 1,600 \\ 
\hline
Jan 05 & PT Lion Bank Thk & ID & Khozarah Holdings Ltd & MY & Sberbank of Russia & RU & 2,604 \\ 
\hline
Jan 05 & Lotus India Asset Management Co. & IN & Tszalmak Holdings (Pte) Ltd. & IN & Religare Enterprises Ltd & IN & 1,427 \\ 
\hline
Jan 05 & China Construction Bank Corp. & CN & Central Huijin Investment Co Ltd. & CN & Bank of America Corp & US & 1,600 \\ 
\hline
Jan 05 & Bank of America Corp. & CN & Central Huijin Investment Co Ltd. & CN & Bank of America Corp & US & 1,600 \\ 
\hline
Jan 05 & International Petroleum Investment Co. & UK & International Petroleum Investment Co. & AE & Market Purchase & UK & 5,641 \\ 
\hline
\end{tabular}

(Kern, 'State Investments' 2009, 28)

\textit{ii. Shifting focus on domestic issues}

Another practice applied by most SWFs during the period studied was to shift their attention to internal issues and apply their reserves to stimulate domestic economies. On the one hand, diversification of a country’s risk and revenue stabilisation sometimes may be the primary objective of a SWF. In those cases,

\begin{flushleft}
\textsuperscript{347} ibid.
\textsuperscript{348} Peter Larsen and Kate Burgess, 'Barclays Falls 14\% After IPIC Sells its Stake' \textit{Financial Times} (London, 3 June 2009) \texttt{<http://www.ft.com/cms/s/0/c4938e46-4fd5-11de-a692-00144feabdce0.html> accessed 26 December 2012.}
\textsuperscript{349} Miracky and Bortolotti (n 161) 11.
\end{flushleft}
The Investment Behaviour of SWFs

therefore, applying the fund’s reserves domestically is part of the fund’s original purpose. This is, for example, the case of the Russian Stabilisation Fund. On the other hand, some SWFs accumulate funds for different purposes and their mandate does not include reviving economy or bailing out domestic companies. Therefore, applying funds in this way appears to be a deviation from their pure profit maximisation objectives in favour of broader macroeconomic and financial stabilisation objectives. These cases prove that governments can be quite flexible as to how to use their SWFs to achieve multiple objectives.

One salient example is Norway’s GPFG. Although its name indicates that is intended to cover pension liabilities, in practice it behaves just like most wealth accumulation state-funds. During the crisis, it was stated by the Norwegian Prime Minister that the country had held back and been restrictive in its use of oil revenues in strong times, but they 'could start and spend more now that [they saw] a downturn coming'. According to Ziemba, Norway's stance was already expansionary as its fiscal rule allows it to spend up to 4% of the GPFG's assets (the assumed return on investment in most years) to meet its non-oil deficit. Although the Norwegian government had already applied a considerable amount of stimulus money from their SWF, additional funds were decided to be drawn on mainly for pump-priming, focusing on public building works supporting local governments and labour market measures. Thus, in January 2009 the Norwegian government announced a 20 billion kroner (£2.112 billion) fiscal-stimulus plan that included spending on infrastructure projects and tax-reliefs for businesses. Furthermore, in February 2009, the Prime Minister unveiled a 100 billion kroner (£10,565 billion) plan to inject capital into the country's banks

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350 These are, for example, the cases of the KIA, whose purpose is mainly to save funds for future generations and the Norwegian and Irish funds that is officially classified as pension funds.
352 Rachel Ziemba, 'Raiding The Sovereign Rainy Day Fund' (RGE Analysts EconoMonitor, 2008) <www.economonitor.com/analysts/2008/12/16/raiding-the-sovereign-rainy-day-fund/> accessed 7 November 2012; Also note that the Norwegian fund is precluded from investing locally.
353 ibid.
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and lend directly to banks and other businesses by buying corporate bonds.\textsuperscript{354} Unlike other European countries, which had to take on more debt to fund increased government spending, Norway was able to tap its oil revenue by using the reserves of its SWF. These measures, however, did not prevent Norway from falling into recession in the second quarter of 2009,\textsuperscript{355} but the stimulus money is said to have helped Norway minimise the contraction to a 0.4% in the first quarter of 2009.\textsuperscript{356}

Other countries have also made use of the SWFs’ considerable resources to offset the impact of the economic crisis in their country. According to Oxford Analytica, SWFs have been used for a variety of purposes. Russia planned drawing on its Reserve Fund to cover the government budget deficit of roughly $75 billion for 2009. Singapore also drew down on past reserves managed by GIC for the first time in the country’s history, while it also considered briefly, but finally rejected, the idea of setting up a ‘Temasek II’ fund to help local firms.\textsuperscript{357} Gulf countries followed a similar route. The government of Kuwait issued a resolution to support and eventually boost the Kuwaiti economy, and assigned to KIA a critical role in buying domestic bank shares to help boost bank capitalisation and confidence in Kuwait.\textsuperscript{358} QIA also said it would buy 10-20% of local banks’ equity portfolios in a $5bn plan.\textsuperscript{359}


\textsuperscript{356} Continued investments in the energy industry have cushioned the effect of the global recession in Norway. The country’s coalition government said in May 2009 that it would spend more of its oil wealth this year to help stimulate the economy and create jobs, see Matthew Saltmarsh, ‘Norway Slides Into Recession’ NY Times (New York, 19 May 2009) <www.nytimes.com/2009/05/20/business/global/20kroner.html> accessed 26 December 2012.


\textsuperscript{358} Karen Remo-Listana, ‘Regional SWFs’ Global Role to Continue’ Emirates Business 24/7 (Dubai, 13 May 2009 <www.emirates247.com/eb247/economy/uae-economy/regional-swfs-global-role-to-continue-2009-05-13-1.32604> accessed 26 December 2012; The USA Department of States mentions that: ‘the Ministry of Finance announced in December 2009 that the Kuwait Investment Authority would set up a KD 1.5 billion ($5.4 billion) fund to invest in Kuwaiti equities listed on the bourse, though the mechanisms for that investment are unclear’,
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During the second quarter of 2008, domestic investment by SWFs made up 10% of all transactions.\textsuperscript{360} By the final quarter this figure rose to over 40%, thus reversing for the first time since 2002 a trend of declining domestic investments.\textsuperscript{361}

After discussing the first two types of responses to the crisis, it is time to examine the cases where the crisis created new investment opportunities for SWFs in western countries and other parts of the world. This, equally important, strategy is analysed next.

\textit{iii. Investing against the flow}

Although there is no doubt that most SWFs incurred losses during the recession, even then some continued to demonstrate a strong appetite for investments. Indeed, the lost value of global equities and the drop in property prices was said to have created new opportunities for many SWFs to expand their investments in areas that might have not been possible before.\textsuperscript{362}

This type of strategy concerned primarily funds originating from China. Chinese funds, and in particular CIC, had abstained for a certain period of time from making large investments in Europe and other western countries. The reason for this approach was the increased scepticism in Europe over the potential political motivations behind Chinese investments. As a result, according to Jiwei, Chairman of CIC, before and during the worst part of the crisis

\begin{flushright}
\textsuperscript{360} Miracky and Bortolotti (n 161) 15.
\textsuperscript{361} ibid.
\textsuperscript{362} This strategy explained here differs from the one described above whereby SWFs intervened in the beginning of the crisis to provide liquidity to ailing financial institutions. Since in the beginning of the crisis most SWFs’ had yet to incur losses, expansion of investments was a more normal practice for them. The investments studied above took place much later and despite the heavy losses suffered by SWFs in their portfolios.
\end{flushright}
The Investment Behaviour of SWFs

CIC focused primarily on emerging markets and thus managed to avoid the losses suffered by SWFs that had invested in western companies.\footnote{As he characteristically said, ‘officials in Europe told me they wanted me to state clearly that we wouldn’t take stakes of more than 10%, or ask for voting rights ... so I said fine, if Europe doesn’t want me, I won’t go. So I want to thank these financial protectionists, because as a result, we didn’t invest a single cent in Europe’, Jason Dean, ‘China Wealth Fund to Boost Investments’ The Wall Street Journal (New York, 20 April 2012) <http://online.wsj.com/article/SB124006120569931959.html> accessed 26 December 2012; Tom Mitchell, ‘China Set to Invest Again in Europe’, Financial Times (London, 20 April 2012) <http://online.wsj.com/article/SB124006120569931959.html> accessed 26 December 2012; Reuters staff, ‘Daimler Held Talks with China Wealth Fund’ Reuters (London, 21 April 2012) <http://www.reuters.com/article/euPrivateEquityNews/idUSTRE53K3TC20090421> accessed 26 December 2012.}


Moreover, in an attempt to diversify its investments, CIC within months bought stakes in a Canadian miner\footnote{Rob Wilson and Jeffrey Hodgson, ‘Cash Rich China Eyes Canada’s Rich Resources’ Reuters (London, 13 July 2009) <www.reuters.com/article/mergersNews/idUSN1315366120090713> accessed 26 December 2012.} and an Australian property trust,\footnote{ibid.} and even
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British drink maker Diageo. It, finally, also participated in the massive bailout of the Canary Warf in London.

Nevertheless, Chinese funds also faced challenges during the downturn, especially through their past investments in USA government bonds and as a result of the recession in the USA and the stimulus packages used to revive the economy China became worried over the value of its holdings. In particular, China feared that heavy borrowing and fiscal stimulus in the USA would cause subsequently interest rates to rise and, thus, erode the value of their held bonds. In this context, in March 2009 at a news conference, the Chinese Premier Jiabao called on the President of the USA to ‘maintain its good credit, to honor its promises and to guarantee the safety of China’s assets’.

Other funds, especially from the Middle East, have equally used the economic downturn to increase their investments despite their losses. Al Ansari, CEO of DIC, had already stated in the end of 2008 that DIC was facing serious economic challenges, but he would still consider the ‘phenomenal’ acquisition opportunities that would arise in the next one to two years as asset prices declined. By the same period, and in the wake of their high profile investments into Barclays and Manchester City Football Club, investors from the Middle East prepared to inject billions of dollars into British companies, mainly in shipping and property but also in the football industry.

The above investments do not suggest that SWFs are ‘recession-proof’, but rather that opportunity costs created by all time low equity prices urged them to invest despite their heavy losses. In other words, those investments were

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370 ibid.
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strategic, meaning that they were not intended to bring immediate returns but were expected to do so in the future (thus fitting with SWFs’ long-term outlook). These investments became a precious source of capital for many western companies during the recession. This and other benefits brought by the operation of SWFs are dealt with at the next chapter.

3. The behaviour of SWFs post crisis (end of 2009 onwards)

At the time of writing it is still early to speak of a post-crisis scenario. As a sovereign debt crisis is still affecting Eurozone members and the USA post-crisis recovery is still fragile, resulting economic instability and market uncertainty preclude safe predictions about the future behaviour of market actors. Nevertheless, certain estimates are possible.

Analysts, for now, do not expect dramatic changes in the future as regards the investment behaviour of SWFs. Monitor Group asserts that, although MENA SWFs have made small adjustments strategies, the financial crisis may not have had a long-lasting effect on their investment behaviour. It is believed by Smith that once financial stability returns, it is expected that this increasingly important pool of money will again be deployed in the west as well as in the east.

On the other hand, SWFs could, as a result of the crisis, become more activist to ensure the continued profitability of their investments. In this case, SWFs could be seen in the future becoming more engaged in the supervision of the management of the companies they invest in and use their voting power in company meetings more proactively.

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377 Middle-East and North Africa.
378 Miracky and Bortolotti (n 161) 34-37.
The Investment Behaviour of SWFs

Several signs suggest that SWFs may become more willing to engage in partnerships and joint ventures with other investors to carry out their projects. One of the leading reasons cited for this trend is the advantage of being able to use a partner’s local knowledge. Another important motivation might be a desire to diversify risk.

Finally, lately SWFs appear to have increased their investments in the renewable energy sector. This could be seen as an attempt to obtain commercial as well as general environmental benefits through their investments. It is said, for example, that certain countries could kick-start green energy projects and then invite SWFs to contribute. Such a contribution would be invaluable as the world is said to face an annual funding gap of around $150 billion on projects to cut carbon dioxide emissions. The increasing interest of SWFs in the sector could help fill this gap especially if the performances of the renewables begin to match that of other asset classes.

CONCLUSION

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381 Natsuko Waki, op. cit.


384 ibid.
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It was seen that, SWFs, through their investments, have a strong presence in western markets, although some of the most notorious investments – finalised or intended – by foreign sovereigns did not originate from SWFs but, rather, from SOEs.

SWFs’ investment strategies are generally quite sophisticated although sometimes they are limited to ‘trends chasing’ and invest largely in financial assets but also in alternative investments. Their regional preferences clearly favour the developed world, they are relatively risk averse and mostly favour long-term investments. SWFs usually opt for a passive stance but there are also examples of active sovereign investors with beneficial results. SWFs share many similarities with other types of investors, such as hedge funds and institutional investors, although their size and ownership status renders SWFs a distinguished class of investor.

The GFC offers a unique case study of the investment strategies of SWFs and can help understand more about their behaviour at time of economic slump. It also contributed to changing many of the general perceptions about SWFs. First, during the crisis some SWFs either modified or completely interrupted their investment plans, and in some cases even sold assets. Second, they invested much of their large reserves domestically to counteract the effects of the crisis on their home markets. Third, a significant number of SWFs, despite their heavy losses saw financial opportunities arising and thus expanded their foreign investments. In some cases these investment strategies changed overtime or overlapped with one another.

In the future, no dramatic change of SWFs’ investment strategies are expected, although it is possible that they will increase their shareholder activism to ensure the continued profitability of their investments. In addition, SWFs appear to invest more frequently in the form of partnerships and joint ventures. Green energy projects are also attracting a growing number of SWF investments.

Providing an analysis of SWFs’ investment strategies was necessary to examine the benefits as well as the main issues of concern that derive from those strategies for recipient countries. The next chapter examines all those issues, as well as a possible rationale for regulating SWFs.
INTRODUCTION

Analysing the investment behaviour of SWFs in chapter 2 was necessary to understand the issues that surround SWFs and examine the case for regulating them. First, a better comprehension of the role and practices of SWFs can alleviate concerns in recipient economies and reduce protectionist pressures. Second, it is also important for recipient economies to have a realistic view of the potential benefits and challenges that FDI can bring to their economies. Third, SWFs themselves need to have a better understanding of those issues so that they can improve their internal governance.

The present chapter aims at identifying the main benefits and special challenges that flow from the investments of SWFs, with particular focus on western economies. As it is generally accepted, regulation is warranted where the costs of market imperfections and failures is greater than the costs of regulation itself.

Applying this principle to the case of SWFs, it becomes essential to examine what market imperfections or failures, if any, exist in the first place. Moreover, the analysis in the present chapter can be of interest not only to policymakers but also to the general public and western media as these actors often fuel popular backlash and drive regulators to introduce measures against SWFs.

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386 This is also called ‘risk assessment’, meaning identifying and assessing the seriousness of the specific areas where detriment to consumers and firms is likely to arise; the economic benefits can then be identified as the impact of the policy on the different risks identified, Isaac Alfon and Peter Andrews, ‘Cost-Benefit Analysis in Financial Regulation’ (1999) Financial Services Authority, Occasional Paper Series 3, 20.
The present chapter deals, firstly, with the general benefits brought by the SWFs’ investments, such as the introduction of liquidity in financial systems and their stabilisation at times of crisis. The following section goes on to analyse the potential costs that may arise from such investments. In this context, the chapter aims to examine the merit of the arguments put forward in favour of or against SWFs, before discussing what is their practical value. This exercise leads to a conclusion based on whether the benefits or the costs exceed one another.

1. Benefits Brought by the Operation of SWFs

   i. SWFs as special foreign investors

One obvious benefit of SWFs is the fact that they offer a valuable source of FDI. In this way, SWFs benefit the functioning of the global capital market and provide funding for global investment. This, in turn, may have a stabilising effect on national economies: as noted by a study focusing on the USA economy, between November 1982 through to December 2007 large overseas capital was available and the economy was in recession only 4.6% of the time. On the other hand, between 1945 through to 1982, foreign capital was generally unavailable, and recession counted for 22.4% of the time.387

Stability in the international financial system can also be reinforced by SWFs’ longer-term strategic outlook. As seen from practice, long-term investors with no imminent call on their assets, and with mainly unleveraged positions, as SWFs are, are able to resist market downturns for longer or even go against market trends.388

Other potential benefits derive from the extraordinary size and strength of SWFs as investors. According to an analysis by Fernandes and Bris, SWFs can be more pro-active in the takeover market and block value-reducing acquisitions by

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387 Will (n 549).
the companies they invest in. Because of their interest in stock returns, SWFs stay away from strategies that purely pursue value-destroying consolidation and scale.\(^{389}\) SWFs can also contribute to increase the takeover premiums\(^{390}\) in the companies where they invest.\(^{391}\) This was illustrated by the case of the opposition between the Norwegian SWF and MidAmerican during the latter’s bid for Constellation, where the Fund pressed the bidder to make a higher offer.\(^{392}\) As this case showed, SWFs can be powerful enough to exert external pressure even as non-controlling shareholders.

Potentially, SWFs can be efficient internal corporate governance mechanisms, and reduce agency costs that flow from the gap between shareholders and top executives.\(^{393}\) This argument is based on a shareholder theory by Shleifer and Vishny.\(^{394}\) As they pointed out, small shareholders lack incentives to monitor managerial performance while large shareholders would offer a partial solution to the free-rider problem and greatly improve monitoring. Fernandes and Bris claim [above] that this contention is also relevant to the case of SWFs. As a substitute for the legal system, one expects the value effect of SWFs to be larger when they invest in companies coming from countries with a weaker legal system. However, the analysis by Fernandes and Bris on SWF holdings in the five years preceding the study shows that the SWF premium is the same no matter what the level of the country of origin’s investor protection.\(^{395}\)

Unlike other types of institutional investors, SWFs provide guaranteed capital in case of future funding needs and therefore reduce the uncertainty regarding the firm’s future financing ability. SWFs have two particular advantages when compared to regular institutional investors, they are larger and


\(^{390}\) A premium is essentially the surplus paid by the bidder for each share.

\(^{391}\) Fernandes and Bris (n 389) 8.

\(^{392}\) In late 2008, Norway’s Government Pension Fund opposed MidAmerican’s bid for Constellation, where the Fund had a 4.8% stake. MidAmerican Energy Company’s bid was interestingly backed by Constellation’s management itself. However Norway’s SWF considered the price insufficient and has brought MidAmerican to court.

\(^{393}\) For an explanation of ‘agency costs’, see n 260.


\(^{395}\) Fernandes and Bris (n 389).
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are still relatively underexposed to equities: As SWFs have access to massive funds, the market rewards the unlimited access to capital of the firms where they invest.\textsuperscript{396} Current estimates by Fernandes and Bris suggest that SWFs have not invested heavily in equities, particularly as compared to most pension funds or other institutional investors.\textsuperscript{397} Hence, it is expected that SWFs will eventually increase their exposure to equities in the coming years to about 40%.\textsuperscript{398} The same assumption is shared by Clark and Monk whose research showed that SWFs will increase their allocation in equities in the years following their study.\textsuperscript{399}

SWFs make companies more valuable because they reduce firms’ cost of capital, as a result of their commanding lower risk premiums.\textsuperscript{400} The opportunity cost of sovereign funds is to invest in risk-free instruments, like USA bonds, as had been their common practice in the 1980s. Furthermore, relative to their size, a single SWF stake represents a small percentage of their total assets anyway, and the marginal investor of the firms where they invest becomes a more global, international, less risk-averse investor.\textsuperscript{401}

According to a European Commission Communication, another important benefit of SWFs, relates to the euro currency: given the tendency towards a diverse range of investment, SWF investments could support the international role of the euro over the medium term.\textsuperscript{402} As the Communication states, for foreign exchange reserves, the goal is liquid and safe assets denominated in a currency with low foreign exchange conversion costs – which tends to favour the

\textsuperscript{396} For example, both studies by Fotak et al. and Kotter and Lel find that on the announcement date of the SWF offer the value of the company’s stock reacts positively, Kotter and Lel (n 218) 4; Fotak, Bortolotti and Megginson (n 51) 17.
\textsuperscript{397} Fernandes and Bris (n 389) 8.
\textsuperscript{398} ibid.
\textsuperscript{400} Fernandes and Bris (n 389) 8.
\textsuperscript{402} Commission (n 1) 4.
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USA dollar. SWFs, on the other hand, ‘have more freedom to choose their investments. This is likely to mean a higher share of the euro assets than now is the case for reserves’. However, while an increased international use of the euro would definitely bring benefits, a hasty shift towards the EU currency by SWFs could put unwelcome upward pressure on the euro. In particular, an excessive appreciation of the Euro, especially during a recession, could entail a drop in exports and industrial production and thus should be avoided.

Additionally, SWF investments yield considerable benefits for the developing world. In fact, SWFs could become major actors of development finance. As it was estimated by the OECD in April 2008 (however under different size and growth estimates for SWFs), if funds chose to allocate 10% of their portfolio to emerging and developing economies over the next decade, this could generate inflows of $1.400 billion, more than all OECD countries’ aid to developing economies put together.

Overall, as noted by the former EU Trade Commissioner Peter Mandelson, ‘we should be much more worried if these investors were not interested in Europe. If they did not rate the euro as a safe reserve currency. If they did not want to invest in euro-denominated assets. Our response should emphasise the positive rather than the paranoid’.

ii. Stabilising western economies

The GFC has helped to underline the potential benefits of SWFs as a stabilising force. Problems in credit markets since the end of 2007 have squeezed liquidity in several key financial markets and increased pressure on

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403 ibid.
404 ibid.
the capital base of financial institutions. As it is was also recognized by the European Commission, several of these institutions have recapitalised with the help of investment from SWFs. SWF investments has thus helped to strengthen the global banking system and to underpin confidence in the international financial system as a whole.

The IMF estimated that by February 2008 SWFs invested over $35 billion into large banks. Concerning financial institutions in particular, it is reported by IFSL that since the spread of the sub-prime crisis in 2007 and until April 2008, SWFs invested between $60 and $92 billion in return for large minority stakes in financial institutions. Of those investments, ‘over two-thirds of the capital invested in foreign financial institutions in 2007 and early 2008 came from Asian SWFs (13% from China), with Middle Eastern SWFs generating the remainder’. These are likely to have facilitated the re-stocking of the capital bases of important banks and helped minimise the impact on credit markets of large bank losses, and safeguard the continuation of bank lending.

Very importantly, it is argued that SWFs may have even contributed to global economic recovery by reinvigorating international investment. Various analysts took a similar position based on the observation that SWFs returned to making high profile acquisitions in the middle and towards the end of 2009 combined with the fact that oil prices had then stabilised at $70 a barrel. This belief was also nurtured by the expectation that SWFs would increase their allocation of equities as a reaction to the crisis within the next few years

407 Commission (n 1) 4.
408 Notably in Citigroup, Merrill Lynch, Morgan Stanley and UBS, Allen and Caruana (n 213) 10.
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(mentioned above).412

Interestingly, given that SWFs seek to maintain a low profile, this acknowledgment of their positive impact can make them feel uncomfortable. As mentioned by a SWF official ‘whether SWFs are criticised of hiding political motivations or are described as charitable organisations, the same answer applies, SWFs are profit maximising firms, nothing more’.413

1. Risks Posed by the Operation of SWFs

Although SWF investments do bring undeniable benefits, they also sometimes become a source of concern for recipient countries. It is accepted by a large part of the relevant literature that the state-owned character of SWFs, combined with their lack of transparency may create a number of risks that should be acknowledged and, if necessary, rectified through a regulatory response in order for SWF investments to continue to flow into the EU and other western countries.

However, before expanding on those potential risks, it is important to put forward a number of considerations that sometimes lie behind those concerns. These are dealt with separately because they are not risks as such, but rather factors that contribute to shaping certain attitudes towards SWFs.

The first consideration is that SWFs, as state-owned entities, challenge western perceptions of private enterprise capitalism. Throughout the 20\textsuperscript{th} century western governments have encouraged the idea – in certain countries more than others – that private enterprise is the most effective form of company and that management by the state more often appears to be ineffective. As a result, many western governments have since the second half of the 20\textsuperscript{th} century embarked upon the privatisation of state-owned companies operating in many fields of the economy. This process was possibly also led by the belief that the management state-owned companies can never fully escape from political

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412 Clark and Monk (n 399) 12; Fernandes and Bris (n 389) 8.
413 Unnamed SWF officer (n 74).
influences or discard political considerations.\textsuperscript{414} In this sense, their privatisation could increase their independence and their effectiveness and would allow them to focus better on profit maximisation.

The very existence of SWFs (or SOEs too for that matter) presents a challenge to this long established belief. Firstly, SWFs are completely owned by the state and yet they often exhibit the same level of sophistication and a similar focus on profitability as one would expect from private owned investment vehicles. Secondly, through their investments, SWFs and SOEs originating from developing countries raise questions as to why they would be more capable to participate in the operation of western companies since western governments themselves chose to abstain from this business and entrust them to private actors. In a 2007 article, former USA Treasury Secretary Summers, described SWFs as the ‘principal irony of the international financial system’ pointing out that formerly state-owned enterprises in the west are now slowly coming under the control of foreign governments.\textsuperscript{415} The question therefore remains: Since committed free-market governments chose to privatisate state-owned companies in the first place, how can it be that the international financial system drives those companies once again under government control?

The second consideration that ought to be stated is that the numerous investments by SWFs reveal an underlying concern that western countries do

\textsuperscript{414} It is stated for example by an OECD paper that:

‘when governments undertake commercial activities, they remain answerable to a wide range of societal pressures that their governance structures are designed to take into account. For this reason, governments may encounter difficulties in making credible commitments to pursue only ‘commercial’ objectives, since their raison d’être involves being sensitive to political pressures and to pursuing non-commercial objectives’.


\textsuperscript{415} Summers (n 302):

This process has also been described as ‘cross-border nationalisation’, or ‘nationalisation through the back door’,


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not generate enough wealth to compete with other economies of the world, leaving them no other option but to sell debt or rely on capital inflows in order to finance their budgets. Today, it becomes increasingly obvious that the productivity of many western economies can no longer outperform the productivity and competitiveness of Asian economies and no western country can match the revenues produced by oil exporting countries (see chart 1.3). In short, this is an argument relating to the long-term viability of western economies.

Chart 3.1: Official reserves held by central banks,
USD tr. (left) and % of total USD (right) 6.4 tr. at end of 2007

(Kern, ‘SWFs and Foreign Investment Policies’ 2008, 5)

The current account deficits recorded in many western economies mean that those governments rely on debt or foreign

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416 For more information on the official reserves of developing and industrialised countries, as well as information on current account balances see:
Kern (n 101) 5-6.
417 A current account is a ‘sub-account of a nation’s balance of payments accounts consisting of visible and invisible trade plus private and official current transfers; capital flows are in the separate capital account’, Rutherford (n 247) 126; Developed countries today, as a group, run progressively larger current account deficits while the developing world, as a whole records current account surpluses, Bank of England, ‘Sovereign Wealth Funds and Global Imbalances’ (2008) Quarterly Bulletin, Q2, Bank of England <www.bankofengland.co.uk/publications/quarterlybulletin/qb080207.pdf> accessed 8 November 2012, 196.
investment inflows in order to stay afloat.\textsuperscript{419} As opposed to nations owning SWFs that typically enjoy budget and current account surpluses, western nations rely on those SWFs to finance their deficit by buying government debt or rely on them to invest in local economies by purchasing domestic equities.\textsuperscript{420} Behind some of the usual criticisms on SWFs,\textsuperscript{421} it is not very difficult to discern an underlying concern that it is simply not a sustainable solution for western governments to sell debt, or sell equity only to keep their finances afloat. In brief, this situation is seen as challenging standard economic theory stating that financial capital should, on net, flow from richer developed countries to less wealthy developing and emerging countries.\textsuperscript{422} In addition to the above, the current economic crisis has exposed the vulnerability of western economies, while the rescuing intervention of SWFs highlighted the concerns relating to the long-term viability of western economies.

\textsuperscript{418} A budget deficit is the excess of government expenditure over government income, which must be financed either by borrowing or by printing money. Smullen and Hand (n 273) 51.
\textsuperscript{420} The sale of national debt finances the fiscal deficit. In the USA this is done through the sale of Treasury bonds. In the last years Asian governments (notably China) and various SWF holder countries, such as OPEC members, Brazil and Russia have been the biggest buyers of USA Treasury bonds thus becoming crucial to the financing of the USA budget, USA Treasury, ‘Major Foreign Holders of Treasury Securities’ (\textit{USA Treasury}, 2012) <http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt> accessed 8 November 2012.
\textsuperscript{421} For example, Garten (n 415);
Other criticisms of this kind suggest their reserves are ‘illegitimate’ because they are created through currency depreciation, John Vail, ‘A Passage to the West for SWFs’, \textit{Financial Times} (London, 31 October 2007) <http://www.ft.com/cms/s/774d62d2-8753-11dc-a3ff-0000779f2ac.html> accessed 26 December 2012; Balin (n 88) 10;
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Thirdly, it is also essential to explain what is meant by ‘politically motivated investment’. As this term is used repeatedly in the analysis below, it would be useful to clarify it first. A politically motivated investment is essentially any investment that is not motivated solely by financial gain (whether short or long term). For example, the Agreement on Principles for Sovereign Wealth Funds between the governments of Abu Dhabi, Singapore and the USA contains the commitment that ‘SWFs’ investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly the geopolitical goals of the controlling government’.423 Such an investment, which may take many forms, aims to benefit the government making it often at the expense of its country’s public financial reserves. It could, for example, be an attempt to support the ailing company of a foreign political ally or to influence the governance of a high profile foreign corporation. Alternatively, it may be motivated by a desire to obtain a degree of leverage in the political leadership of a foreign country, or in the opposite sense, a foreign investment may then lead a government to seek special treatment of a company it has invested in, in return for political support. Specific examples, as well as the effects of such a strategy are set out in more detail below. At this point, it suffices to say that politically motivated investments, if they ever occur, can have potentially adverse effects to the countries that receive them.

Having made the above observations, the concrete concerns posed by SWFs’ investments are examined next. Those concerns have attracted much attention in the past and have been analysed extensively by a large volume of literature. As will be seen, while some are justified, many were exaggerated or subsequently proved to be unfounded. For the sake of clarity, the main issues identified by the literature are grouped into five different groups, the merits of each are examined in turn.

i. Risks associated with the motivations behind the investments of SWFs

Some of the existing theories about the relationship between shareholder size and corporate governance could illustrate some of the risks involved when SWFs control large stakes in western firms. In a 1986 article, Shleifer and Vishny pointed to the fact that small shareholders lack incentives to monitor managerial performance and they relate this to a free-rider problem.⁴²⁴ They suggest that the presence of large shareholders would offer a partial solution to the free-rider problem and greatly improve monitoring.⁴²⁵

Stulz, on the other hand, in 1988 presented a model arguing against the positive relationship between ownership concentration and firm performance.⁴²⁶ Based on his model, although higher ownership concentration leads to higher profitability because of reduced agency costs, as ownership concentration increases the largest owners gain incentives to impose goals and priorities not necessarily consistent with maximisation of its portfolio companies’ value. Thus, ultimately the efficiency of corporate governance mechanisms is impaired, leading to increasing agency costs⁴²⁷ and declining firms/shares value and possibly squeezing out minority shareholders. This model was subsequently confirmed by Morck, Shleifer and Vishny in a 1989 study.⁴²⁸

The above theory can be easily applied to the case of SWFs. Indeed, such funds, given their large investments and strong financial backing have in theory, the capacity of imposing their own goals and priorities on the rest of the shareholder body. The fact that they are foreign state-owned entities might imply that they will not necessarily pursue the same objectives as traditional private investors. Their opacity (and therefore the impossibility of others scrutinising their decision-making strategies) can give rise to suspicions that SWFs could use their voting power or promote members to the company boards

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⁴²⁴ Shleifer and Vishny (n 394) 463.  
⁴²⁵ ibid 474-477.  
⁴²⁷ This may be because their assets allocation and management are not always necessarily driven by risk-adjusted profit maximisation motives, and/or simply by virtue of their low transparency breeding uncertainty as to their behaviour as shareholders.  
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to advance the financial, or even political, interests of foreign governments at the expense of other shareholders and ultimately the company itself.

A response to this argument is also the one put forward by Pistor that, although ownership of a domestic firm by a foreign entity may generally come with important powers over that firm (such as the right to appoint and dismiss management), such ownership may not necessarily come with ‘control’.429 In particular, the theory of ‘separation of ownership and control’430 may explain how share ownership in companies with dispersed shareholding, may not necessarily convert shareholders’ de jure rights over management with defacto control. In addition, it is submitted that notions of control retained in many SWF holding countries, such as China, where a level of influence over senior fund officials is in the hands of the Communist Party may be entirely unexportable in western legal systems and business practices.431 An indication of the above is China’s reluctance so far to demand the right to appoint board members in the management of Blackstone.432

Thus the key question becomes whether SWFs can use their voting power and whether they can act as fiduciary agents and directors on boards for the financial and economic well-being of a company. It was noted by Cabrera that, in such cases, it might become necessary to ‘put firewalls to keep [companies] from political interference’.433 As he says, activism scares recipient countries, whereas, ‘activism plus transparency adds value’.434 Activism, in the sense of voting at general meetings or seeking board changes, however, could help firms improve shareholder value by embracing a longer-term perspective than that adopted by other activist investors, such as hedge funds. In addition, more participation in corporate governance from these funds may also lead them to more

431 Pistor (n 429) 294-5.
432 n 198.
434 ibid.
accountability and transparency, thus helping them to become better accepted by recipient countries.\footnote{Pistor (n 429) 294-5.}

The empirical analysis of SWFs’ investment behaviour undertaken in chapter 2 can serve to discard this concern. As seen above, most of the available evidence suggests that SWFs are largely passive investors with no willingness to impact on company decisions. First, it is very common among the largest SWFs to outsource the management of their assets to independent managers and many choose to vote by proxy to give up board seats or even voting rights.\footnote{And as seen by the China – Blackstone case, n 198.} Second, the limited evidence on shareholder activism on the part of SWFs has so far been positive. It is believed, in particular, that SWF activism can contribute towards increasing the takeover premiums in the companies where they invest.\footnote{Fernandes and Bris (n 389).} One example is Norway’s GPF which opposed in late 2008 a bid by MidAmerican for Constellation, where the Fund had a 4.8% stake. MidAmerican’s (a unit of Buffett’s Berkshire Hathaway Inc.) bid was interestingly backed by Constellation’s management itself. However Norway’s SWF considered the price insufficient and has since brought MidAmerican to court.\footnote{ibid 8.} This example of, non-controlling, shareholder activism is indicative of the weight of SWFs in defending the interests of the companies they invest in. Another example of a company where a more active role on the part of the SWF has brought considerable benefits to the target firm is the case of Marfin Popular Bank, a former Greek based bank controlled in part by Dubai Group Ltd.\footnote{See below n 917 for more details on the links between Marfin Popular bank and the Dubai based fund.} According to Bouloutas, ‘SWFs make very good investors because of their know-how and their assistance in establishing good corporate governance’.\footnote{Statement by Efthimios Bouloutas, former CEO Marfin Popular Bank, Athens (personal communication 20 December 2008).} Although the official position of both Marfin and Dubai Holdings is that the latter does not intervene in management decisions, it is suggested that SWFs’ presence in a company’s meetings can play a beneficial role by ‘offering valuable ideas and material’.\footnote{ibid.}
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Moreover, one should not forget the legal protections that are in place, for example, under English company law the duties of directors are owed to the corporation and the shareholders as a whole and not to the ones who by contract or voting power placed the director on the board.442 Alternatively, one might say that influencing corporate governance for their own benefit is unlikely, simply because it would imply that SWFs run their portfolios inefficiently.443

The abovementioned study by Fotak and others constitutes an additional argument in favour of supporting greater SWF activism. In their analysis, the authors find an average abnormal return of +1% for targets on the day in which the SWF investments are announced.444 However, over two years after the transaction, the abnormal buy-and-hold returns average -41%.445 They find that this effect is not related to the size of equity stake purchased by the SWF, and also does not differ across the various SWFs. They interpret the results as indicative of the additional agency costs that the SWF imposes on the companies, causing a deterioration of performance,446 which implies that shareholder activism from SWFs might not only be welcome, but also needed.

Overall, although the shareholder theory could in theory apply to SWFs and exacerbate concerns over their impact on host companies, the evidence shows that SWFs generally avoid the practice of influencing company decisions. Additionally, the few examples of SWF-specific activism prove to be rather beneficial, an argument that may be used to encourage more activism on their behalf in the future.

ii. The motivations behind the investments of SWFs and national security concerns

442 The rule in Percival v Wright [1902] 2 Ch 401 now given statutory force by virtue of s 170 which establishes that directors owed their duty to the company of which they are directors. This means that the shareholders themselves have no cause of action against directors for breach of their duties. Only the company has a cause of action, John Lowry and Arad Reisberg, Pettet’s Company Law: Company Law & Corporate Finance, 4th edition, Pearson 2012, 158.
444 Fotak, Bortolotti and Megginson (n 51) 4.
445 ibid.
446 However, since deteriorating firm performance is not directly connected to the size of the investment it may be concluded that the ‘additional agency cost’ effect does not increase the larger the stake acquired by the SWF.
An extension of the previous concern is the risk of political interference in the investment decisions of SWF managers and that investment decisions will be based on political rather than purely economic criteria. While the previous section related to the impact of the SWF on the recipient company, this section deals with the potential harm on the recipient country/government which can raise issues of national security. This concern is exacerbated when funds originate from geopolitical rivals to the west, such as China, Russia and Iran or when foreign state-owned funds invest in sensitive sectors (energy, defence, telecoms etc). As with the previous scenario, this theory again would imply that SWFs would run their portfolios inefficiently, meaning that they would make financially detrimental investment decisions with the prospect of extracting some sort of political gain.

This is where the opaque nature of SWFs becomes more relevant. In particular, the absence of clear reports on the management structures, names of top managers, investment plans, size and financial assets held by SWFs, makes it impossible for recipient governments to ascertain the degree of government interference in the decisions of SWFs.

This concern becomes more alarming if one considers the potential detrimental results of politically motivated investments by SWFs. Among the potential risks often reported is the danger of stealing critical information or critical technology, shipping jobs abroad, influencing the corporate governance or taking control of national strategic companies with potentially devastating effects for recipient countries. 447 Other fears expressed at times seem highly

447 These positions can be found in the entire literature, either as rightful arguments or referred to critically, see for example, 
Summers (n 302);
Weisman (n 415);
Garten (n 415);
Fotak, Bortolotti and Megginson (n 51) 7-8;
IFLR staff, ‘Panic’ (2008) IFLRRev <www.iflr.com/Article/1976753/Panich.html> accessed 8 November 2012, and for a more detailed review, see:
Gordon and Tash (n 414) 11-18.
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speculative, for example, during the DWP case\textsuperscript{448} USA Congressmen and Senators from both parties brought up the risk of terrorists being smuggled into USA territory from the Middle East.\textsuperscript{449} Similarly, in a 2007 article, Steven Weisman warned about the potential detrimental effect of SWFs on a recipient government due to political motives: ‘some experts would wonder what would happen if China took over a pharmaceutical company and pressed for changes in prescription drug programs’.\textsuperscript{450} In any event, the potential risks therefore, can range from small nuisances to concerns about national security.

It is not always clear which companies are considered of ‘national strategic importance’ and surely these may vary from one country to another. However, as discussed in the previous chapters, these are usually companies operating in the fields of energy, defence, transport and telecoms (or whenever national networks are involved), as well as technology and major manufacturers. In this regard, in the last few years, European governments have at times expressed fears that Gazprom’s extensive investments into European energy infrastructure\textsuperscript{451} may render European countries more vulnerable vis-à-vis Russia.\textsuperscript{452} Past examples such as DIC’s and Russian state-controlled bank OAO Vneshtorgbank investments into EADS, Abu Dhabi’s investments into AMD,\textsuperscript{453} as well as

\begin{itemize}
\item \textsuperscript{448} n 936 onwards.
\item \textsuperscript{449} Carl Levin, ‘Opening remarks at Senate Armed Services Committee Briefing on Port Security’, News Release, 23 February 2006 \textltt{http://levin.senate.gov/newsroom/release.cfm?id=251838}\ accessed 8 November 2012;
\item \textsuperscript{450} Weisman (n 415).
\item \textsuperscript{451} For example, Danny Fortson, ‘Gazprom Plots UK Expansion, but Buying Centrica Is a Pipe Dream’ \textit{The Independent} (London, 2 June 2008 \textltt{www.independent.co.uk/news/business/news/gazprom-plots-uk-expansion-but-buying-centrica-is-a-pipe-dream-838164.html}\ accessed 26 December 2012.
\item \textsuperscript{452} Traynor (n 74);
\item Weisman (n 415).
\item \textsuperscript{453} AMD is a computer technology company and the world second largest computer chip maker, Don Clark, ‘Abu Dhabi Doubles Down on AMD Investment’ \textit{The Wall Street Journal} (New York, 8 October 2008) \textltt{http://online.wsj.com/article/SB122335835617410929.html}\ accessed 26 December 2012.
\item \textsuperscript{454} For more on this case see n 876 onwards.
\end{itemize}
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MIG’s\textsuperscript{455} aggressive policy towards Greece’s telecommunications operator, have at times caused national debates linking the operation of SWFs with issues of national and economic security.

Those national security arguments put forward are often over-exaggerated. Even if assumed that a SWF invests in a company operating in a sensitive industry,\textsuperscript{456} such as aviation or energy, existing laws will in most conceivable cases protect the public from any misconduct on the part of the fund.\textsuperscript{457} In most western governments (and surely in all of those that are taken as case studies and are examined in the following chapters) there is a sufficient legal framework as well as special agencies regulating investments that may have an impact on national security.\textsuperscript{458} In most of these countries there are also operating agencies in the field of energy, transport, telecommunications, and the like, that oversee the management of those companies for the benefit of the public.\textsuperscript{459} Nevertheless, national security issues at times may still be used by elected representatives for no reason other than to reap personal political gains or they can be evoked by the media or the wider public in order to disguise pure xenophobia. Paraphrasing Johnson: national security can be the last refuge of the scoundrel.

On the other hand, the duty falls upon a national government to scrutinise all situations that could genuinely raise issues of national security. For example, all national agencies should be aware of how far has a SWF obtained control of strategic or other important companies. They should also be aware of how much, through its shares, it can exercise political influence on the decisions and future

\textsuperscript{455} As said above MIG, a Greek private equity firm, is largely controlled by Dubai Holdings. For the relation between MIG and Dubai Holdings see n 917.
\textsuperscript{456} However rare a scenario, according to Brune ‘inside OECD countries, controlling stake deals in sensitive sectors accounted for 2% by number and 4% by value,’ Brune (n 279) 29.
\textsuperscript{457} For example, in the USA, see Federal Aviation Act of 1958 Pub L No 85-726, 72 Stat 731, para 101; Atomic Energy Act of 1954 Pub L No 83-703, 68 Stat 919, 937 para 103(d), codified at 42 USC, para 2133.
\textsuperscript{458} The best known example being the USA Committee on Foreign Investment in the United States (CFIUS), chapter 5, n 954 onwards.
\textsuperscript{459} In the UK, for instance, under the Communications Act 2003, telecommunications are regulated by Ofcom, who ensures the proper functioning of communication providers in the interest of consumers, see Ofcom, <www.ofcom.org.uk> accessed 21 February 2013.
development of those companies. This duty may also extend to other important firms such as financial institutions and large manufacturing companies.

Concrete past examples can serve to put the perceived risks into context. In a study by Bernstein and others, it was reported that some of Singapore’s investments in China and India were interpreted as forging strategic ties with the city-state’s larger and more powerful neighbours rather than seeking financial returns. The same study also claimed that political considerations have led to the abandonment of prescient investment strategies, as when the Norway’s GPFG caused uproar in 2006 by shorting the shares of Icelandic banks. Fotak and others also mention the examples of Singaporean and Korean SWFs making investments with the purpose of executing technology transfers for the benefit of their home countries. Similarly, an OECD study in 2009 referred to an agreement by Mubadala Investment Company, to invest in a hospital in the Japanese city of Kobe through which it intended to gain improved access to medical technologies and provide training for its domestic doctors. All the above investment advanced both public and commercial objectives.

Other examples with a stronger element of political interference have also been recorded. Such is the 2006 purchase by Temasek Holdings of a stake in a company owned by the former Prime Minister of Thailand, Thaksin Shinawatra. The subsequent demonstrations were so severe that they led to the ousting of the prime minister a few months later in a military coup. China, moreover, was held to have used its reserves in SAFE to sway Costa Rica to give up its diplomatic ties with Taiwan. According to Andrew Batson, the agreement provided that China would buy $300 million bonds from Costa Rica and the latter, in return, would switch diplomatic recognition to Beijing from Taiwan.

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460 Bernstein and others (n 100) 29.
461 ibid.
462 Which however where made in full knowledge and with the consent of the recipient government, see chapter 1, n 99.
463 Gordon and Tash (n 414) 9.
464 Fotak, Bortolotti and Megginson (n 51) 7; Weisman (n 415).
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Such practices, known as ‘checkbook diplomacy’, are common for both self-governed Taiwan and China, who considers Taiwan to be part of its territory.

Therefore, although there are specific examples of politically motivated decisions on the part of SWFs, these are extremely limited and none of them have raised particular concerns, i.e. none involved the ownership of national strategic companies or other issues of national security.

The record of SWFs so far shows that the only cases of concrete political interference in investment decisions concern domestic investments made mainly during the ongoing economic crisis to bail out local economies. But an obvious question might then arise: if SWFs clearly make ‘political’ investments domestically, how can it be guaranteed that they will not also make them in foreign markets? None of the available literature can offer a satisfactory answer to this question. It may, however, be sufficient to say that nothing so far has indicated a desire by SWFs to make politically motivated investments overseas. On the contrary, as Bernstein et al. report, when politicians are involved, funds invest more in their home country (44% of the deals in the sample), relative to funds without politicians involved (only 31% of the transactions). In fact, until today there is no significant example of a politically motivated investment in a foreign country that could raise serious concerns.

Strategic investments may certainly occur but this should not be something alarming. Backer cites the example of the Norwegian fund making investments in

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466 ibid, The term generally denotes using international financial investments to promote foreign policy objectives.
467 Another cited example of a politically driven decision is that of Norway, who in 2007 pulled its investment out of Wal-Mart, citing accusations that it has violated child-labour laws and scuttled efforts by employees to unionise, Weisman (n 421);
It should be stated here that, although Weisman sees this investment decision as essentially 'political' (and in the broad sense it may be) it could also be taken as part of Norway's policy to simply avoid morally controversial investments. In the same way as certain funds may avoid excessive risk-taking because of religious/ethical reasons, Simon Chesterman, 'The Turn to Ethics: Disinvestments from Multinational Corporations for human Rights Violations – The Case of Norway’s SWF' (2008) 23 American University International Law Review 588-593.
468 Bernstein and others (n 100) 15.
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India during the crisis, when most investors were withdrawing funds from the Indian market.\textsuperscript{470} This may certainly be a ‘strategic’ investment, but it is not tantamount to a ‘politically motivated’ investment. As he states, ‘saying that states invest to promote political aims is somewhat dubious. Investors sometimes invest strategically with incremental gains, states may do the same’.\textsuperscript{471} Therefore, there is nothing unique about this behaviour. In a similar tone, Epstein and Rose argue that most foreseeable cases where the investment decisions of SWFs might involve some political consideration are not significant and may be allowed.\textsuperscript{472} In their view, a USA-based pension fund should be able to invest their workers’ income and vote their shares, to maximise some political choice that the group as a whole has endorsed.\textsuperscript{473} This same logic could apply to SWFs as well.

In any event, the unique scrutiny under which SWFs operate makes it unlikely that a SWF will purport to exert political influence in the future.\textsuperscript{474} If it did so, the imminent backlash by governments, international bodies and the business community at large would certainly damage the fund’s reputation and close most of its business opportunities in the future. It is, therefore, in the interest of the foreign funds to avoid any behaviour that might send the wrong signal to recipient countries and target companies.

In addition to the above, the demands directed to SWFs to increase their transparency levels may also dissipate the concerns of target countries. For example, since ADIA published some information about its governance structure, it is possible for companies and governments to understand better how it conducts its business strategies and reduce the fear of politically motivated


\textsuperscript{471} ibid.

\textsuperscript{472} Epstein and Rose (n 162) 125.

\textsuperscript{473} The writers give the example of the California Public Employee’s Retirement System that entertained proposals not invest in specific countries or to funnel investments into firms that hire workers from disadvantaged countries, ibid.

\textsuperscript{474} Paul Rose, ‘Sovereigns as Shareholders’ (2008) 87 N.C.L.Rev 102-166, who observes that SWFs operate under unique scrutiny and that the suspicion surrounding them causes them to act ‘hypercautiously’.
decisions. At this stage, it is known that the government of Abu Dhabi may create a mandate within an asset class (for example the ‘Italian market’, or ‘real estate’), but it falls upon the manager to decide how the asset allocation will be executed because the benchmark of his performance is defined according to a national index (for example, the S&P500 Index, or the MSCI Index). This benchmark will eventually also determine the bonus that the manager will receive. If political involvement was more intrusive it would become impossible for managers to execute their best performance and this would jeopardise their salary bonus. Despite this limited information disclosed by ADIA, the fund still remains a largely secretive SWF and substantially more progress will be required for it to reach the transparency level of the Norwegian fund or Temasek. The above example, however, makes clear how increased transparency alone can serve to dissipate concerns and shows that most SWFs have failed to put forward a better communications strategy in order to explain why governments should not be fearful of their investments.

Today, most commentators and public officials focus less on the risks of political interference while many of the concerns that were expressed in the past either now seem exaggerated or were subsequently proved unfounded. This would not necessarily be because SWFs have convinced national governments to the opposite, but rather because the ongoing financial crisis and the need for external capital does not leave much room for criticisms on SWFs. In short, the current situation, does not allow western governments to be too sceptical as to the origin of foreign investments.

475 A benchmark is ‘1. a standard used to measure the performance of an investment or portfolio. 2. A standard specification of contract, for example a futures contract. 3. A base price or interest rate’, Smullen and Hand (n 273) 39.
477 The example of Temasek also demonstrates how transparency can dissipate concerns. In 2008, the management of Temasek sent its executive director, Israel, to a USA Congressional Hearing to impress upon lawmakers how the fund is insulated from political interfering. Israel noted that Temasek has an independent eight-member majority in its board supplemented by an international advisory panel including famous personalities from the field of investment banking, Simon Claude Israel, ‘Testimony before the Financial Services Committee’ (2008) USA House of Representatives.
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It is not easy to speculate what the attitude of governments and analysts will be in the future. That said, it is likely that once the financial crisis is over the debate over national security and SWFs will revive again. As Epstein and Rose argue, 'after the dust settles on Wall Street, and the blame game begins in earnest Washington, SWFs will in all likelihood find themselves in the regulatory crosshairs once again'.479

iii. Risks associated with undue leverage

Politically motivated investments are not the only concerns expressed by the literature on SWFs. Through their investments SWFs may also obtain an undue leverage vis-à-vis their target countries, for example, in foreign policy negotiations.480

The ‘undue leverage’ hypothesis could take large proportions and may appear more realistic than the 'national security' theories discussed above. One can imagine for example, a Middle Eastern state demanding from the USA government favourable tax cuts for its companies in the USA, in return for its support in Arab-Israeli peace talks or for assistance in Iraq or Afghanistan. It would also not be unrealistic to imagine the difficult position of EU Member States or the European Commission during negotiations with China on measures to tackle climate change, if China controls a significant portion of EU national economies.

479 Epstein and Rose (n 162) 113;
It was also stated by Liqun's (Chairman of the CIC’s Supervisory Board and Deputy Chairman of the International Forum of SWFs) that 'misgivings about SWFs are likely to rekindle as economies recover and the credit crunch becomes less of a problem. The mood would probably swing back [...] SWFs’ relevance to global stability does not guarantee their status as a guest of honor in some of the economies where they have proved to be part of the solution, not part of the problem'.

480 Or as described by O’Brien, it is a matter of exercise of ‘soft political power’,
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A more concrete example is the following: The USA relies to a large extent on China buying its federal debt in order to finance its deficit.\(^{481}\) According to Brad Setser’s estimates, the majority of USA equity in China are held by SAFE, a well known SWF.\(^{482}\) It is indicative that when, former Presidential candidate Hillary Clinton, was asked why do the USA not take a tougher stance on China she replied, 'how do you get tough on your banker'?\(^{483}\) Later in February 2010, and following a disputed arms sale by the USA to Taiwan, a Chinese official, Gen. Luo, was quoted saying, ‘we could sanction them using economic means, such as dumping some USA government bonds’.\(^{484}\) A closer look, however, to the facts surrounding USA government bonds indicates that the threat of selling such bonds is not a realistic one. Indeed, if Chinese officials started selling their USA assets and touched off a run on the dollar, their vast remaining dollar holdings would plummet in value.\(^{485}\) This lack of incentive, also known as the modern


\(^{484}\) It was also confirmed in the Financial Times that ‘the bulk of SAFE’s holdings remain in USA Treasury bills and much of the loss on riskier assets will be offset on gains on long term bills’, Jamil Anderlini, ‘China Lost Billions in Diversification Drive’ Financial Times (London, 15 March 2009) <www.ft.com/cms/s/0/11fa4136-119f-11de-87b1-0000779f2ac.html?nclick_check=1> accessed 26 December 2012;

\(^{485}\) Finally, Teslik confirms that in ‘as investors spooked by the global economic crisis poured money into [government-backed assets, like Treasury bills] as a safe haven’, Teslik (n 115).


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\(^{485}\) Finally, Teslik confirms that in ‘as investors spooked by the global economic crisis poured money into [government-backed assets, like Treasury bills] as a safe haven’, Teslik (n 115).
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‘balance of financial terror’,\textsuperscript{486} has guaranteed that China will not sell USA asset and that the idea that China’s bond holdings grant it an ‘undue leverage’ over the USA may be exaggerated at times.

Until now, and to the knowledge of the international academic and media community, there has not been any serious case of a threat or exercise of leverage against a recipient economy of SWF investments. That said, Clinton’s above statement must be taken seriously because it consists of an illustration of the actual degree of influence of one country on another through the means of its SWF. American financial dependence on China is a fact. It is also a fact that many third country investors control significant stakes in some of the most valuable companies in the western world. This development might not entail national security risks, but may reduce the political bearing of many western states.

However, it is difficult to see how a national or international measure or any kind of regulatory framework could reverse this trend of growing influence of developing countries over western ones. It would, indeed, be difficult to argue under any circumstances that state protectionism can offer a satisfactory solution to this issue.\textsuperscript{487} Instead of opting for more protectionism, governments that face similar problems should prioritise reforms to adjust their current account or fiscal deficit and thus reduce their need for foreign capital.\textsuperscript{488} While doing so, maintaining an open economy towards SWFs must remain a priority for any government.\textsuperscript{489}

\textit{iv. Risks associated with the impact of the operation of SWFs on the economy}


\textsuperscript{487} As put by Epstein and Rose, ‘although the growth of SWFs may be a symptom of the weakened position of the [USA] in the global economy, it is not the cause—and increased regulation of SWFs, not the cure’, Epstein and Rose (n 162) 113.

\textsuperscript{488} In the words of Truman, they should avoid the ‘understandable temptation to try to use international assets to promote domestic economic development objectives’, Truman (n 82) 6.

\textsuperscript{489} For example, see:
Commission (n 1) 2, 6-8.
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There are a number of analysts who focus on the macroeconomic, rather than political, risks arising from the investments of SWFs. These mainly consist of arguments relating to economic stability, but the experience of SWFs so far has shown that SWFs offer more benefits to the international financial system than they present risks.

The first economic argument against SWFs, as formulated by Blundell-Wignall and others, holds that the creation of excessive global liquidity caused by SWFs can cause asset bubbles.\(^{490}\) Fixed exchange rates in the face of capital inflows lead to foreign exchange accumulation and easier domestic monetary conditions.\(^{491}\) This can contribute to local asset bubbles. The global investment of the reserves of one country may affect prices in other financial markets. Kambayashi has also offered support for the above theory.\(^{492}\) A similar argument is given by Kern who is mostly concerned about the impact of SWFs on the decisions of other investors. As he puts it:

‘it cannot be excluded that an individual transaction undertaken by one SWF may lead to herding behaviour by other market participants, resulting in excessive capital movement and price and rate changes for the security concerned as well as – if contagion effects occur – for correlated assets’.\(^{493}\)

Herding behaviour generally occurs when competitive conditions may induce banks to behave in line with other banks and incur excessive risk in the process and is a phenomenon that often precedes bank crises.\(^{494}\) The likelihood of herding increases if a transaction is undertaken by an opaque fund. Kern’s fear is that such herding behaviour caused by SWFs can destabilise regional or

\(^{490}\) Blundell-Wignall, Hu and Yermo (n 75) 12.
\(^{491}\) Reflected in the encouragement of low interest rates and low leverage.
\(^{493}\) Kern (n 43) 11;
Kern (n 101) 13;
\(^{494}\) Llewellyn (n 385) 27-28.
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segmental parts of the financial industry or even financial markets on a global scale.\textsuperscript{495}

Truman has also acknowledged in his testimony before the USA Senate that the most serious risk brought by SWFs is the economic and financial stability of the countries accumulating these huge stocks of international assets.\textsuperscript{496} According to Truman, there is an understandable temptation to try to use international assets to promote domestic economic development objectives. However, ‘doing so is essentially impossible without undermining or reversing the fiscal, monetary, and exchange rate policies that gave rise to the initial accumulations of the external assets’.\textsuperscript{497} With the possible exception of exchange rate policies, such reversals are likely to boost inflation, create wasteful distortions in domestic economies, and contribute to slower, not faster, growth and development.\textsuperscript{498}

Another perceived danger relating to investments of a large scale, such as those by SWFs, is the possibility in which investors, all of a sudden, massively withdraw their funds from one country. This situation can materialise as a reaction to a foreseeable political or economic instability or simply because investors chose to seek investment opportunities elsewhere. The immediate result of such action would be a depreciation of share prices as well as a devaluation the recipient country’s currency which has occurred in the past in a number of East Asian countries and earlier in several Latin American

\textsuperscript{495} Kern (n 43) 11.
\textsuperscript{496} Truman (n 82) 6.
\textsuperscript{497} ibid.
\textsuperscript{498} ibid.
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countries. If such outflows occurred during a recession it would force the country’s central bank to raise interest rates to attract capital inflows.

Herd behaviour and lack of transparency into the market, have been contributory factors to the spread of the financial crisis that began in 2007 with the collapse of the subprime mortgage market and peaked towards the end of 2008 and until 2009 after the collapse of Lehman Brothers in the USA. In particular, the inability of regulators to oversee and warn of the alarming behaviour of financial firms pre-crisis (and their limited tools in responding to the events leading up to the peak of the crisis), have demonstrated the sensitive nature of financial stability within today’s powerful financial markets.

For the two types of risks described above (the creation of asset bubbles and the risk of collective withdrawal of investments) it not very easy to give a satisfactory answer. However, one could point at certain facts on SWFs that mitigate the likelihood of such risks materialising. First, it should be remembered that the capital markets of most western economies are quite large and host sizeable market players, big enough to dwarf the SWF investments. This is especially true in those economies that receive the majority of SWF investments (USA, UK, Germany, France, Switzerland and Australia), which are too large to anticipate that a simple combination of investments by SWFs (or their withdrawal) could possibly cause macroeconomic distortions. An empirical study conducted for the IMF in October 2009 examined financial stability issues

The later example of the East Asian crisis (1997) should in a large measure also be attributed to the panic reaction and herd behavior of foreign investors. Examples include Hong Kong, Thailand, Malaysia, Indonesia, Laos, the Philippines and South Korea, Frederick Mishkin, ‘Lessons from the Asian crisis’ (1999) Vol 18(4) JIMF 709.
500 As certain examples were recorded during the GFC in mid 2009, see chapter 1, n 340 onwards.
502 A summary of the GFC is provided in chapter 2, n 306 onwards.
503 See table 1.2 in chapter 1, where the size of SWFs was compared to other larger private institutional investors.
that arise from the increased presence of SWFs in the global financial markets.\textsuperscript{504} It equally concluded that there is no significant destabilizing effect of SWFs on equity markets.

As regards ‘herding’ in particular, as the recent experience in the market for mortgage-backed securities proves, it cannot be excluded that SWFs may contribute to such behaviours that are responsible for the creation of asset bubbles. It must be emphasised, however, that such risks are inherent in the operation of free markets. It is the objective of market regulators to attempt to prevent such outcomes by supervising the development of the market as a whole including in their consideration of SWFs as much as any other type of investor. As mentioned in the previous paragraph, SWFs alone are not sufficiently large or numerous to have a definitive contribution to ‘herding behaviour’, let alone create one.

Second, as regards the risk of a massive outflow of capital, it should be remembered that SWFs are mostly long-term investors and they have the resources and the financial backing to withstand harsher economic conditions than most investors. This is demonstrated by the example of Japan, where ADIA had invested since the 1970s and continued to invest during the difficult economic times of the 1990s.\textsuperscript{505} When the global equity market fell again sharply in Japan between 2000 and 2002, the Norwegian GPF was a large buyer of global equities.\textsuperscript{506}

The same has occurred lately during the financial crisis caused by the 2007 property bubble. Despite their losses, most SWFs continued to invest in financial markets (sometimes alongside bailing out their domestic economies) and, as mentioned above, they may have even played a role in the reviving of the American and European economies. Later on, during the European debt crises of

\textsuperscript{504} This conclusion was based on 166 publicly traceable events collected on investments and divestments by major SWFs during the period of 1999-2009. It evaluated the short-term financial impact of SWFs on selected public equity markets in which they invest. The impact is further analysed on different sectors (financial and non financial), actions (buy and sell), market types (developed and emerging markets), countries, and level of corporate governance (high and low). Sun and Hesse (n 388)1.

\textsuperscript{505} Emily Thornton and Stanley Reed, ‘Inside the Abu Dhabi Investment Authority’ Businessweek (New York, 6 June 2008) <www.businessweek.com/globalbiz/content/jun2008/gb2008065_742165.htm> accessed 20 December 2012.

\textsuperscript{506} Bank of England, (n 417) 199.
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2010 which ultimately affected all members of the single European currency, SWFs remained in the Eurozone market. The president of CIC, for instance, reassured EU governments in 2010 that ‘CIC will keep its investment level in Europe’ and that ‘short term fluctuations won’t bring serious effect on [them]’. Moreover, in 2011 following a downgrade of USA debt by Standard and Poor’s, it was confirmed by Slynstad the head of Norway’s SWF, that the downgrade rating the USA received ‘had no effect on the way the fund views investments in the country’.

As this recent experience showed in practice, the extremely limited cases of asset sales, are by no means enough to characterize the general behavior of SWFs and should not be a cause for concern. Therefore, the danger of collective withdrawal of funds should not apply to SWFs. For some this was an expected development, since it is generally admitted that collective maneuvering of funds primarily harm foreign investors themselves because a huge supply of securities in the market will instantly reduce their gains from liquidation. In short, SWFs’ investment criteria and financial backing are enough to discard any argument based on ‘herding behaviour’ whether concerning inflows or outflows of capital.

A final risk concerning the USA is that SWFs could cause a spike in the USA interest rates. This fear follows a traditional argument which holds that a continuation of the large current-account deficits will eventually boost interest rates further as foreigners become sated with USA assets (bonds in particular) and stop increasing the share of their portfolios invested there.

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507 See n 375.
511 Feng (n 443) 495.
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concerning the USA is the possibility that foreign investors such as China will stop investing in USA government debt. Whether a rise in interest rates might be desirable or not, Balin believes that such a scenario is not realistic. As he says, Although SWFs will allow countries to diversify their holdings of foreign securities away from USA government bonds, future global reserve growth apart from the growth of SWFs (assuming global growth) is more than adequate to absorb the anticipated disbursement of USA government bonds at their current prices in the years to come. Thus, SWFs alone cannot cause a spike in USA interest rates.

v. Risk of increased protectionism

Two articles by Sesit and Lynch warned in 2007 of the increased danger of a new form of financial protectionism as a reaction to the rise of SWFs. Since then, a number of commentators have dealt with this risk since, for a period of time, it appeared that governments were either taking the possibility of raising barriers seriously, or were tightening up the conditions for foreign investors to operate in their market.

For the time being, since the recent effects of the financial crisis, protectionist attitudes towards SWFs have been temporarily silenced. There is no other rationale for this change of attitude, other than that in the face of economic instability, countries choose to focus on the direct benefits of FDI and put the political considerations of those investments aside. It is understandable, however, that in the long term, policymakers have also a duty to see beyond the immediate economic benefits of FDI and assess its wider political and

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513 Balin (n 88) 12.
514 Michael Sesit, '[SWFs] are Starting to Dominate Global Finance', International Herald Tribune (Neuilly-sur-Seine, 18 June 2007) in Fotak, Botrolotti and Megginson (n 52) n 13.
515 Lynch (n 512).
516 Allen and Caruana (n 213) 14, Castelli (n 231) 8.
517 Fotak and Megginson (n 478) 1-3.
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macroeconomic impact. Eliminating all the risks associated with SWF investments may be difficult but if left completely unaddressed it might fuel concerns, and could as a result force national governments to resort once again to protectionism in the future.

Indeed, the rise of protectionist attitudes until before the financial crisis was seen as mainly caused by the opaque nature of SWFs. As SWFs continue their shopping spree in financial assets without substantially improving transparency, protectionist voices could arise again once national governments and the general public perceive the crisis to be over. All of these elements are likely to fuel again the same debate on economic patriotism as they did before the crisis. This tendency may be more likely in countries that have traditionally exhibited protectionist attitudes, such as France and southern EU Members, or countries where national security is more often part of the political debate, such as in the USA.

Additionally, the effects of the financial crisis, and the subsequent calls for tighter regulation in the entire financial sector, could also be extended to cover the transactions of SWFs as well. Although the case for regulating hedge

518 For more details see: Gordon and Tash, 'Foreign Government-Controlled Investors and Recipient Country Investment Policies' (n 414) 8-19.
519 An OECD paper published during the crisis warned of those risks 'Faced with rising public fear and distrust, governments are now necessarily focused on restoring national economic and employment growth and financial stability. Although they recognise that open markets will ultimately contribute to a sustainable recovery, domestic economic and political pressures might make them less mindful of their international commitments to openness. In this context, there is a risk that countries will be tempted to adopt "beggar thy neighbour" policies, including investment protectionism in various guises', OECD, 'Building Trust and Confidence in International Investment: Report by Countries Participating the "Freedom of Investment" Process' (2009) OECD 12.
520 See the literature commenting on the threats and risks of SWFs, Weisman (n 415).
521 Where notions such as 'economic patriotism' are still prevalent, chapter 5, n 828.
523 See above the characteristic examples of DPW (n 935 onwards) and Unocal (n 545 and 934) cases.
524 One example being the Larosiere report, De Larosiere and others (n 290) 59-68.
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funds and investment banks is fundamentally different from the case of SWFs, the latter may also come under the recent demands for more transparency in the financial system. In other words, lack of transparency of SWFs is likely to become even less acceptable as a response to the conditions that led to the financial crisis. These demands may originate from international bodies, such as the IMF or the EU, or may come from individual states.

In short, the debate on SWFs may take a different form or shape, but the nature and the characteristics of SWFs will continue to attract attention and even cause controversy. The issue of protectionism regulation and national responses is analysed in detail in the following chapters. For the moment it suffices to say that protectionism is an undesirable response and often it reflects misinformed perceptions about SWFs. From the standpoint of national governments some form of regulation may sometimes be warranted to address genuine concerns. The necessity (or not) of regulation is discussed in the following chapter.

CONCLUSION

This chapter aimed at identifying the main issues that revolve around the investments of SWFs with a specific emphasis on western countries. While the benefits brought in the system appear to be tangible, expressed concerns are often theoretical or over-exaggerated.

In particular, it was shown that SWFs can be quite beneficial to recipient economies, particularly because of their size and long-term investment behaviour. Additionally, their investments proved to be very important for the most part of the financial crisis so far and may have even contributed to the stabilisation of western economies.

On the other hand, SWFs also give rise to some concerns. One such concern is whether they are likely to use their voting power to the detriment of other shareholders and the company as a whole. A further key concern extends to whether SWFs are likely to be a threat to national security. It has been seen that

525 These are touched upon in chapter 4, n 1058.
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there is no evidence to suggest that SWFs could constitute any serious threat. In fact, an analysis of their investment behaviour suggests that SWFs are generally passive and with no intention to act in politically controversial ways. Nevertheless, the question remains as to whether some individual SWFs use their financial ties as an undue leverage against some other country to obtain political benefits.

The potential risks of SWFs can also be of an economic nature. Experts have in the past considered the possibility of ‘herding behaviour’ and the creation of asset bubbles or causing a currency depreciation if they collectively withdraw their investments. These threats, however, are based on hypothetical scenarios that do not necessarily coincide the SWFs’ reputation as long-term investors. In any event, SWFs do not act in concert and it is very unlikely that the actions of a single or a few SWFs alone are sufficient to disrupt a country’s entire economy. Nevertheless, many of the above risks, if left completely unaddressed, may fuel protectionist tendencies in many western countries as it did in the recent past.

All in all, after taking into account all issues discussed above, it becomes obvious that the benefits originating from those investments clearly outstrip the perceived risks. This conclusion should serve as the basis for discussion on the matter of regulating SWFs in the following chapter.
INTRODUCTION

Chapter 2 analysed the investment behaviour of SWFs. Its findings were used in chapter 3 to discuss the benefits of and concerns about SWFs as the base for their regulation. This chapter examines whether there is a rationale for regulating SWFs and goes on to present and scrutinise various regulatory proposals.

Economic protectionism exists in many areas of economic activity. It is especially prevalent in the fields of ownership of domestic corporate assets and the screening of foreign investments. While it is easy to achieve consensus among governments and commentators against the adoption of investment protectionist measures, determining whether there is a clear rationale for regulating SWFs is more controversial. If it is accepted that SWFs do pose risks (and thus costs) to national security and systemic stability, then a rationale for regulation is easier to establish. If, however, those threats are not genuine (and hence the regulatory costs unjustified), a very limited form of regulation aiming to address protectionist pressures and maintain consumer/corporate market confidence could suffice. It is argued that it is possible that countries managing huge SWFs could exert political leverage over countries in which they invest. However, this risk cannot be tackled by a simple regulatory instrument, the ambit of which must be limited to securing financial stability or national security. Nor could such an instrument reverse the growing world influence of developing nations.

In establishing a rationale for regulation, a central aspect of the discussion is the place and role of transparency. While many authors believe that the main
object of legislation should be to tackle the opacity of SWFs (either as an intermediate aim, or as a problem in itself), others deem that opacity is not the problem and, thus, tackling it would be futile. The position in this thesis is that, while transparency and accountability are sound principles in themselves, SWFs should be allowed to derogate from it to the extent that their immediate competitors are allowed to do so. In other words, transparency in financial markets should go hand in hand with competitive neutrality.

Regulatory proposals relating to SWFs can be grouped into three broad categories. First, there are those who advocate restricting the operation of SWFs either by imposing investment caps, or removing entire sectors from their investment ambit. A second group supports imposing softer restrictions upon SWFs to create incentives for them. Third, some argue that the best solution would be to impose mandatory reporting requirements on SWFs.

A different view, which is discussed in more detail in the final chapter, encourages SWFs to deliberate and find adequate solutions by themselves (the option of ‘self-regulation’). An analysis of all those models from the point of view of theory, implementation and costs will reveal that none of the above proposals deals satisfactorily with the rising influence of SWFs.

1. The Rationale for Regulation

   i. The avoidance of investment protectionism

‘Protection’ in the economic sense is defined as:

‘The imposition of tariffs, quotas, or other non-tariff barriers to restrict the inflow of imports. Non-tariff barriers have included restrictive licensing, discriminating government procurement programs, subsidies, custom clearance delays, health and safety and environmental regulations and export quotas to maintain supplies to the domestic market.’
Protectionism is an old concept that has existed in various forms throughout history. It is said, for example, that during their early stages of development, now-developed countries systematically discriminated against foreign investors. They used an array of tools to retain the ownership of their national industry, including limits on ownership; performance requirements on exports, technology transfer or local procurement; insistence on joint ventures with local firms; and barriers to ‘brownfield investments’ through mergers and acquisitions.527 As argued by Chang, only when domestic industry has reached a certain level of sophistication, complexity, and competitiveness do the benefits of non-discrimination and liberalisation of FDI appear to outweigh the costs.528

Modern views of protectionism derive to a large extent from Keynes, who noted that ‘the policy of an increased national self-sufficiency is to be considered, not as an ideal in itself, but as directed to the creation of an environment in which other ideals can be safely and conveniently pursued’.529 Indeed, Keynes became convinced that the retention of private enterprises is compatible with greater material well-being only if the interest rate is reduced towards a vanishing point. But, as he stated, a system by which the rate of interest finds a uniform level, after allowing for risk and the like, throughout the world under the operation of normal financial forces, is most unlikely to occur. Accordingly, Keynes was persuaded that ‘economic internationalism embracing the free movement of capital and of loanable funds as well as of traded goods’ may result in a ‘much lower degree of material prosperity than could be attained under a different system’.530 It was noted by Keynes, however, that a deliberate movement towards greater national self-sufficiency and economic isolation will

527 For more, see:
528 ibid.
530 ibid.
make the task of economic policy easier, ‘in so far as it can be accomplished without excessive economic cost’.\textsuperscript{531}

A number of protectionist measures emerged in the aftermath of the global financial crisis. In particular, it was reported by the World Bank that 17 out of the G20 countries\textsuperscript{532} had implemented a total of forty-seven measures whose effect was to restrict trade at the expense of other countries.\textsuperscript{533} Others resorted to sector-specific bailout programs to support crisis-hit industries, such as automobile firms.\textsuperscript{534} Programs that distort resource allocation and prove disadvantageous for other sectors and competitors in other countries effectively amount to trade barriers.\textsuperscript{535}

Protectionism may be motivated by political, or short-term economic considerations;\textsuperscript{536} however, it often comes at a significant economic cost to national welfare. One such cost is the deadweight loss caused by restrictions to free trade, borne by consumers and society as a whole.\textsuperscript{537} It is estimated that trade restrictions raise the cost of imported goods in the USA by 20\% on average, and raise the price of comparable domestically produced goods by 10\% to 14\% because of reduced price competition.\textsuperscript{538} For example, a Brookings Institution

\textsuperscript{531} ibid.
\textsuperscript{532} G20 is an abbreviated name for the Group of Twenty Finance Ministers and Central Bank Governors (nineteen countries plus the European Union), who periodically confer at summits since their initial meeting in 2008.
\textsuperscript{533} According to the World Bank’s monitoring list of trade and trade-related measures, since the beginning of the financial crisis, officials have proposed or implemented roughly 78 trade measures. Of these, 66 involved trade restrictions.
\textsuperscript{535} Wolf-Georg Ringe and Ulf Bernitz, ‘Company Law and Economic Protectionism – An Introduction’ in Ringe and Bernitz (eds) (n 429) 2;
\textsuperscript{536} One example being the German government’s national car scrappage scheme, labelled as an ‘environmental bonus’.
\textsuperscript{537} ibid.
\textsuperscript{538} Such as the preservation of employment, see Messerlin, who attempts to estimate the cost of protectionism in Europe in the 1990s and concludes that protection in the form of tariffs and non-trade barriers is too costly an instrument for ‘saving’ jobs. Only a few jobs – roughly 3 percent of the total number of jobs existing in the sectors studied – are estimated to have possibly been saved by the high protection granted to these sectors. The combination of high costs of protection for EC consumers and few jobs saved leads to an astronomical average annual cost per job saved: roughly EUR 220,000, or ten times the European average wage of the sectors involved.
\textsuperscript{537} See Milton Friedman and Rose Friedman, ‘Free to Choose’ Harcourt, 1980, 41.
study estimated that ‘voluntary’ export restrictions on automobiles cost consumers about $14 billion in the mid-1980s, while on a cost per auto basis, one study estimated that import quotas added, on average, $2,400 to the price of a Japanese car. The abovementioned costs are not borne by consumers alone, local businesses and industries obtain products at higher prices, thus subjecting their business activities to additional monetary burdens: a study of the pre-1985 restraint agreement between the USA and the European Community estimated that the induced increase in the price of imported steel was 30%. In short, restricting trade can have negative effects on allocative, productive and dynamic efficiency: consumers (and businesses alike) are not able to purchase products or services at the lowest prices or benefit from wider consumer choice and innovative products/services. Moreover, the promotion of national products at the expense of foreign competitors can prove dangerous, as it is said to ‘run the risk of encouraging retaliation and severely constrain supply chains that use imported goods’.

Takeover barriers are equally economically harmful in the sense that they are often designed to ring-fence weak and inefficient management to the detriment of shareholders and/or to protect a few shareholders to the detriment of the rest. As a result, the economy foregoes the efficiencies associated with open markets. In addition, political opposition to cross-border M&A can impose monetary costs on the economic value of domestic firms. To demonstrate those

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541 For example, if the steel industry receives protection, steel-using industries have to pay more for their steel.
543 Such as the ‘buy American’ clause included in stimulus packages,
Ringe and Bernitz (n 429) 2.
544 ibid.
545 Crispin Waymouth, 'Is "Protectionism" a Useful Concept for Company Lawyers?' in Bernitz and Ringe (eds) (n 429) 49.
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costs, Won and Wang have examined the case of Congress's opposition to CNOOC's proposal to acquire Unocal in the USA in 2005. As they indicate, the share prices of both firms suffered a significant setback in the wake of the anti-CNOOC events. While an equal-weighted portfolio of 13 USA oil refining companies (excluding Chevron) showed an average decline of nearly $7.9 billion in its market value per event, another equal-weighted portfolio of 66 USA oil and gas exploration companies (excluding Unocal) registered a decline of some $1.9 billion on average per event. As they mention, these two portfolios lost a total of nearly $59 billion in their market values, which exceeded the GDP of Kuwait in 2005. In short, takeover protectionism can, similar to trade protectionism, compromise social welfare as well as an economy's growth prospects.

Investment protectionism may also have detrimental effects on national welfare. A comparative analysis of the USA economy between two periods can serve to prove this point. In the later period, between November 1982 and December 2007, large overseas capital was available in the USA and the economy was in recession only 4.6% of the time. On the other hand, in the period between 1945 and 1982, foreign capital was generally unavailable, and the economy was in recession for 22.4% of that time. More recently, the global financial crisis showed FDI not only as useful as a stabilising force post-crisis but also as possibly contributing to the recovery of the economy.

As far as industry bailouts are concerned, it is important to add that these are accomplished with the use of public funds, forcing national governments to run high fiscal deficits. Although maintaining fiscal deficits is often the norm for many countries, this proves problematic when those deficits become excessive.

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546 Kam-Ming Wan and Ka-fu Wong, 'Economic Impact of Political Barriers to Cross-Border Acquisitions: An Empirical Study of CNOOC's Unsuccessful Takeover of Unocal' (2009) J CORP FINANC 15, 447; To quantify the impact of the CNOOC case, the authors examine the share price reaction of numerous USA oil companies to the events pertaining to a political challenge against CNOOC’s proposal to acquire Unocal. Their sample firms comprise companies in the USA oil refining and oil and gas exploration industries. For more on those events, see (n 934).

547 ibid 5.

548 ibid 5-6.


550 ibid.

551 Chapter 3, n 407 onwards.
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In particular, high fiscal deficits were perceived as one of the main causes of the sovereign debt crisis currently experienced by a number of Eurozone member countries. Judging from these outcomes, Keynes’s ‘excessive cost’ (referred to above) becomes more relevant. The problem is that this excessive cost is not always obvious at an early stage, when, for example, countries take the decision to execute large bailouts.

In this context it may be useful to refer to the national champion argument. The term ‘national champion’ usually refers to companies which are subject to a particular treatment from governments because of some national dimension to their operation. A government may wish to interfere with the management of assets, which they deem of strategic national importance by restricting the control of these assets by foreign individuals or entities. Suedekum argues that globalisation and trade integration seem to reinforce the case for promoting national champions. He notes that even a protectionist government ‘may allow a foreign takeover if trade openness is low, because the consumer gain from vanishing transport costs is most substantial’. Yet, as trade becomes freer, the domestic competition agency opts for the national champion beyond a certain point, in order to prevent a buyout of domestic producer surplus by a foreign corporation. Governments may, through the system of incentives and


553 This matter is also dealt with in chapter 5 n 913 onwards, where the situation of Greece is examined.

554 This point raises the question of whether the risk of causing a debt crisis (by handing out bailouts) is preferable to letting the recession devastate the industry in question. But the point raised here is that government bailouts, intended to fend off national industries from foreign competitors, when carried out by governments with deep structural macroeconomic imbalances, can trigger negative consequences that go far beyond the risk to the industry initially perceived. A good example of this is the debt crises currently suffered by many Eurozone members.

555 For instance, because of the importance of the industry concerned or simply because its assets at located within the country.


557 ibid.

558 ibid.
constraints, ensure that domestic shareholders are more aligned with the policies of government. To this end, a government may provide state aid or adapt regulations to achieve its desired outcome.\textsuperscript{559} This policy is questionable. Firstly, it takes an extremely paternalistic view of an infallible government whose policies always enhance national welfare. Secondly, it endorses an opaque and arbitrary use of state aid policy and government regulation. Thirdly, this policy rests on the assumption that the decisions of the shareholders are affected by their nationality. However, it is difficult to prove that domestic shareholders’ concerns differ from foreign ones with regard to a firm’s long-term profitability and viability.\textsuperscript{560} Neven finds that the multinational character of a firm may matter more for growth and productivity than the actual nationality of the shareholders.\textsuperscript{561} But, as he says, the growth of multinational firms requires access to foreign assets, so a presumption against government interference remains.\textsuperscript{562} Arguably, local managers and shareholders may have a better understanding of local culture and customs, but foreign ones may understand foreign clients better.

Still, there are more than just market-based arguments against investment protectionism: political arguments also play a role. In particular, western states need to understand that the global economic power equation is rebalancing: the west is no longer the uncontested dominant player in global financial markets. The emergence of SWFs is no passing phenomenon but a permanent feature of the international financial order. Securing access to capital from the Arab world and other emerging economies has become a substantial challenge for western economic diplomacy.\textsuperscript{563}

Formulating the proper regulatory response requires striking a fine balance between the need for foreign capital and the danger of foreign governments interfering in certain sectors of the national economy. It is difficult, in this sense, to predict when a regulatory response may go too far and become (or be perceived as) overly protectionist. An example of the downside of protectionism

\textsuperscript{559} ibid.
\textsuperscript{560} ibid 1.
\textsuperscript{561} Neven (n 555) 8.
\textsuperscript{562} ibid.
\textsuperscript{563} Behrendt (n 257) 19.
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was when China suspended investments in Europe before the financial crisis.\textsuperscript{564} Similarly wary of protectionism, Nair argued that India should not create a SWF with the aim of investing India’s surplus in energy abroad, on the assumption that SWFs generally face protectionism and political backlash throughout the world.\textsuperscript{565} In short, Nair believes a SWF for India is more likely to bring problems rather than benefits.\textsuperscript{566} Similar claims have been made by the Governor of the Central Bank of the United Arab Emirates.\textsuperscript{567} Finding where the red line lies for each potential (benign) investor is not an easy task either.

In this context, it is understandable why, as long as SWF investments are not examined from a public policy perspective, concerns about them will persist, resulting in mounting pressure on national governments to adopt protectionist measures.\textsuperscript{568} Indeed, protectionist attitudes,\textsuperscript{569} obvious until the financial crisis, were seen as the direct result of the opaque nature and difficulty of determining the investment motives of SWFs.\textsuperscript{570} As Kern notes, ‘there should be no naivety about it, strategic interests should be protected’. The question then becomes: is regulation necessary to achieve these aims?

\textit{ii. The rationale for regulatory intervention}

\textsuperscript{564} n 364.
\textsuperscript{565} Nair, a senior fellow at the Wharton Financial Institutions Center, supports this view on the basis that India should diversify its excess reserves in energy, a sector tightly protected by governments from foreign investments. He cites the examples of Venezuela and the USA. Vinay Nair, ‘Should India Set up a Sovereign Wealth Fund? It’s a Bad Idea’ (India, Knowledge@Wharton), 27 March 2008, \url{http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4272} accessed 9 November 2012.
\textsuperscript{566} ibid.
\textsuperscript{568} A paper published by the OECD during the crisis warned of this risk: ‘Faced with rising public fear and distrust, governments are now necessarily focused on restoring national economic and employment growth and financial stability. Although they recognize that open markets ultimately contribute to a sustainable recovery, domestic economic and political pressures might make them less mindful of their international commitments to openness. In this context, there is a risk that countries will be tempted to adopt ‘beggar thy neighbor’ policies, including investment protectionism in various guises’, OECD, ‘Building Trust and Confidence’ (n 519) 12.
\textsuperscript{569} For such examples, OECD, ‘More Governments Invoke National Security’ (n 285).
\textsuperscript{570} See n 519; Allen and Caruana (n 213) 16.
Having established the broad principles that must shape the regulatory response to SWFs, the next step is to establish a rationale for regulating SWFs. History has been dominated by the clash between economists who consider market forces to be largely sufficient to regulate the behaviour of market participants, and those who see regulation as an alternative to the failure of market forces to produce a socially optimal outcome. Regulation, itself, does not come without costs, nor is it panacea to every inefficient market outcome. It is essential, therefore, for the establishment of a regulatory rationale, to expose the elements that make regulation necessary. The background to this discussion was analysed in chapter 3 which examined the benefits and concerns associated with SWFs. The present discussion uses the conclusions from chapter 3 to establish a rationale for regulation.

The adoption of financial regulation is a process that is, to a large extent, reactionary to financial crises. According to Brunnermeier and others ‘when everyone is calling for more regulation, for example, as now, in a post-crisis setting, it is not needed at all, since bank managers are timid and risk averse. When regulation is needed no one wants it, because asset prices are rising, there is a boom, everyone is optimistic and regulation just gets in the way’. In the case of regulating SWFs, on the other hand, as demonstrated before and after the start of the financial crisis, regulation is more popular when the economy is performing well, when company managers and governments can afford to be more selective about the origin of foreign investments and the reserves of SWFs

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571 Such economists are Friedman of the Monetarist school, Stigler and Posner of the Chicago School and Hayek of the Austrian School. These economists believe that government intervention creates more problems than it is supposed to be solving.
Milton Friedman, Capitalism and Freedom: Fortieth Anniversary Edition (Chicago University Press, 2002);
Ludwig von Mises, The Historical Setting of the Austrian School of Economics (Ludwig von Mises Institute, 2007).

Steven Schwartz, ‘Regulating Complexity in Financial Markets’ 87(2) WULRev, 211.

573 This refers to the GFC, chapter 2, n 306 onwards;

574 ibid.
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grow at a faster pace.\textsuperscript{575} During downturns, however, when foreign investments become crucial for the economy, hardly any government or company manager discusses regulation. As to the time when regulation is more needed, there is no definitive distinction between times of growth and times of crisis, since the perceived risks of SWFs exist independently of the state of the recipient economy. Arguably, regulation is pertinent at all times, but especially at times of crisis when governments are more willing to set aside national security and other concerns, as they are more desperate for foreign capital. Screening SWF investments during an economic downturn, however, could come at extremely high cost for the domestic economy. Therefore, during recessions, the immediate national interest dictates that SWFs remain unregulated, even, perhaps, at the cost of possible future national security risks.\textsuperscript{576}

When using the concept of regulation, distinctions must be established between regulation, monitoring and supervision. While \textit{regulation} is defined as the establishment of specific rules of behaviour, \textit{monitoring} means observing whether the rules are obeyed, and \textit{supervision} refers to the more general observation of the behaviour of financial firms.\textsuperscript{577} Although in the case of SWFs both \textit{regulation} and \textit{supervision} are important, the main focus of this section is regulation.

Before any basis for regulating SWFs can be established, it is crucial to distinguish between the perceived objectives of, the rationale for and the reasons for regulating. An \textit{objective} refers to ‘the outcome that regulation is trying to secure’, \textit{rationale} determines ‘why regulation is necessary if the objectives are to be achieved’ while the \textit{reasons} concern ‘why, in practice, regulation takes place’.\textsuperscript{578}

Thus, the objectives of wider financial regulation might be, for example, to sustain systemic stability, to maintain the soundness and safety of financial firms or to protect consumers. The economic nature of those objectives implies that

\textsuperscript{575} As it was argued, for instance, at n 478.
\textsuperscript{576} See formerly concerned governments, when the recession struck, set aside their concerns over national security and actively sought investments by SWFs, see Fotak and Megginson (n 478).
\textsuperscript{577} Llewellyn (n 385) 6.
\textsuperscript{578} ibid 8.
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regulation ultimately aims to improve national welfare. However, it was seen above\textsuperscript{579} that regulating economic activity, such as trade or FDI, can run counter to national welfare. The explanation for this apparent contradiction is that regulating trade or FDI (and thus giving rise to protectionism) can impede healthy economic activity and thus be welfare reducing. Regulating the financial sector, however, might address problematic activity, protect society from recessions and maintain national welfare. By extension, it is understood that trade and FDI can increase total welfare (defined as the surplus consumers and producers benefit from while conducting an economic activity) in the long term, whereas an unregulated financial sector can increase total welfare only in the short term. In the longer term, the financial sector, if left unregulated, will succumb to the boom and bust cycle, threaten financial stability and produce losses for society as a whole.

Thus, the objectives of regulating the wider financial sector are mainly economic. The existing arguments for regulating SWFs, however, are both political and economic. As seen in chapter 3, the objectives behind regulating SWFs are not only the maintenance of financial stability and the protection of individual firms and minority shareholders, but also the safeguarding of national security and assets.\textsuperscript{580} It is crucial to note that the objectives of regulation are determined with relation to the perceived threats inherent in the way markets operate in the absence of such regulation. Therefore, in the absence of any credible basis for the abovementioned risks, regulation becomes unnecessary and a large part of the rationale for regulating SWFs is defeated.\textsuperscript{581}

According to Llewellyn, there are seven components of the economic rationale for regulation and supervision in banking and financial services.\textsuperscript{582} These are discussed below and their applicability to the case of SWFs is considered (see also table 4.1 below). For this purpose, the main risks caused by SWFs are considered, examining their applicability to the various components of the rationale for the regulation of banking and financial services.

\textsuperscript{579} n 549 onwards.
\textsuperscript{580} n 447 onwards.
\textsuperscript{581} As seen in chapter 3 with regard to national security and the protection of national assets.
\textsuperscript{582} Llewellyn (n 385) 9-10.
The first component is the potential systemic problems associated with *externalities* (a particular form of market failure). This point is intended to address the systemic risks caused by the behaviour of financial institutions. Systemic risks that flow from externalities usually describe the economically rational behaviour of a financial firm, which, if adopted by all firms, will cause the banking system to collapse.\textsuperscript{583} This threat is generally considered to be inherent in the financial sector because of the links between the firms operating in it and does not apply to other sectors, such as manufacturing.\textsuperscript{584} In the case of SWFs, such a threat is present only to the extent that SWFs might contribute to the creation of asset bubbles or where they collectively withdraw their investments. It was seen in chapter 3 that the likelihood of such threats being realised is very limited and SWFs should not require separate consideration from other investment vehicles in the general context of financial regulation. However, a number of authors deem such a threat to be real.\textsuperscript{585}

The second component of the rationale for regulation is the correction of other *market imperfections and failures*. This means that there are inherent costs in the market, such as information problems, conflicts of interest and agency problems that are not taken into account by the relevant actors when determining the price for their transactions.\textsuperscript{586} In the case of SWFs, this rationale appears to be more topical; it was seen in chapter 3 that such information asymmetries, mainly supported by the opacity of SWFs, raise questions as to their behaviour as shareholders and the risk of political interference.\textsuperscript{587} There is, therefore, a case for arguing for the existence of internal costs in the transactions of SWFs that, in the absence of regulation, are not accounted for.

The third rationale identified by Llewellyn is the need for *monitoring* of financial firms and the economies of scale that exist in this activity. This rationale does not necessarily relate to the purpose of regulation. Instead, it requires that all firms observe the rules laid down by market regulators, whether they concern

\textsuperscript{583} Brunnermeier and others (n 572) 13-23.
\textsuperscript{584} ibid.
\textsuperscript{585} Which justifies, in their eyes, the regulatory proposals put forward (see discussion in chapter 3, n 490).
\textsuperscript{586} Llewellyn (n 385) 21.
\textsuperscript{587} See the discussion in chapter 3, at 118 onwards, on national security and political leveraging.
financial stability, national security or investor protection. This rationale suggests that established rules are meaningless unless the regulator establishes the method, scale and frequency of monitoring financial firms’ compliance with them. As such, monitoring is a fundamental principle of any form of regulation and it applies to financial firms and SWFs alike.

The fourth component of the rationale for financial regulation is the need for consumer confidence (which also has a positive externality). In general terms this means that, because of regulation, consumers are confident that their rights and interests are duly protected and, therefore, undertake more transactions and increase liquidity into the market. In the case of SWFs, regulation could ensure that parties on the other side of a transaction involving a SWF (whether companies, a shareholder or entire countries) will be protected from any abuse by such a fund. Regulation could, based on this argument, reduce popular or business backlash to sensitive SWF investments.

The fifth component is the potential for Grid Lock. This term describes the situation where all firms know how they should behave towards customers but, nevertheless, adopt hazardous strategies because they secure short-term advantages and the detection of such hazardous behaviour is only possible in the long run. SWFs, assisted by their opacity, could engage in such a behaviour and hide political agendas behind their investments. However, it was argued in chapter 3 that such a threat is limited and should not be overstated.

The risk of moral hazard is listed as the sixth rationale for regulation. This point is associated with the revealed preference of governments to create safety net arrangements, such as lender of last resort, deposit insurances, and compensation schemes. This element has no relevance in the case of SWFs.

Finally, Llewellyn states consumer demand for regulation as the final component of the rationale. This aims at creating a degree of assurance among consumers, as well as encouraging lower transactions costs (for example, saving costs in investigating the position of financial firms). This applies in the case of SWFs if the recipient companies and countries are considered to be the consumers. A graphic representation of this analysis is provided at table 4.1 below.

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588 Llewellyn (n 385) 27.
Each risk identified leads to its own type of cost. However, the risk of market imperfections can be broken down into different kinds of risks, each involving its own costs.

As seen from the discussion above, the majority of rationales used to justify the regulation of the wider banking and financial sector also apply to the case of regulating SWFs. In particular, it is argued that SWFs should be regulated to deal with the risks of externalities, market imperfections and Grid Lock, to boost consumer confidence and address consumer demand for regulation, and to enable monitoring. However, the underlying premises of these rationales are disputed by various commentators. For example, various experts in the field contest the risks SWFs bring on systemic stability (Llewellyn’s first

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589 An empirical study conducted for the IMF in 2009 examined financial stability issues that arise from the increased presence of SWFs in global financial markets. It concludes that there is ‘no significant destabilizing effect from SWFs on equity markets, which is consistent with anecdotal evidence’, Sun and Hesse (n 388) 4.
component) or political interference 590 (part of the second ‘market imperfections’ component). In the event where such risks are not substantial, but merely theoretical or unlikely to occur, then the rationale for regulating SWFs does not hold.591

Another view would hold that a number of risks undoubtedly exist but there is disagreement as to the degree to which they give rise to costs in the financial system. Those risks, mainly systemic stability risks, and various market imperfections (such as the uncertainty of their behaviour as shareholders and the danger of hidden political motives), arise because of SWFs’ lack of transparency. The perceived costs that flow from those risks may vary. They may amount to compromising national security, disrupting the functioning of international markets or damaging companies through the abuse of voting power in shareholders’ meetings. Somewhat lesser, they may consist in the exercise of political leveraging, affect market confidence (by causing uncertainty) or provoke a protectionist backlash in recipient countries.592 Based on the analysis carried out in chapter 3, this thesis holds that the costs at the higher end of the spectrum are not within the realm of possibility, and, thus, they do not need to be addressed by regulation. On the other hand, the costs at the lower end of the spectrum can be legitimate concerns and thus deserve consideration. However, it is not always the case that all of these problems can be resolved easily or even at all. International influence and leverage are as old as politics.593

Consumer/corporate confidence in the market for SWF investment may be an achievable goal for regulation, but reversing international political power is not.

Thus, the question is whether the abovementioned market imperfections necessarily warrant the adoption of regulation or whether the market response

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590 For example, Truman states that ‘these risks’, meaning the risk of political interference, ‘are largely in the realm of the hypothetical’, Truman (n 82) 4.
591 Applying the terminology used above, if rationale determines ‘why regulation is necessary if the objectives are to be achieved’, then it could be argued that the current structure is sufficient to achieve the objectives of stability and security without further regulation.
592 Regarding the risk of extracting technology, see the discussion in chapter 3 (n 605) as to why this should not constitute a concern.
593 Pistor, discussing the many ‘gracious’ investments by SWF to distressed western financial institutions, argues that SWF holding countries view themselves as being politically and economically intertwined with western countries, ‘and their relative autonomy depends on arrangements that mitigate their dependence’, Pistor (n 429) 296.
to market imperfections can be cost-effectively replaced or improved by government. Indeed, it is argued by Mezzacapo that, although markets do not necessarily provide first-best incentives to behave as efficiently as possible, (sometimes) they could however provide very good incentives. 594 Thus, Mezzacapo argues that, when searching for an appropriate market response to market imperfections, it is crucial to determine the incentives of the various market participants. As stated above, the market imperfections created by SWFs (and the subsequent costs) are rooted in the SWFs’ lack of transparency. Therefore, a clear incentive is created for SWFs themselves to build trust, but also more particularly, to devise rules, institutions and behaviours minimising the costs flowing from the opacity of SWFs. 595 At the same time, recipient governments and companies welcoming FDI have a clear incentive to maintain an open economy, whilst ensuring the protection of vital national and economic interests.

iii. ‘Transparency’ at the centre-stage of the discussion

If a discussion on the regulation of SWFs ultimately leads to the topic of transparency, this is because making SWFs more transparent is often considered the solution to most concerns regarding SWFs. 596 Thus, the question of whether it is transparency that must be targeted by regulatory proposals has been elevated to the centre-stage of the discussion. 597

As mentioned in chapter 1, when discussing the opacity of SWFs, USA and EU regulations provide for a considerable and comprehensive mandatory disclosure regime, that operates, for example, when a major stake in a listed company is

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594 Mezzacapo (n 422) 39-40.
595 ibid.
596 Although, as seen below, this has also been disputed.
597 As said by Schweitzer, ‘it seems that any regulatory regime meant to capture SWFs that would reach beyond transparency requirements would need to start from a definition of specific risk scenarios. To this day, these risk scenarios have not been well defined’, Heike Schweitzer, ‘[SWFs] – Market Investors, or Imperialist Capitalists? The European Response to Direct Investments by Non-EU State-Controlled Entities’ in Bernitz and Ringe (n 429) 273.
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acquired. However, as demonstrated in various parts of this thesis, such requirements have so far not produced an effective disclosure regime, and, as a result, many investment vehicles, such as SWFs and hedge funds remain extremely secretive.

Opinions diverge as to what the role of transparency is in the debate about regulating SWFs. On one side of the discussion stand authors who view transparency as a means to achieve other results, while others argue in favour of transparency as an objective in itself.

Mezzacapo, for example, says that transparency is to be regarded as an ‘intermediate target’, one used to attain other policy objectives, and is not an objective itself. Thus, for Mezzacapo, there is no objection to allowing opaque investors to operate in foreign market because ‘any shareholder/investor is not per se transparent (for example, hedge funds and private equity funds) unless required or imposed to [be] so’. Therefore, for Mezzacapo the real concern about SWFs is not their lack of transparency per se, but the fear of hidden political motives that might impact on international and domestic markets.

Along similar lines, it has been argued by Lowery that in looking at both a large SWF (Norway’s GPFG) and a large USA state pension fund (California Public Employee Retirement System – CalPERS) which exercise their voting rights, two things stand out: one is ‘the utility of laying out in advance the broad policies that guide how the fund votes, in order to avoid undue, unwelcome surprises.’

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598 In the USA, the Securities Exchange Act requires disclosure of important information by anyone seeking to acquire more than 5% of a company’s securities by direct purchase or tender offer, Securities Exchange Act of 1934, PubL 73-291, 48 Stat. 881, 15 U.S.C. § 78a et seq; When a major holding in a listed company is acquired or disposed, see Articles 85-97 of Council Directive 2001/34/EC of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities; In case of acquisition and disposal of ‘qualifying holding’ in banks, insurance, financial intermediaries, mutual funds and other regulated subjects, see Articles 12, 19-21 of Council Directive 2006/48/EC of 14 June 2006 relating to the taking-up and pursuit of the business of credit institutions OJ L177/1.

599 n 150 onwards.

600 Such as Mezzacapo (n 422) 28; and Lowery (n 603).

601 Such as Truman (n 65) and Halvorsen (n 167).

602 Mezzacapo (n 422) 28.

Another is ‘the utility of disclosing the actual votes themselves, so that outside observers can assess whether the fund is following its stated broad policies.’604

A somewhat more principled approach towards transparency is adopted by Truman, who states that ‘transparency [in SWFs] promotes horizontal accountability among the interested parties and stakeholders (domestic and international) as well as vertical accountability within the policy process’.605 ‘Accountability’, as he adds, ‘involves the citizens of the home country, the citizens of the host country (who may distrust the motives of the foreign government), and the international financial community in general, including other participants in global financial markets’.606 Although Truman does not make his position as to the place and role of transparency in the discussion entirely clear, his stance comes close to arguing that there is a case for transparency per se. Similarly, Halvorsen’s (former finance Minister of Norway) statement that ‘transparency is key, transparency builds trust’607 implies that transparency is not merely a tool, but rather a principle according to which international financial markets should operate.

As noted by the European Commission, SWFs transparency ‘is also important to ensure SWFs are included in global surveillance of financial markets’.608 It appears, therefore, that according to the EU regulator, public monitoring and supervision of SWFs may be mainly or primarily focused on the phase of ‘integration’ of SWFs financial resources in recipient countries’ economies, and aims at increasing the overall level of transparency as well as strengthening the supervision of entities and intermediaries used by SWFs to manage their assets.609

Gilson and Milhaupt offer a different perspective. They argue that increasing transparency is not even necessary, that the fundamental problem lies in the state-owned nature of SWFs and in the fact that sovereigns have ‘different

604 ibid.
605 Truman (n 65) 7.
606 ibid 8.
607 Statement made in an OECD forum about SWFs in 2008, see chapter 1 (n 167).
608 Commission (n 1) 5.
609 Mezzacapo (n 422) 45.
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interests from private investors’. Therefore, ‘lack of transparency is not in itself the problem, and as a result transparency cannot be itself the solution’.

The position taken in this thesis is that while transparency and accountability of financial firms are sound governance principles, financial actors should be allowed to derogate from applying them fully if this is necessary for their operation. Transparency and accountability could become powerful tools in the hands of regulators tasked with maintaining financial stability and eradicating market imperfections. In the case of SWFs, such funds should be actively encouraged to increase their transparency levels, as this can alleviate potential concerns of recipient countries and create a more open environment for SWFs. On the other hand, as things currently stand, SWFs should not be obliged to implement higher transparency standards than those required for their competitors (which is usually taken as the standard required for the maintenance of financial stability). This point raises many issues seen under the principle of competitive neutrality, namely, that ‘no business entity is advantaged (or disadvantaged) solely because of its ownership’. In fact, a certain degree of opacity is necessary for SWFs in order for them to maintain their effectiveness and competitiveness vis-à-vis other investment vehicles, such as hedge funds. If hedge funds and investment banks are allowed to operate in complete obscurity, then it would seem unacceptable to impose stricter standards upon SWFs simply based on theoretical and unclear concerns about national security and political interference. If, however, regulators deem that more transparency from hedge funds and other investors is necessary to avoid

610 Gilson and Milhaupt (n 156) 3.
611 According to Gilson and Milhaupt, international investments are always political and the very existence of sovereign investors (quoting Truman) ‘calls into question our most basic assumptions about the [...] functioning of our economies and the international financial system,’ ibid 3.
The response offered by Gilson and Milhaupt is analysed below at n 654 onwards.
612 Antonio Capobianco and Hans Christiansen, ‘Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options’ (2011) OECD Corporate Governance Working Papers, No. 1, OECD Publishing 3. Competitive neutrality is usually concerned with possible sources of competitive distortions which can arise because of advantages some public sector businesses have due to their government ownership. Governments may create an uneven playing field in markets where a state firm competes with private firms, as they have a vested interest in ensuring that state-owned firms succeed. In the current case, competitive neutrality is concerned with the reverse, namely that state-owned firms are not subjected to additional constraints simply because of their state ownership.
another financial crisis, then the same standard should apply to SWFs as well. This way SWFs would not be permitted to resist calls for transparency on the basis that they are being unfairly discriminated against.\footnote{See for instance, n 160, 1061.} In short, while transparency may be a good principle in itself, derogating from it can be necessary to protect competitiveness.\footnote{This point is touched on again in chapter 6, at 286–287.}

Based on the rationale and the objectives of regulation discussed above, the second part of this chapter develops various theoretical regulatory models that have been suggested in the past and may be applied to regulate the behaviour of SWFs.

\textit{iv. Can foreign investments be blocked?}

A final question relevant to establishing a rationale for regulation relates to whether the actions of foreign governments can indeed be regulated by other governments. In other words, can a sovereign government be asked to comply with specific standards in the way it manages its public wealth or can it benefit from a form of sovereign immunity?

Discussing the possibilities of regulating SWFs is not equated to intervening in the sovereignty of other governments. Instead, the focus is on regulating the commercial activities of those governments in foreign jurisdictions. It would be very difficult, if not impossible, to link the investment behaviour of SWFs with any issues of sovereignty, let alone, sovereign immunity.

To establish a connection between SWFs and sovereign immunity, one must first consider whether an act of a SWF can be attributed to a government\footnote{In the sense of being attributable to a state or a 'separate entity, distinct from the executive organs of the government of the state and capable of suing or being sued', Fabio Bassan, \textit{The Law of Sovereign Wealth Funds}, Edward Elgar Publishing, 2011, 100; This definition appears both in United Kingdom State Immunity Act 1978, s 14(1) and the 1972 Convention on State Immunity (Art 27, and para 107-9 of the Explanatory Note).} SWFs can have varying degrees of independence from government influence.\footnote{This decision depends on its incorporation, its powers and activities, as well as on its relationship with the state.} In certain cases it would, indeed, be futile to attempt to link a SWF action to its respective government.
Secondly, even if the first hurdle is overcome, most governments nowadays adopt a more restrictive approach towards sovereign immunity, which immunises foreign states from suits in connection with sovereign acts, but does not equally cover commercial acts.617 This exception from immunity applies both with regard to immunity from jurisdiction as well as immunity from execution.618 States adopting this approach include the USA619 and the UK620 the primary recipients of SWF investments. The jurisdictional immunities of the state were addressed again in February 2012 in the case of Germany v. Italy (Greece intervening)621 before the International Court of Justice. The Court noted that it was not called upon in these proceedings to consider the question of how international law treats the issue of state immunity for non-sovereign activities, especially private and commercial activities (acta jure gestionis) to which, under many laws, immunity does not apply. As Truman, rightly, notes, ‘governments are understandably concerned about not compromising their room to manoeuvre in managing their international investments [...] however, once a government seeks to operate outside its national borders, then it no longer is ‘sovereign’ in most respects.’ 622 Indeed, in most jurisdictions, sovereign immunity does not apply to foreign governments’ commercial activities.623

The above point becomes relevant when considering the applicability of the ‘act of state doctrine’ to the behaviour of SWFs. The act of state doctrine holds that ‘every sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgement on the

619 Letter from Tate, Acting Legal Adviser, USA Department of State, to Acting USA Attorney Perlman, 19 May 1952, reprinted in 26 Dept. State Bulletin 984–85; Under the restrictive theory, foreign states were accorded immunity for their governmental acts, but not for their private or commercial acts.
620 Section 14(2), (3) State Immunity Act 1978.
621 Jurisdictional Immunities of the State (Germany v. Italy: Greece intervening) - Judgment of 3 February 2012.
622 Truman (n 65).
623 For a more detailed discussion on the issue of ‘sovereignty’ and how it applies in the context of SWFs see, Gordon and Tash (n 414) 16, ‘a trend away from conferring absolute sovereign immunity’.
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acts of the government of another done within its own territory'. This doctrine is used to protect a national government from the scrutiny of acts performed within its own borders by foreign courts. For acts performed by a government outside its national borders, the act of state doctrine cannot be evoked. Thus there should be no obstacle on the basis of ‘sovereignty’ in the regulation of SWFs.

An additional question before regulatory frameworks are discussed is whether national regulatory measures comply with international foreign investment law, or, in other words, to what extent can SWFs rely on international multilateral treaties? At a multilateral level, the existing treaties give limited guarantees to SWF investments. Given the absence of a specific treaty on investments, the protection afforded to SWFs by international treaties is ‘indirect, conditional, fragmented, if not occasional’.

Firstly, such national measures can be viewed from the scope of World Trade Organisation (WTO) rules, in particular, Agreements on Trade-Related Investment Measures (TRIM) and General Agreements on Tariffs and Trade (GATT). TRIM Agreements are agreements reached by WTO members. These, however, do not relate to FDI. They only deal with trade issues and aim to guarantee that foreign investments are not subject to trade restricting measures.

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In this case, Underhill instituted an action in a New York Court to recover damages for his detention in Venezuela by Hernandez’s new revolutionary government. Finding for the defendant, the court determined that Hernandez had acted in his official capacity as a military commander so his actions were those of the Venezuelan government. Therefore, based on the act of state doctrine, the Court refused to hear Underhill’s claim against the government.

625 For more see,
626 Bassan (n 615) 76.
628 Any attempts to broaden the notion of investments in TRIM agreements, or extend their scope so they can apply not only between states, but also between states and individuals have not been concluded; Bassan (n 615) 55.
GATT rules, on the other hand, may, at least in theory, apply to SWFs. In particular the relative provisions are the principle of mandatory national treatment on internal taxation and regulation (Article III), and of non-discrimination (external, Article I, and internal, Article XIII). The principles of reciprocity (Preamble and Article XXVIII), and transparency (Article X) are also of relevance. These principles however, can hardly apply in practice to SWF investments. As stated by Bassan, these are general principles that cannot apply to specific investment cases and GATT rules apply to the trade of goods and, as such, its principles would apply only indirectly to investments.

Regulations promulgated by the OECD may also provide a theoretical framework to apply to SWF investments, although it may be of limited relevance in practice. In particular, the OECD has issued the 1961 Code of Liberalisation of Capital Movements and the 1976 Declaration on International Investments and Multinational Enterprises (containing the principle of national treatment), both of which are of relevance to SWF investments. These instruments also provide for non-discrimination of foreign investments and transparency.

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630 The requirement that taxes and other internal charges are not applied to imported products so as to afford protection to domestic products.
631 Requiring that any advantage accorded to any product originating by another country, shall immediately and unconditionally be accorded to any like products originating by all other contracting parties.
632 The rule of non-discriminatory administration of quantitative restriction.
633 Requiring reciprocity of obligations and guaranteeing equal trade opportunities.
634 Guaranteeing the publication of the measures that a state may take to restrict foreign SWF activities.
635 Bassan (n 615) 57.
636 OECD rules specific to SWFs are dealt with in chapter 6 n 1067. At this stage, only the general rules on foreign investments are examined.
637 This document, which applies to all long- and short-term capital movements between residents of OECD countries (including FDI), is the only binding multilateral instrument promoting liberalisation of foreign direct investment and establishment in all sectors of the economy. OECD ‘Code of Liberalisation of Capital Movements’, (OECD, 2012) <www.oecd.org/daf/internationalinvestment/investmentpolicy/39664826.pdf>, accessed 25 August 2012.
638 This document was last amended in 2011. As opposed to the Code of Liberalization, this one is merely a recommendation and it is addressed to the enterprises, and not to national governments. OECD, 'Text of the OECD Declaration on International Investment and Multinational Enterprises' (OECD, Investment Policy, 2011) <www.oecd.org/daf/internationalinvestment/investmentpolicy/oecddeclarationoninternationalinvestmentandmultinationalenterprises.htm>, accessed 7 October 2012.
obligations of restrictions adopted, along similar lines to the WTO instruments. However, both documents seem rather toothless when considering the range of exceptions provided in their text. The Code of Liberalisation, in particular, provides an exception for public order and security in Article 3, but abstains from defining those concepts and entrusts this task to member states. Moreover, the obligation to treat non-residents on an equal footing with residents applies only between residents of OECD countries. Finally, OECD instruments do not contain legally binding dispute settlement provisions, although Article 17 offers the possibility of bringing to the Organisation any case of alleged violation of its obligations by a Member.

So far this chapter has analysed the theoretical framework of the rationale for regulating SWFs as well as the legal implications involved. The next step is to examine regulatory structures that have been proposed in the past in the context of SWFs.

2. Potential regulatory frameworks

In recent years, and since SWFs have attracted a level of attention, various regulatory models for SWFs have emerged. These proposals have appeared in both academic papers and media articles and, naturally, some are set out in more detail than others. A categorisation of the models most commonly offered in the relevant literature follows.

In the first category are models that favour limitation of the operation of SWFs. It has been suggested, for example, that a ceiling should be imposed on the amount of shares SWFs can acquire in domestic companies, or that it be made conditional (on state approval) for share ownership to exceed a certain
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percentage. Other models falling within this category suggest removing various sensitive sectors from the scope of SWFs altogether. Combinations of the above models have also been put forward.

A second type of model favours ‘incentive-type’ regulations. Supporters propose imposing charges on SWFs (such as additional taxes or restricting their voting rights) until they rectify the costs they impose on target countries, or until they transfer their assets to private actors.

The third kind of regulatory proposals suggests imposing reporting requirements on SWFs.

Finally, another regulatory model, discussed below, advocates allowing SWFs to regulate their behaviour by themselves (‘self-regulation’).

i. Limiting SWFs’ acquisitions and protecting strategic industries

The first model suggests imposing ceilings on the amount of shares SWFs can acquire and/or protecting certain industries from their investment ambit. This regulatory model finds its root in a measure which first appeared in the UK during the 1980s, known as the ‘golden share’. It originally concerned formerly state-owned enterprises, such as energy companies, in which former Prime Minister Thatcher purported to continue to exercise control over future ownership and activities, through the possession of a ‘golden share’.642 Through a golden share, for example, the state could control the percentage of shares held in a company by foreign investors, or ensure its approval was required for the execution of business activities, such as mergers and asset sales.

In 2007, Garten was among the first to propose a similar scheme, in an article in the Financial Times.643 Many governments, he stated, were at the time contemplating adopting measures to protect their industries from SWFs. However, ‘so far no western government has had the courage to admit that dealing with SWFs may require departures from the conventional liberal

orthodoxy concerning global trade and investment flows’. Yet, according to Garten, this is what was needed. He suggested that SWFs should not own more than 20% of any company in the USA or the EU without the host government making a decision to permit it. Garten suggested a requirement of reciprocity, where the ability of a country to buy foreign assets was conditional on that country granting similar access to foreign (western) funds. In his view the underlying premise is that SWFs are essentially political entities and should be treated as such.

In the same year, Davis, a Wall Street Journal columnist, also argued for a two-step response to SWFs. First, the USA, Europe and Canada would seek a common position on issues such as whether government funds should be limited to minority stakes, whether certain companies, such as defence and media companies, should be protected from foreign investments, and whether countries whose funds invest in certain sectors, such as financial services, should be required to open those same sectors in their domestic markets to foreign investment. Davis argued that a failure to coordinate could result in funds playing ‘one country against another to attract investment, like automakers play one state in the [USA] against another to get a richer package of tax cuts’. In the second stage, the SWF holding countries would participate in these talks, to ensure they would be ‘maintaining the freest possible access to invest in the world’s richest markets’. If the talks ended in failure, the USA and the EU could unilaterally impose rules.

Setting investment caps soon became a popular idea among various countries in Europe and elsewhere. Das pointed out that the commonly seen ‘knee-jerk reaction’ of analysts and policy makers in the recipient economies ‘is to limit the stakes that SWFs can have in [a] certain category of industries and keep it below a prescribed proportion’. Under such a model, the regulatory

644 ibid.
645 ibid.
647 ibid.
648 ibid.
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Authorities of the host country can determine both the industries accessible and the stake limit. Such a model is currently applied in India, where the Foreign Exchange Management Act of 1999 enables ‘Press Notes’ to be issued by the Department of Industrial Policy and Promotion and establish the foreign investment policy applicable to each sector. The Press Notes determine which sectors require the prior approval of the Foreign Investment Promotion Board before foreigners may directly invest in them and which do not require such approval. Additionally, the Press Notes establish the maximum percentage of a company that can be owned by a foreign investor based on the sector in which that company operates. Pursuant to Press Note 7, foreign direct investment is prohibited in the following industries: retail trading, atomic energy, lottery, gambling and betting, Nidhi companies (non-bank financial services), trading in transferable development rights and activities/sectors not open to private sector investment.

Some EU Member States, such as France, Greece and Germany also adopted similar measures. These were shaped by the circumstances that prevailed in each country at the moment of their adoption and were designed to address concerns specific to each of them. Thus, using the examples of France, Greece and Germany, each set of measures presents different degrees of protectionism. The legislative framework of these countries (as well as of the USA) as it relates to SWFs is the subject of detailed analysis in chapter 5.

**ii. Incentive-type regulation: restricting voting shares or imposing taxes**

Incentive-type regulation is softer than the regulation type discussed above. It is designed to offer incentives to SWFs operating in various countries which encourage them either to rectify the various costs they impose on the system or to transfer the exercise of voting rights attached to company shares to third parties. Superficially appealing, a detailed look reveals that the underlying

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650 While some sectors are 100% open to foreign ownership, they may not be invested in by foreigners without required FIPB approval.
651 Press Note 7, Issued by the Government of India, Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, SIA (FC Section), 16 June 2008.
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The purpose of such proposals is to incentivise SWFs to suspend investment activities altogether.

The first incentive-type regulation is the one restricting the voting rights of shares held by SWFs. This idea, as a protectionist measure against foreign corporate control, appeared towards the end of the 18th century. In the USA in 1791, legislative provisions were made in the charter for the country’s first quasi-central bank, the first Bank of the USA, to avoid foreign domination. Under the charter, only resident shareholders could vote and only American citizens could become directors. This provision prevented foreign control of the Bank, even though 62% of its shares by 1803 and 70% by 1811 were owned by foreigners.652

Buiter was among the first in 2007 to put forward a proposal of this type to tackle SWF concerns. A main concern was the risk of political extortion if, for example, the Russian Stabilisation Fund acquired a controlling stake in a UK energy distributor.653 According to him, SWFs should only be allowed to invest in equity that does not have control rights attached to it, that is, in non-voting stocks and shares.654

In 2009 Gilson and Milhaupt developed the idea in more detail. The authors’ ‘minimalist approach’ (as they described it) was to remove the voting rights of equities of USA firms acquired by foreign government controlled entities, until the equity is transferred to private hands.655 Their rationale behind their proposal is that, in principle, the interests of sovereign and private investors clash and they accept Keynes’s maxim that ‘international cash flows are always political’.656 The authors call this state directed capitalism ‘mercantilism’. By removing voting rights, sovereigns will refrain from exercising influence over management and those who have purely financial motives will continue to

652 Despite this, when its charter was up for renewal in 1811, the Congress did not re-charter the Bank ‘in large part owing to fears of foreign influence’, Chang (n 527) 3.
654 Ibid.
655 Gilson and Milhaupt (n 156) 10.
656 Ibid 1.
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This mechanism is mirroring the ‘break through’ rule provided by the EU Takeover Directive.658

Gilson and Milhaupt accept that their model may lead to unsuccessful results if applied in an under-inclusive or an over-inclusive manner. In the first case (under-inclusion), the model will lack effectiveness if it is not applied to other manipulative transactions, such as requiring strategic concessions before a SWF injects more capital into a portfolio company (problem of reciprocity); or if does not cover state investment entities other than SWFs which may also be used to advance political goals, such as government controlled companies.659 The authors believe that these problems can be dealt under the disclosure rules already present in developed countries or via other measures dealing with the phenomenon of state capitalism in general.660

In the second case (over-inclusion), the measure may apply to foreign public entities other than SWFs, such as state pension funds, and could risk being imposed by foreign governments on USA state pension funds, such as the CalPERS. Gilson and Milhaupt argue that suspending the voting rights of USA state pension fund foreign equity investments should not hurt the funds’ performance for the same reason that vote suspension should not deter USA equity investments by foreign SWFs who do not have a strategic motive.661 On the other hand, what is lost is the positive impact that shareholder activism by USA state pension funds, most vocally by CalPERS, has had on corporate governance standards in other countries. The authors accept this cost, but believe it is not a large one, mainly because the role played by USA state pension funds in the effort to improve corporate governance standards has not been

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657 ibid.
658 The ‘break through’ rule provides that shareholder voting restrictions provided by corporate charter, contracts or different shareholders’ agreements do not apply where the offeror has gained 75% of the shares of the target company, Thomas Papadopoulos, ‘The Mandatory Provisions of the EU Takeover Bid Directive and Their Deficiencies’ (2007) Vol 1(6) LFMR 525.
659 Gilson and Milhaupt (n 156) 26-28.
660 ibid 28.
661 ibid 30.

As they say, ‘the difficulties caused by the plate tectonics between capitalist systems in which the government plays radically different roles are far more important and far more complicated than those associated with SWFs. Suspended voting addresses only the latter’.

661 ibid 30.
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central.\footnote{662}{ibid.}

Another proposal falling in the category of ‘incentive regulation’ is the one offered by Fleischer in 2009.\footnote{663}{Victor Fleischer, ‘A Theory of Taxing Sovereign Wealth’ (2009) UIll&Econ Research Paper No LE08-030.} Fleischer based his discussion on the USA tax regime which currently treats SWFs as sovereigns for tax purposes.\footnote{664}{U.S. Tax Code, s 892.} Sovereign status in this context can be a significant benefit. As long as the SWF does not engage in commercial activity other than ‘portfolio investments’ (defined as the acquisition of non-controlling stakes), the funds can avoid both USA income taxes and withholding taxes on their USA investments.\footnote{665}{See also, Michael Knoll, ‘Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?’ (2009) 82 Southern California Law Review 712.} Private foreign investors, on the other hand, are generally taxed lightly on their portfolio investments in the USA, but do face significant taxes on some types of income, such as dividends from USA corporations and certain real estate investments.\footnote{666}{Fleischer (n 663) 24-25.} Fleischer, citing \textit{Qantas Airways v. US},\footnote{667}{Qantas Airways, Ltd. v. United States, 62 F.3d 385, 388–90 (Fed. Cir. 1995).} argues that such generosity is not required under international law, as ‘the international doctrine of sovereign immunity as such imposes no restrictions’ on the USA’s right to tax SWFs.\footnote{668}{Fleischer (n 663) 19.}

Fleischer develops a theory of taxing sovereign wealth as a complementary instrument to other regulations. He performs a cost-benefit analysis of the operation of SWFs and concludes that the negative externalities outweigh the positive ones.\footnote{669}{He says that SWFs threaten American foreign policy interests, support the inefficient allocation of resources, increase managerial slack (for example when China acquired a non-voting stake in Blackstone), their lack of transparency may have a contagion effect, they encroach on the autonomy of the American enterprise (in exchange for foreign investments) and support autocratic regimes, ibid 46-54.} In his view, because the potential for negative harm is severe, the potential for positive benefit modest, and the capital supplied by SWFs so easily replaced by private investors,\footnote{670}{Although he states that ‘neither the brightest promises nor the greatest perils of [SWFs] have yet been realized’, ibid 49.} there is a \textit{prima facie} case for a Pigouvian
tax. Fleischer argues that setting the right tax rate depends on what policymakers believe the hurdle rate of sovereign wealth fund investors is, which means in practice, whether they should be taxed more or less than private investors.

The main object of the above proposals is to incentivise SWFs either to sell their stakes to privately held companies (Buiter/Gilson and Milhaupt) or to reduce the costs they impose upon the system (Fleisher). However, as discussed below, both systems contain the basic elements of all incentivising schemes but fail to provide clear guideline by which SWFs could continue to operate in financial markets and, at the same time, retain their voting rights or avoid the tax charges.

**iii. Command and control regulation: increase transparency through reporting requirements**

This type of regulation advocates forcing SWFs, through legislation, to produce reports with specific information, thus aligning themselves with the regulated part of the industry, such as mutual funds, banks and insurance companies.

Such proposals appeared in Truman’s analysis of SWFs, where he supported the adoption of strict guidelines and the issuance of annual reports (and preferably quarterly reports) by SWFs. Similarly, Garten argued in favour of such action, as he suggested that investment restrictions be coupled with reporting requirements to tackle concerns about SWFs. Neither of these articles specify whether such reporting requirements should be for national authority purposes only or whether such information should be made public so that investors and media are equally able to scrutinise them.

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671 A Pigouvian, or corrective, tax, is designed to make the person who engages in an activity with negative externalities or public harms internalise the costs associated with that activity, Arthur Pigou, *The Economics of Welfare* (Macmillan and Co., 4th ed., 1932) 192–93.

672 Fleischer (n 663) 29, 33.

673 See n 1062 with examples of regulation.

674 Truman (n 65).

675 Garten (n 643).
Additionally, an ‘indirect’ supervisory and regulatory framework adapted to address the specific concerns about SWF investments may be based, as suggested by Keller, ‘on the mandatory requirement for a SWF to conduct investments over a certain threshold (or investments of certain kinds) through third-party professional asset managers’ or alternatively ‘to disclose its shareholder voting records when the ownership percentage in a company exceeds a given threshold’.676

A more detailed model is proposed by Mezzacapo, who suggests following a two-layer approach of ‘self-regulation within a statutory framework’,677 as the one widely adopted in Europe for stock exchanges regulation. In this respect, she recalls the provisions introduced in 2005 in the Italian Financial Consolidated Act678 in order to increase transparency, and thus market discipline, in relationships between Italian listed companies and foreign companies having their registered office in a country whose legal system does not ensure transparency.679 The same provisions also apply to Italian companies with financial instruments widely distributed among the public and affiliated with or controlled by such foreign companies.

Pursuant to Articles 165ter–165septies of the Italian Financial Consolidated Act, Italian listed companies linked, controlled or under the influence of ‘foreign non transparent companies’, for example SWFs, should attach to their Annual Report a Relation, signed by CEO and CFO, illustrating the relationship existing with the ‘foreign non transparent companies’. The Italian Securities Commission is entrusted with significant supervision and on-site inspection powers, while relevant countries are identified in joint decrees issued by the Minister of Justice and the Minister of the Economy and Finance (using criteria listed in the same Italian Financial Consolidated Act).

In order to prevent jurisdiction shopping by SWFs, where state investors would select as targets the jurisdictions that are more favourable to them, reporting requirements could be implemented on a global basis. A number of

677 Mezzacapo (n 422) 45.
678 Legislative Decree n. 58 of 24 February 1998.
679 Meaning transparency as to their establishment, assets and liabilities, and operations.
international organisations could be considered to host such an enterprise, although it is argued by Mattoo and Subramanian that the WTO would be the ‘natural’ place to strike a bargain between countries with SWFs which want secure and liberal access for their capital, and capital-importing countries that have concerns about the objectives and operations of SWFs. According to the authors, such a bargain would necessarily involve greater transparency by SWFs and channelling investment through independent asset managers, in return for access for SWF investors to western markets. The model for the transparency requirement could be the disclosure requirements of the OECD’s principles of corporate governance.\footnote{680}

\textit{iv. Self-regulation}

Since the beginning of the debate on SWFs, the idea of self-regulation has not received wide support in the literature. It seems that most commentators did not trust that, left to themselves, SWFs would produce a reliable regulatory framework to address the perceived costs raised by the activity of SWFs.\footnote{681} The model of self-regulation was, nevertheless, the one opted for by the IMF during the IWG which culminated in the ‘Generally Accepted Principles and Practices’ (GAPP) and which is discussed in more detail in chapter 6. To this day, GAPP, or the ‘Santiago Principles’ as they are often called, offer possibly the most effective route towards reducing the costs due to SWFs and silencing their critics, and together, reducing protectionist pressures.

The categorisation above of the most commonly proposed regulatory models has offered a platform of analysis on the basis of the real issues that surround SWFs, namely their benefits and concerns about them. The analysis below focuses on the theoretical aspects of the above models, but also aspects pertaining to the implementation and the costs of each system.

\footnote{681} For the OECD’s principles, see n 1066.

\footnote{681} See table 6.1 above.
3. Analysis

The basic problem identified in the abovementioned proposals is that they appear to be overshooting the mark. Nearly all of these proposals are based on the misguided premise that regulation is necessary to preserve national security and other interests, while the conclusions from chapter 3 show that such intervention is not necessary.\(^{682}\) In addition, each of those proposals is likely to impose extra burdens upon SWFs which might incite them to seek investment opportunities elsewhere, where they will not face protectionism.\(^{683}\) Thus, such models can result in being more economically injurious than beneficial.

Moreover, imposing additional burdens against foreign funds simply on the basis of state ownership appears discriminatory and ignores the fact that state-owned actors can behave like model investors in global markets. Finally, some of the measures contemplated are too severe on those SWFs that have already implemented high transparency standards, such as the Norwegian and USA funds,\(^{684}\) and may even discourage others from making similar progress. These difficulties are discussed in detail below.

i. Theory

The first ground for criticising the above models is that, with the exception of the self-regulatory model, they cannot avoid being labelled as overtly protectionist. In the words of Mattoo and Subramanian, ‘unilateral action could easily acquire a protectionist slant, especially if protectionists articulate their concerns in the language of national security as happened in the aborted acquisition effort by DPW and in the case of the Chinese SOE, CNOOC.’\(^{685}\) This first

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\(^{682}\) Although it may still serve a useful purpose in satisfying critics and general consumer demand for a risk free economic environment.

\(^{683}\) See above the case of Chinese funds, n 363.

\(^{684}\) See table 1.3 at chapter 1.

\(^{685}\) Mattoo and Subramanian (n 680) 16.
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objection could form a preliminary basis for rejecting most of the above models. In practice, any measure that aims at screening FDI on national security or any other grounds (even those justified) involves some degree of protectionism. However, the above models appear to go beyond what is necessary to guarantee specific national interests. As shown in chapter 3, most of the concerns about SWFs, which prompted the above regulatory models, are either theoretical, exaggerated or completely unfounded and thus do not need addressing with hard-line legislative measures.

Garten’s model (setting investment caps) has been met with fierce opposition in The Economist. In its criticism, The Economist described Garten’s view as ‘outrageous’ and said that he fails to explain ‘how any of this would serve the interests of the countries in which SWFs might want to put their money’. It was, moreover, argued that there are better ways of managing risk. If for example, the government of North Korea were in a position to lay its hands on vital defence-related technology by buying British Aerospace, say, that would, indeed, be a worrisome development. But the danger could be prevented ‘by making any such takeover subject to a national-security veto’, as would be the case in the USA. Following this article, and during the financial crisis, Garten himself retreated from his position, stating that he had ‘misjudged the context of global capital flows in the last half of this decade’ and that ‘we should be careful not to discriminate against SWFs, especially as compared with other investors such as private equity, hedge funds and corporations’.

Although Buiter’s model (allowing SWFs to invest only in non-voting equity) falls in a different category from Garten’s, he makes a similar mistake. It is a common practice, when discussing SWFs, to concentrate on extreme scenarios, such as that of a Chinese or Russian SWF taking over a controlling stake in a sensitive western company. This practice excludes from consideration the usual investment practices of SWFs dating back many years, and lacks an analysis of

687 Ibid.
the likelihood of such a scenario materialising.689 In the absence of this essential analysis, such scenarios cannot be granted much credibility.

The essence of Buiter’s suggestion, i.e. stripping SWFs of voting power, also appears in Gilson and Milhaupt’s model on how to deal with SWFs. Gilson and Milhaupt, however, offer a more complete proposal than Buiter in this regard, and therefore merit a greater level of scrutiny. Gilson and Milhaupt do not consider their proposal ‘protectionist’. In their view, a protectionist measure would be one designed to protect domestic companies’ commercial interests, whereas their proposal ‘would not lower investment values for foreign investors on account of their nationality or sovereign affiliation per se.’690 Gilson and Milhaupt believe that the absolute value of the investments (and thus their attractiveness) will remain unaffected by their proposal. However, it cannot be guaranteed that the economic value of a non-voting share will remain the same vis-à-vis sovereign investors,691 or that the overall value of a share will not decrease (even very modestly) if demand by SWFs drops. In any event, Gilson and Milhaupt’s argument appears to be an attempt to stretch the analysis of their model to bypass the ‘protectionism’ label. It is difficult to see how removing an important privilege from a specific type of foreign investor can escape the characterisation of ‘protectionism’. In addition, Gilson and Milhaupt’s proposal appears to discriminate against sovereign investors by removing a fundamental proprietary right (of the voting right attached to each share) for a weak justification, which is to protect ‘market based capitalism against mercantilist regimes’.692 Their justification, therefore, appears to be based primarily on the ideological premise that state capitalism is inherently problematic.

A similar inclination to that of Gilson and Milhaupt’s is also evident in Fleischer’s proposal (a fact which reinforces the reasons for including these two models in the same category). Fleisher argues that ‘a tax on sovereign wealth

689 As explained in chapter 2 and 3, SWFs never follow such investment practices when they invest in western companies; neither is it possible for them to do so.
690 Gilson and Milhaupt (n 156) 11.
692 Gilson and Milhaupt (n 156) 10.
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could help encourage a broader policy of supporting private investment over state-controlled investment’.\(^{693}\) This stance is a clear example of the challenges to western notions of capitalism posed by SWFs to which reference was made in chapter 3. In this respect, it should be said that while taxing and removing voting rights from SWFs appears to ‘incentivise’ them to operate differently, in reality what both theories suggest is to maintain the restrictions for as long as SWFs hold domestic securities or to tax them simply for their presence in the domestic market. There is not much SWFs can do to remove those restrictions or avoid being taxed, other than abandon the market altogether.\(^{694}\)

Finally, the issue of discrimination equally arises with relation to the command and control regulatory proposals, specifically those by Truman, Garten and Mezzacapo, advocating mandatory reporting requirements (which also involve placing sovereign investors at a serious competitive disadvantage).

The chapter now turns to analyse problems with regard to the implementations of the regulatory proposals.

\(\text{ii. Implementation}\)

The second of this three-part analysis focuses on implementation of the above proposals. It is shown that many of them involve important, if not insurmountable, difficulties, and as such do not represent a reliable solution to the concerns about SWFs.

The implementation of the first category of proposals, namely restricting the investments of SWFs, is thwarted by the question of how to identify an investor or a fund that should be subjected to such restrictions. This is a controversial and multifaceted issue (see discussion at 176-177). Furthermore, some host country

\(^{693}\) Fleischer (n 663) 55.

\(^{694}\) If a restriction or tax was implemented as a penalty for their opacity, all SWFs would have to do to regain their voting rights or avoid a tax would be to become more transparent. However, this is not required of them, rather Gilson and Milhaupt and Fleischer believe this restriction should be implemented for as long as they exist. Indeed, it is unlikely that a ‘special tax’ would incentivise the countries managing them to ‘stop threatening USA national economic interests’, or ‘cease to be autocratic’.
corporations and pension funds may be as averse to such limitations on the
SWFs as the SWFs themselves.\footnote{695}

First, restricting SWFs (either by imposing investment caps or excluding
various sectors from their ambit) would run into difficulties if applied in the EU.
Under the Treaty on the Functioning of the European Union (TFEU), capital
movements from third (non-EU) countries into the EU may not be hindered,
otherwise they run the risk of contravening the provisions of the Treaty.\footnote{696} So far
no judgment has been delivered by the Court of Justice of the European Union
(CJEU, formerly 'European Court of Justice') involving investments by SWFs, but
the existing case-law is sufficient to serve as a roadmap for most types of
investments, including those of SWFs. According to the rulings of the Court, FDI
may be screened, or hindered, only so far as it is necessary in order to protect a
fundamental national interest, such as national security or the provision of a
universal service (water, electricity etc.).\footnote{697} These provisions must also be
specific and proportional to the threat encountered and must not intrude into
the decision-making autonomy of the undertakings concerned.\footnote{698} In light of this
provision, most of the proposed regulatory frameworks, such as Garten's share
limitation model, Buiter's, and Gilson and Milhaupt's restriction of voting rights
and Fleischer's tax model (and in some cases even Truman's reporting
requirements model) would risk contravening EU law as they would fail to
demonstrate how SWFs can present an imminent and specific threat to the
national security of the recipient countries. As such, they would be struck down
by the EU Courts.\footnote{699}

Since some of those models support restriction of FDI in particular sectors, a
serious obstacle in their implementation would be identifying those ‘strategic
sectors’ that warrant special protection. It would be very difficult to adopt in the
EU context a uniform framework establishing which industries are ‘strategic’ and
which are not. In carrying out such an enterprise, each Member State would be

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\footnote{695}{Das (n 649) 99.}
\footnote{696}{See the discussion at chapter 5, n 739 onwards.}
\footnote{697}{n 752.}
\footnote{698}{ibid.}
\footnote{699}{The reach of the prohibition as well as the applicability of the case law in the case of SWFs is
discussed at 199 onwards.}
bound by its own interests and beliefs and by its own special circumstances, making it difficult to identify those sectors or sub-sectors of a strategic value to every member state. The fact that, in 2005, France included ‘casinos’ in its list of strategic industries as being ‘directly or indirectly linked to matters of national security’,\(^700\) is only demonstrative of the difficulties awaiting the EU regulator faced with the task of formulating an EU-wide list. Such an enterprise might also invite considerable public interest and render policymakers sensitive to populist arguments or subject them to special interests when determining strategic industries.\(^701\) In its capital movement case law,\(^702\) the CJEU has given directions as to what activity constitutes a strategic interest (which would in any event exclude sectors as obviously not strategic as ‘casinos’) but they still remain very broad and, more importantly, they do not give sufficient directions as to what specific parts of a sector are strategic and what not. As a result, the Court may consider Telecoms as a ‘strategic’ industry,\(^703\) although the Commission might not classify an entire national telecoms industry as strategic, but rather only specific parts of it.

A similar, if not more difficult, task would consist in identifying those funds that should be subject to reporting requirements.\(^704\) First, a number of high profile SWFs would refuse to be characterised as one of these.\(^705\) Thus each country would be faced with the task of unilaterally picking the specific funds that must disclose more information without driving those funds’ investments away to other countries.

To ensure a level playing field among all countries concerned, a global list of SWFs could be agreed multilaterally, possibly within the context of the WTO, as suggested by Mattoo and Subramanian.\(^706\) Indeed, a level playing field would prevent two types of harms: firstly, it would prevent the reduction of FDI in

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\(^701\) Certain industries might, for example, make use of lobbying in order to be included in such a category.

\(^702\) See n 739 onwards.

\(^703\) *Commission v Spain* para 71, n 749.

\(^704\) No universally accepted definition of SWF exists to this day.

\(^705\) Such examples include China’s SAFE, and Singapore’s Temasek, see chapter 1, n 44, 45.

\(^706\) Mattoo and Subramanian (n 680).
countries that implement stricter reporting requirements and, secondly, it would prevent the exploitation by SWFs of poorer underdeveloped countries in urgent need of foreign capital that are unable to screen FDI, let alone impose reporting requirements upon them.\textsuperscript{707} However, it is not clear how an international institution could force a member to subject its state-owned funds to reporting requirements, or even force it to recognise that it possesses such a fund in the first place.\textsuperscript{708}

The failed outcome of the negotiations for a Multilateral Investment Agreement (MIA) in 1998\textsuperscript{709} under the auspices of the World Bank and the OECD, and the failure of the WTO to include investment issues in its mandate in 1994 are sufficiently paradigmatic of the difficulties of such an endeavour.\textsuperscript{710}

Nevertheless, even assuming that a list of the world’s SWFs was universally accepted, the road would still be open for governments to modify the structure and arrangement of state entities in order to circumvent the regulatory regime. In some cases, state-owned enterprises or even the ruler’s private wealth could be used to carry out the same activities as SWFs do today. All in all, the models suggested by Truman, Garten and Mezzacapo appear extremely time consuming and ultimately unworkable.

Fleischer’s taxing model appears less difficult to implement, but it is doubtful whether tax policy can identify the appropriate tax to compensate for risks to national security. Tax authorities are hardly the appropriate bodies to protect national security and set foreign policy – how is a tax official supposed to calculate and impose a tax to compensate for the cost of ‘threatening American national interests’ or ‘supporting autocratic regimes’?\textsuperscript{711}

\textsuperscript{707} In such a case the WTO’s dispute resolution mechanism would ensure that countries with SWFs respect the established rules.
\textsuperscript{708} For example Saudi Arabia does not accept that it manages such a fund, see chapter 1, n 43.
\textsuperscript{709} MIA purported to develop multilateral rules that would ensure intra-state investment was governed in a more systematic and uniform way. Despite the considerable areas of consent, this enterprise came to a halt because of insurmountable disagreements, such as the ‘exception culturelle’ maintained by France and Canada in support of French culture.
\textsuperscript{710} ibid.
\textsuperscript{711} See above, footnote 669.
Finally, as regards the application of investment screening mechanisms, there remains a risk of politicisation, where political representatives attempt to influence the outcome of its work, or where the officials tasked with its execution are responsive to political considerations beyond those inherent in the object of their work. Additionally, politicisation of the process might also result from private activities (where the target company favours one investor over another). Such a risk is especially present in Fleischer’s model, which involves value judgments by a governmental authority, but also arises in Garten and Davis’s model which restricts the investments of SWFs or excludes certain sectors from the ambit of their investments.\textsuperscript{712}

Finally, an obstacle to the applicability of the proposals as to reporting requirements is the question of whether information disclosed will be available only to regulators or disseminated to the public in the form of corporate reports. Although it is not always specified in the proposals, it is necessary for it to be made clear, as each option would entail different consequences. If the information as to size, holdings, structure and investment strategies is available to the public at large, then SWFs may become popular targets and their investment strategies may be exploited by their competitors. On the other hand, if such information is disclosed confidentially only to regulators, then safeguards must be taken to avoid the leaking of information to competitors.\textsuperscript{713}

\textit{iii. Costs}

The final part of the analysis discusses the potential costs of each system. These may differ greatly, but they also depend on the special circumstances of each country. For example, during the Dubai Ports case, the argument was used that such a deal might facilitate the smuggling of terrorists into the USA from the

\textsuperscript{712} This risk becomes more serious if it is considered that the CJEU has required that the screening of foreign investments is done on the basis of clear and objective criteria, reviewable by national courts, in order to avoid its abusive application by national governments, \textit{Commission v France}, n 747.

\textsuperscript{713} Such was the case of a hedge fund named Amaranth. In this case, position transparency enabled prime brokers (or their proprietary trading desks) to use this information to their advantage, Michael King and Philipp Maier, ‘Hedge funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks’ (2009) Vol 5(3) JFS\textsubscript{stabil} 293.
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Middle East. Concerns about terrorism, however, are not identical for all countries that receive SWF investments. This fact must be considered when assessing the costs and benefits of a model, when applied in different countries. If the USA is a far more popular destination for foreign capital than other recipient countries, it may be more willing to give up a small part of this in order to maintain national security safeguards. In contrast, FDI in Greece, Portugal, Spain and Ireland might have a higher value during the debt crises currently facing these countries, and thus the cost of hindering foreign capital might be higher for them than for Switzerland or Estonia. For this reason, the costs (or benefits) of each regulatory model are determined by circumstances which are better assessed on a case-study basis.

Any national authority contemplating establishing a regulatory framework for SWF should do so on the basis of a cost-benefit analysis (CBA). According to Alfon and Andrews, a regulator that does not use CBA to formulate new policy or to check on the impact of specific measures runs the risk of delivering an output that may reflect the given objectives but may lead to unintended inefficiency, since not all relevant factors will be taken into account. Thus, for example, a regulator who curtails the freedom of banks in order to promote greater systemic safety, without considering the wider implications of the measure taken, runs a greater risk of imposing the costs associated with a lack of innovation and investment. One of the most important elements of the CBA is the description of the difference between the world as it would be if a proposed option were adopted and the situation if it were not adopted. CBA therefore focuses on the incremental impact of the proposed options (including the ‘do nothing option’). According to Alfon and Andrews, the cost of no action in the

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714 Levin (n 449).
715 n 375, 552.
717 The special circumstances of specific case studies are discussed in the next chapter.
719 ibid.
720 ibid.
wider financial sector could be big: a complete market failure, while the indirect costs (negative market impact) are those that are least obvious from a cash perspective.\textsuperscript{721} On the subject of regulation of SWFs, the option of no action will hardly result in a complete market breakdown or a threat to national security. On the other hand, the indirect costs that may arise from strict regulation of FDI warrant more attention and analysis.\textsuperscript{722}

At the present time there are sufficient indications of the types of costs that may ensue if governments give way to protectionist calls and adopt legislation restricting SWFs. Bloomberg and Schumer have cited the example of the Sarbanes-Oxley Act 2002 in the USA – shortly after its passing, there were signs of investment shifts towards Europe and Asia.\textsuperscript{723} While discussing protectionism (see above), it was stated that Chinese funds have proved that they are prepared to seek investment opportunities elsewhere if faced with a protectionist backlash, even before the adoption of concrete legislation.\textsuperscript{724} Such behaviour was in line with previous statements by Chinese officials that they will avoid investing in countries that use national security as an excuse for protectionism.\textsuperscript{725} Moreover, as already explained, the protectionist outlook of many western countries in the energy sector may be hindering India from creating a SWF in the first place, thus further reducing global liquidity.\textsuperscript{726} Such a fund would aim to direct its investments in the western energy sector to complement India's lack of natural resources, but such a move would certainly

\textsuperscript{721} ibid 18.
\textsuperscript{722} Some prefer to speak in terms of 'type I and type II errors' or 'false positives and false negatives'. The first case consists in prohibiting conduct that should be allowed, while the second consists in allowing conduct that should be prohibited. In the field of SWFs it is preferable to speak of CBA rather than type I and type II errors since the CBA allows for a more concrete identification of actual costs.
\textsuperscript{724} n 363.
\textsuperscript{726} n 565.
raise suspicions and eventually face the resistance of western governments.\textsuperscript{727} Even when investments are not met with resistance by national administrations, the highly heterogeneous standards of foreign investment regulations set up by different governments can still inflict considerable costs of compliance on SWFs and hence affect the efficient flow of capital.\textsuperscript{728}

It thus becomes apparent that each of the above regulatory models (perhaps with the exception of self-regulation) imposes significant costs on the system, the extent of which depends on the nature of each model and its degree of protectionism. These costs can ultimately defeat the very rationale for adopting each of the above models, which is to rectify other costs associated with SWFs, such as political extortion, systemic instability and/or investor uncertainty. This finding should inform the next part of the analysis.

In the first category of regulatory models (such as Davis’s or Garten’s), imposing ceilings upon the share ownership of SWFs may surely be an effective way of discarding most possible concerns, such as the threat of financial stability and using corporations to achieve political means. However, at the same time, it creates an excessively hostile economic environment for SWFs and is almost certainly the most effective way of driving their investments overseas. Under such a framework, SWFs would be automatically classed as ‘bad investors’ and their investment activity would meet various reputational obstacles apart from the legal ones. Therefore, from the point of view of costs, excluding various sectors altogether is preferable to the ‘investment caps’ solution because it offers SWF managers the assurance that there is no limit on the amount of investment they wish to undertake. Such a system, however, is still far from optimal because of the uncertainty it creates with regard to the sectors open to investment. Such a model has serious drawbacks when considering its implementation, which may lead to additional costs in the form of the loss of investment activity.

Gilson and Milhaupt, who suggest removing the voting rights of state investors, themselves admit the risk of over-inclusion, namely the expectation that governments whose SWFs and pension funds have their voting rights

\textsuperscript{727} ibid.
\textsuperscript{728} Mattoo and Subramanian (n 680) 16.
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suspended will impose similar suspensions on the equity holdings of comparable USA government entities. As they admit, this side-effect might cause the positive impact that shareholder activism by USA state pension funds, for example, CalPERS, has had on corporate governance standards in other countries, to be lost. However, Gilson and Milhaupt appear prepared, albeit tacitly, to accept a larger loss than they openly admit, since the positive effect of activist SWFs investing in domestic equity will also be lost. As seen in chapter 2, activist sovereign shareholders have on many occasions benefited companies by raising takeover premiums, opposing hostile takeovers and making valuable contributions to shareholder meetings. SWFs have so far shown weak signs of activism, but, if, following the financial crisis, sovereign shareholder activism develops further in the future, then those benefits will also increase. Finally, an additional type of cost incurred by this model is the reduction in value of the shares in question. As SWFs would abstain from purchasing such stock, and would arguably favour stocks from other countries or investments in government bonds or real estate, the subsequent drop in demand for shares would also be reflected in their price. Although this reduction could be small (even minuscule) no company management would choose to incur it simply to prevent sovereign shareholders from voting in company meetings.

Gilson and Milhaupt adopt such a stance based on their inherent suspicions of state capitalism regardless of the individual characteristics of state investment companies. Their ideological position, however, necessitates imposing costs on the entire international financial system and as such it cannot be supported.

Fleischer’s model is more nuanced than Gilson and Milhaupt’s, and offers a theoretically more interesting system of dealing with the concerns about SWFs, at least from the point of view of costs. Fleischer suggests that the transactions carried out by SWFs impose certain costs on the recipient countries, which, however, are not reflected in the actual price of the transaction. Fleischer’s proposal suggests that opaque SWFs pay a ‘Pigouvian’ tax to the recipient

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729 Gilson and Milhaupt (n 156) 29.
730 Ibid 30.
731 See above chapter 2, n 441.
732 As was argued above in chapter 2, n 261.
733 n 671.
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countries, to compensate for the costs they impose on them (however large or small) and at the same time be incentivised to become more transparent.\textsuperscript{734} It can be argued that the tax incentive proposal is a good way to incorporate the cost, if any, in the decision making of SWFs and thus appears to be the most effective way to regulate ‘market imperfections’.\textsuperscript{735} Although Fleischer’s proposition, surely, also creates the risk of turning investors away and hardly escapes criticism as to the obstacles to its implementation, from the point of view of costs it is, at least in theory, the best of the models discussed so far.

Table 4.2: Summary of Regulatory Proposals

<table>
<thead>
<tr>
<th>Regulatory Model</th>
<th>Theoretical Objections</th>
<th>Implementation</th>
<th>Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Caps</strong></td>
<td>Discriminatory/Protectionist</td>
<td>Contravening EU law/ Difficulty of adopting a common position</td>
<td>Reduced foreign investment</td>
</tr>
<tr>
<td>(Garten/Davies)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Incentives Regulation</strong></td>
<td>Discriminatory/Protectionist</td>
<td>Contravening EU law/ Difficulty of value judgments</td>
<td>Reduced foreign investment/ Loss of equity value/ Reduced shareholder activism</td>
</tr>
<tr>
<td>(Gilson &amp; Milhaupt/ Fleischer)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Command and Control</strong></td>
<td>Discriminatory/Protectionist</td>
<td>Public or confidential disclosure?</td>
<td>Reduced foreign investment</td>
</tr>
<tr>
<td>(Truman/Garten/ Mezzacapo)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Self Regulation</strong></td>
<td>No objection</td>
<td>Doubts as to effectiveness</td>
<td>No objection</td>
</tr>
<tr>
<td>(IMF/SWFs)</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

\textsuperscript{734} If the negative externalities from SWF outweigh the positive externalities, it may warrant a higher tax on SWFs. Conversely, if the positive externalities outweigh the negative externalities, this may warrant subsidising SWFs, ibid 29.

\textsuperscript{735} As argued by Llewellyn on the rationale for regulation, ‘focusing on the accountancy cost of regulation (which can be measured) overstates the true cost of regulation because it does not incorporate the true value of the consumer benefit if the effects of market imperfections are alleviated’, Llewellyn (n 385) 21.
Finally, another important element is that most models are likely to impose extra administrative costs as, apart from the additional administrative agencies they create, they also impose both substantial transaction costs on SWFs and costly delays to their investments, especially if their transactions are to be reviewed.

The above analysis indicates that most types of hard regulatory interventions to regulate SWFs have serious setbacks as much from a theoretical point of view, as from the perspectives of implementation and costs. The next chapter scrutinises specific case studies of models introduced to regulate SWFs where many of the issues discussed so far can be observed in practice.

CONCLUSION

Investment protectionism has long existed. Where SWFs are involved, there is no consensus on how they should be dealt with from a regulatory perspective. A close examination of SWFs’ investment behaviour and a sober analysis of the real benefits and potential costs they bring to international financial markets leads to the conclusion that the nightmare scenarios about financial instability and national security predicted by many are not realistic.

As a result, the actual costs of SWFs are not significant enough to justify hard regulatory intervention. Nevertheless, a limited form of regulation may be warranted simply to ease protectionist pressures and maintain consumer (and corporate) confidence in the market for SWF investments. While, other risks, such as the undue political leverage of countries managing huge SWFs, may be real, they cannot be tackled by a simple regulatory instrument. Increasing transparency might have a positive impact, but SWFs should be allowed to remain opaque to the extent that their immediate competitors are allowed to.

Taking all of the above into account, neither the ‘restriction’ of SWFs, the ‘incentives’ or the ‘command and control’ regulatory models can offer a satisfactory regulatory response to the rising phenomenon of SWFs.
models are either excessively protectionist and discriminatory (and are not justified by the real facts regarding SWFs) or they are too costly and unworkable. The following chapters demonstrate this even further by examining case studies as well as a proposed model of self-regulation.
CHAPTER FIVE

National Regulatory Models

INTRODUCTION

Chapters 3 and 4 have examined the benefits from, and potential concerns caused by, SWFs' investments as well as the main legislative proposals to regulate the operation of SWFs. It has been established that SWFs do not pose serious risks to financial stability or national security that would justify the adoption of hard regulatory instruments. 736 Nevertheless, many of the regulatory proposals examined in chapter 4 are designed to address those perceived risks by imposing transparency requirements or limiting SWF investments in individual companies. It has been argued that the majority of these proposals are disproportionate in their response to the rising phenomenon of SWFs and are thus overly protectionist.

This chapter examines hard law instruments adopted by national governments to regulate SWF investments and analyse them using the conclusions from the previous chapters. The analysis of each case study includes a general overview of the operation of SWFs and of the debate about such funds in each country. As far as EU Member States are concerned, it is relevant to consider the compatibility of these laws with the EU rules on free movement of capital.737

The present chapter is divided into three sections. Section A examines laws directed at SWFs implemented by EU Member States. For this, it is first necessary to provide an analysis of the EU legal provisions on free movement of capital and freedom of establishment. Section A then examines the legislation of two EU

736 While some existing risks, such as the potential influence on a recipient country's economy, cannot be addressed by regulation itself, See chapter 3, discussion at ‘The motivations behind the investments of SWFs and national security concerns’ onwards.

737 As incompatibility of the measure with those rules may result in striking down the measure, n 739 onwards.
National Regulatory Models

Member States, France and Germany, as well as that of Greece as an additional jurisdiction. These jurisdictions were chosen because they offer a standpoint for analysis of two large markets that attract a large share of SWFs’ investments (France and Germany), and a smaller market with specific circumstances that led to the adoption of legislation relating specifically to SWFs (Greece).

Section II will, for comparative purposes, examine the legislation of a non-EU jurisdiction – the USA. The choice of a non-EU jurisdiction is to offer a broader perspective on the national laws regarding SWFs. Finally, in Section C, a comparative analysis of all of the above systems is provided. This analysis includes an assessment of the problematic aspects of these instruments, as well as an overview of their potential clash with EU law.\footnote{738}{In particular, the EU rules on free movement of capital, see the discussion below from n 739 onwards.}

The purpose of this chapter is to demonstrate that unilateral measures at the national level intended to apply to SWFs are liable to be too protectionist and create negative spill-overs for recipient countries and the global financial system. This finding is used later in this thesis to establish that between the adoption of national measures and a supranational response to address concerns about SWFs, the latter is preferable.

A. EU LAW AND EU NATIONAL MODELS

1. EU Law

i. Free movement of capital

As mentioned in the previous chapter\footnote{739}{n 696.}, regulations screening the investments of SWFs, and thus limiting their ability to invest freely in the EU, may fall foul of the established laws on the free movement of capital, and in some
cases the free movement of establishment. More specifically, Article 63(1) TFEU (previously 56(1) EC) is worded as follows:

‘Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited’.

Furthermore, Article 65(1)(b) TFEU (previously 58(1)(b) EC) states that:

‘the provisions of Article 63 shall be without prejudice to the right of Member States: (b) To take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security’.


First, direct investments, which are defined as the ‘establishment and extension of branches or new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings’, and, ‘participation in new or existing undertakings with a view to establishing or maintaining lasting economic links’. The explanatory notes at the end of Annex I to the above-mentioned Council Directive state that direct investments are:

‘investments of all kinds, by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain lasting

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and direct links between the person providing the capital and the entrepreneur to whom, or the undertaking to which, the capital is made available in order to carry on an economic activity. This concept must therefore be understood in its widest sense'.

As regards those undertakings referred to under I-2 of the nomenclature, which have the status of companies limited by shares, there is participation in the nature of direct investment where the block of shares held by a natural person or another undertaking or any other holder enables the shareholder, either pursuant to the provisions of national laws relating to companies limited by shares or otherwise, to participate effectively in the management of the company or in its control.

Second, the nomenclature of Annex I to the above-mentioned Council Directive also refers to operations in securities normally dealt with on the capital market such as the acquisition by non-residents of domestic securities dealt in on a stock exchange and the acquisition by non-residents of domestic securities not dealt in on a stock exchange.

Moreover, Article 345 TFEU (previously 295 EC) provides that ‘this Treaty shall in no way prejudice the rules in Member States governing the system of property ownership’. Thus, EU law has taken a neutral approach to the state ownership of firms and has refrained from subjecting the Member States to a duty to privatise.

The Lisbon Treaty, which entered into force in 2009, has granted the EU the exclusive competence to the abolition of restrictions on foreign direct investments. Article 206 of the TFEU provides that by establishing a custom union in accordance with Articles 28–32, the Union shall contribute to the progressive abolition of restrictions on international trade and foreign direct investments. Article 207 includes foreign direct investments as one of the areas covered by the common commercial policy of the Union.

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743 Explanatory notes, ‘Direct Investments’.
744 This provision has important implications, not only regarding the ownership status of firms based in EU Member States, but also with regard to the treatment of foreign state-owned entities, such as SOEs and SWFs, n 751.
The above hard law sets out the basis upon which investment restrictions are scrutinised by the EU courts. As such, it also applies to the national measures adopted to regulate the investments of SWFs.

It is necessary to analyse the case law deriving from the above provisions and their interpretation by the EU courts. The case law on free movement, often also referred to as the 'golden shares' case law, is said to be an example of intense scrutiny and strict application by the courts.\textsuperscript{745} It is important to bear in mind that, according to the case law, an infringement of Article 63 TFEU is no longer limited to discriminatory national provisions, but covers all norms that might hinder the free movement of capital, even if their effect is not discriminatory.\textsuperscript{746}

In essence, when discussing the EU approach to restrictions on foreign investments (and thus to the free movement of capital and freedom of establishment) a distinction must be made between \textit{ex ante} and \textit{ex post} measures. \textit{Ex ante} measures consist of prior administrative approvals, whereas \textit{ex post} measures require a review of the suspected investment once it has been made. Both types have been used at the national level to screen the investments of SWFs. Therefore, the next sections deal with this binary distinction. The ability of Member States to implement \textit{ex ante} and \textit{ex post} measures differs as the EU legal framework clearly prohibits the former, while it allows the second type under certain circumstances. Issues concerning freedom of establishment are also examined.

a. \textit{Ex ante} restrictions

A measure constituting an \textit{ex ante} restriction of all or certain categories of investment will, as far as EU law is concerned, qualify as a restriction on foreign investments. Article 63 TFEU lays down a general prohibition with regard to restrictions on the free movement of capital between EU Member States and between EU Member States and third countries. The prohibition goes beyond the

\textsuperscript{745} Andrea Biondi, 'When the State is Owner – Some Further Comments on the Court of Justice “Golden Shares” Strategy', in Bernitz and Ringe (n 429) 97.

mere elimination of unequal treatment on grounds of nationality. Such treatment amounts to discrimination, even if it applies alike, without distinction, to national shareholders and to shareholders who are nationals of other Member States. The problem, as stated by the CJEU, is that such a measure risks rendering the free movement of capital illusory.\textsuperscript{747}

The CJEU has stated that national measures must be regarded as restrictions within the meaning of Article 63(1) TFEU if they are likely to prevent or limit the acquisition of shares in the undertakings concerned or to deter investors of other Member States from investing their capital.\textsuperscript{748} Moreover, the Court has repeatedly ruled that measures which limit the acquisition of shareholdings, such as making the acquisition of voting rights above a certain cap subject to prior administrative approval, constitute a restriction on the free movement of capital.\textsuperscript{749}

Hence, the next question is whether such \textit{ex ante} restrictions fall under the justifications of public policy and public security provided in the Treaty and, in particular, Article 65 TFEU. Indeed, the free movement of capital may be restricted by national measures on the basis of Article 65 TFEU or by overriding reasons in the general interest.\textsuperscript{750} It follows from the case law that this Article does not have the effect of exempting the Member States’ systems of property ownership from the fundamental rules of the Treaty. Member States cannot refer to this Article to justify obstacles resulting from privileges attached to their position as shareholder in a privatised undertaking.\textsuperscript{751}

However, depending on the circumstances, certain concerns may justify the retention by Member States of an exceptional degree of influence within undertakings that were initially public and subsequently privatised. This is the case where those undertakings are active in fields involving the provision of

\textsuperscript{748} \textit{Commission v France} paras 36-37; \textit{Commission v UK} paras 39-40.
\textsuperscript{749} Case C-463/00 \textit{Commission v Spain} [2003] ECR I-4581; \textit{Commission v Portugal}, and especially in the case of \textit{Commission v France}, where the acquisition of 20% of voting rights was subject to prior administrative approval by the French Ministry of Economic Affairs.
\textsuperscript{750} Case C-319/02 \textit{Manninen} [2004] ECR I-7477 para 29.
\textsuperscript{751} \textit{Commission v France} para 44.
services in the public interest, or strategic services.\textsuperscript{752} This exception also is supported by reference to the 1997 Communication on certain legal aspects concerning intra-EU investment\textsuperscript{753} (the ‘1997 Communication’). On a similar note, the former EU Trade Commissioner, Mandelson, made some qualified comments about the possible usefulness of some kind of European golden share, to vet foreign takeovers of key industries.\textsuperscript{754} In any event, it becomes apparent that under the current regime, the free movement of capital may be restricted by national measures justified on the grounds set out in Article 65 TFEU, or by overriding reasons in the general interest,\textsuperscript{755} but only to the extent that there are no relevant EU harmonising measures already in place ensuring the protection of those interests.

In this context it should be noted that the relevant Directives, as, for example, in the electronic communications or energy sectors, do not lay down the standards that should apply in the context of privatisations.\textsuperscript{756} The liberalisation of certain sectors does not affect or reduce the importance of the services provided in a Member State. It is, in principle, for the Member States to decide on the degree of protection that they wish to afford to such legitimate interests and the way in which that protection is to be achieved. They may do so only within the limits provided by the TFEU and should, in particular, observe certain general EU law principles, such as the principles of necessity and proportionality. These general legal principles require that the measures adopted must be appropriate to secure the attainment of the set objectives and must not go beyond what is necessary in order to attain those objectives.\textsuperscript{757}

\textsuperscript{752} Commission v Spain para 66;
See also, Commission v Belgium para 43; Commission v Portugal para 47.

\textsuperscript{753} OJ 1997 C220/06.

\textsuperscript{754} See for more information below, n 1117.

\textsuperscript{755} Manninen para 29;
See also Commission v Belgium para 45.

\textsuperscript{756} See for example,

\textsuperscript{757} Commission v Belgium para 45; Commission v Portugal para 49.
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The Court of Justice of the EU (CJEU) has accepted in *Commission v Belgium* that public security considerations may justify an obstacle to free movement rules.\(^{758}\) Moreover, in *Commission v Netherlands* it stated that the guarantee of a service of general interest is capable of justifying an obstacle to the free movement of capital.\(^{759}\) Therefore, as stated by the CJEU, as regards undertakings active in the petroleum, telecommunications and electricity sectors, it is undeniable that the objective of safeguarding supplies of such products, or the provision of such services within the Member State concerned, in the event of a crisis, may constitute a public-security reason.\(^{760}\)

Nevertheless, the CJEU also held that the requirements of public security, as derogation from the fundamental principle of free movement of capital, must be interpreted strictly, so that their scope cannot be determined unilaterally by each Member State without any control by the EU Institutions. Thus, public security may be relied on as justification only if there is a sufficiently serious threat to a fundamental interest of society.\(^{761}\) The Court does not define what constitutes such a fundamental interest of society. However, in *Portugal v Commission* the Court stated that retention of a degree of influence in a recently privatised undertaking is justified where that undertaking is ‘active in fields involving the provision of services in the public interest or strategic services’.\(^{762}\) Furthermore, it was specified in *Commission v Belgium* that ‘the objective pursued by the legislation at issue, namely the safeguarding of energy supplies in the event of a crisis, falls undeniably within the ambit of a legitimate public interest’.\(^{763}\) On the other hand, in *Commission v Spain*, undertakings involved in the banking and tobacco manufacturing sectors (but also the telecommunications sector, where they were formed to provide telephony

\(^{758}\) para 46 – although the relevant para refers to free movement of goods, the Court states that it applies equally to the free movement of capital.


\(^{760}\) *Commission v France* para 47; *Commission v Belgium* para 46; *Commission v Spain* para 71; This conclusion is reinforced when the adopted national measure targets companies that control or make use of a national network.

\(^{761}\) As required by C-54/99 *Eglise de Scientologie* [2000] ECR I-1335 para 17; *Commission v Belgium* para 47; *Commission v Spain* para 72.

\(^{762}\) para 47.

\(^{763}\) para 46; See also, Case 72/83 *Campus Oil and Others* [1984] ECR 2727 paras 34–35.
overseas) could not be the subject of justification based on overriding requirements of the general interest.\footnote{Commission v Spain para 35.} Overall, restrictions appear to be justified only where they protect the provision of a public service, such as petroleum, telecommunications and electricity,\footnote{ibid para 71.} without which society would undeniably break down.

Any prior administrative approval scheme must be proportionate to the objective pursued in so far as the same objective cannot be attained by less restrictive measures, in particular a system of declaration \textit{ex post facto}.\footnote{Commission v France para 46.} The objectives must be clear enough to justify the measure as being the least restrictive means of achieving the set objectives. According to the case law, the prior authorisation scheme must also relate to specific companies and must state the reasons which render any restrictive measures indispensable.\footnote{Commission v France para 46.} In addition, all persons must have a legal remedy available.\footnote{Commission v Spain para 69: ‘such a system must be based on objective, non-discriminatory criteria which are known in advance to the undertakings concerned, and all persons affected by a restrictive measure of that type must have a legal remedy available to them’; Also see Commission v Portugal para 50; Case C-205/99, Analir and Others [2001] ECR I-1271 para 38.}

For example, the introduction of a golden share in the case of \textit{Belgium} depended on the specified, and yet widely defined objective of ‘national interest’. In particular, the Minister in charge had to ascertain that there was an ‘adversary affectation to the national interest in the energy sector’. This provision was regarded as the least vague of all national provisions scrutinised by the European Courts. Although the wording seemed to be giving a broad discretion, important restrictions were subsequently introduced by a Decree: the infringement proceedings, while they were still pending, prompted the Belgian government to introduce stricter rules at a second level. The Belgian state-controlled rights henceforth could be exercised only for ‘objective, non-discriminatory and transparent considerations’ and numerous clauses of purposes or objectives were specified in Decrees.\footnote{Analir para 38; Commission v Portugal para 50.} As a result, a state decision

\begin{footnotesize}
\footnotetext[764]{Commission v Spain para 35.}
\footnotetext[765]{ibid para 71.}
\footnotetext[766]{Commission v France para 46.}
\footnotetext[767]{Commission v Spain para 69: ‘such a system must be based on objective, non-discriminatory criteria which are known in advance to the undertakings concerned, and all persons affected by a restrictive measure of that type must have a legal remedy available to them’; Also see Commission v Portugal para 50; Case C-205/99, Analir and Others [2001] ECR I-1271 para 38.}
\footnotetext[768]{Analir para 38; Commission v Portugal para 50.}
\footnotetext[769]{This was provided for in the Belgian Article 29 para 2, \textit{Loi relative a l’organisation du marché du gaz et au statut fiscal des procedures d’électricité}, on the basis of which Articles 1 and 3 of \textit{Arrêté royal fixant les criteres pour l’exercice des droits speciaux attachés aux actions specifiques}}
\end{footnotesize}
could be imposed upon the privatised company only in order to ensure the operation of the wires and conduits infrastructure as well as the technical and financial competitiveness of the companies.\textsuperscript{770} On this basis, it was apparently considered by the Court that interested parties had an effective legal remedy before Belgian courts: the concrete conditions specified in the legislation rendered the judicial review of the authority's decision possible.\textsuperscript{771}

A necessary final point is that the principle of free movement of capital, as foreseen in Article 63 TFEU, applies equally to the EU Member States and third countries. However, certain Articles, such as Articles 64 (previously Article 57 EC), 66 (previously Article 59 EC) and 75 TFEU (previously Article 60 EC) foresee the possibility of specific restrictions, safeguard measures or sanctions in respect of third countries. Under Article 64 TFEU, restrictions on the free movement of capital involving direct investments can be maintained as regards third countries.\textsuperscript{772} Article 66 TFEU foresees in a safeguard clause the possibility of adopting restrictive measures for a period not exceeding six months should extremely disturbing capital movements with third countries endanger the operation of economic and monetary union. Hence, there might be room to argue that certain measures might be justified in view of the potential danger that investments from third countries might entail and that certain objective criteria may be necessary in those sectors of strategic importance as a safeguard. It is emphasised that the EU case law referred to above dealt with restrictions on the freedom of capital coming from within the EU and not from third countries.

b. \textit{Ex post} restrictions

An \textit{ex post} measure does not establish a system of prior administrative authorisation for an investment, but, rather, a system of opposition \textit{ex post facto}. Though it is generally considered to be less restrictive than the system of prior

\textsuperscript{770} See Articles 2 and 4 of the abovementioned law.
\textsuperscript{771} Seen para 29 on the obligation of the Minister to provide a statement of reasons.
\textsuperscript{772} Member States may continue to apply restrictions which existed with regard to third countries in respect of direct investment on 31st December 1993 (or in the case of Bulgaria, Estonia and Hungary, 31st December 1999).
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authorisation,\textsuperscript{773} it still qualifies as a restrictive measure that must be justified under EU law.

Similarly to the system of prior authorisation referred to in the previous section, it may be justified under Article 65 TFEU (previously Article 58 EC). Again, the adopted legislation must be capable of securing the pursued objective and must not go beyond what is necessary in order to attain it. In other words, proportionality is key.\textsuperscript{774} Accordingly, the safeguarding of the public interest objective, as well as the continuous supply of services in strategically important sectors\textsuperscript{775} may be considered as falling within the ambit of legitimate public interest which, in turn, may justify a restriction on the free movement of capital.\textsuperscript{776}

In this context, any legislation must be predicated on the principle of respect for the decision-making autonomy of the undertaking concerned, in as much as, in each individual case, the exercise of control by the Minister responsible requires an initiative on the part of the government authorities.\textsuperscript{777}

In addition, as regards the justification for the restriction, the same level of specificity, as prescribed for the \textit{ex ante} measure, is also required for the \textit{ex post} measure. In other words, the relevant restrictions must relate to a genuine and sufficiently serious threat to a fundamental interest of society\textsuperscript{778} and be limited both in time and to strategic assets of the company. Moreover, the objective must guarantee the continuous provision of the strategic services and, limit the ministerial power to those companies’ activities as providers of public services.\textsuperscript{779} Finally, it must offer all persons an effective legal remedy because the national courts may review the ministerial decision. It follows from the \textit{Belgian

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\textsuperscript{773} Commission v France} para 52.

\textsuperscript{774} Commission v Belgium} para 45.

\textsuperscript{775} Such as companies active in telecommunications, petroleum, gas, electricity and defence. Companies managing a public network are more likely to be considered as strategic (n 759). But banks and other sectors of the economy, however lucrative, usually do not fall in this category, \textit{Commission v Spain} para 70.

\textsuperscript{776} Commission v Belgium} para 46.

\textsuperscript{777} ibid, para 49.

\textsuperscript{778} \textit{Eglise de Scientologie} para 17; Commission v France} para 49; Commission v Belgium} para 47.

\textsuperscript{779} As pointed out by the Advocate-General in his opinion in \textit{Commission v Netherlands} para 38 and 39 and later upheld by the Court para 40.
case that there is no need to set out in detail the reasons something is a sufficiently serious threat, but it is necessary to indicate what this threat is.

ii. Freedom of establishment

A law may not only hinder direct and portfolio investment, but may also hinder the taking of controlling holdings in companies, namely investments which confer a definite influence over the management and control of these companies. In this case it is likely that the government in question may be held to breach its obligations under Article 49 TFEU (previously 43 EC) on freedom of establishment. 780 This Article provides that restrictions to freedom of establishment, including the setting-up of agencies, branches or subsidiaries, as well as activities pursued by self-employed persons, shall be prohibited. Article 54 TFEU (previously 48 EC) holds that:

‘companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purpose of this chapter, be treated in the same way as natural persons who are nationals of Member States’.

In so far as a particular measure may entail restrictions on the freedom of establishment, such restrictions are a direct consequence of the obstacles to the free movement of capital, to which the additional restrictions are inextricably linked.781 Consequently, if a justification of the restriction of Article 63(1) TFEU is established, there is no need for a separate examination and the same justifications apply to the restriction of Article 49 TFEU (previously Article 43 EC). However, in this context it should be noted that Article 49 TFEU does not make reference to restrictions in respect of third countries outside the EU. There is therefore a significant difference from Article 63 TFEU, since Article 49 TFEU does not catch restrictions to the freedom of establishment with regard to investments coming from outside the European Union. As stated in Fidium

780 Commission v Netherlands para 42; Case C-208/00 Uberseering para 77.
781 Commission v Spain para 86; Commission v Netherlands para 43.
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*Finanz*, this Article cannot be relied on by a company established in a non-EU Member country.\(^{782}\)

Regarding the Court’s choice of application between the freedom of establishment or the free movement of capital, there is no order of priority between the two. Instead, each freedom is held to regulate different situations with the Court applying what Schweitzer calls the ‘centre of gravity’ approach, i.e. the most relevant of the two.\(^{783}\) At the same time, there is the possibility of a simultaneous application of both articles if the restriction on free movement of capital is ‘merely an unavoidable consequence of the restriction on the freedom to provide services’.\(^{784}\)

Having examined the distinction of ex ante and ex post rules with regard to both the free movement of capital and freedom of establishment, the next section examines how a golden share strategy may be applied in practice.

### iii. The ‘Golden shares’ debate and other ex post rules

‘Golden shares’ may be broadly defined as company shares that give the state special rights over management decisions despite privatisation of state assets.\(^{785}\) These enable the state to retain a certain degree of influence in previously state-owned enterprises. Golden shares are particularly relevant in the study of SWFs as, in the past, they have been used extensively by governments in Europe to maintain control over newly privatised companies\(^{786}\) and have been considered again more recently with the rise of SWFs.

Privatisation emerged as a global trend in the last 20–30 years. Nowhere in Europe, however, did privatisation really put an end to state interference in a

\(^{782}\) On the difference between free movement of capital and freedom of establishment see C-452/04 *Fidium Finanz* paras 25-35.

\(^{783}\) Schweitzer (n 597) 273.

\(^{784}\) *Fidium Finanz* para 48.


\(^{786}\) The prime example is the UK, and Margaret Thatcher who is largely regarded as the inventor of golden shares. Examples involve the privatisations of Jaguar in 1984 and British Oil in 1982, see also Andrei Baev, ‘Is There a Niche for the State in Corporate Governance? Securitization of State-Owned Enterprises and New Forms of State Ownership’ (1995) *Vol 18(1) HouseInt’l L J*;
variety of specific decisions and information rights.\textsuperscript{787} Golden shares usually vest the state with influence over strategic decisions of the company concerned, sometimes even extending to an outright veto.

Recognising that the special rights of the state are concerned, the discussion in Europe seems to have largely been regarded as a public law issue.\textsuperscript{788} Nonetheless, Grundmann and Möslein suggest that the issue is rather one of company law. They argue that this is, firstly, because it involves rights attached to one share, accordingly raising the question of equal right conferred by shares (‘one share one vote’) and golden shares alter the decision power in a company.\textsuperscript{789} Secondly, the discussion goes beyond privatisation and the retention of special decision-making powers by the state. Golden shares reduce the decision making power of the undertaking and may potentially make investment in its shares less attractive.\textsuperscript{790} These special rights do not only depend on holding such a share, but also upon a share being held by a state body.\textsuperscript{791} The state, however, could retain influence even without a requirement to hold a single share. It could deal with this matter under traditional forms of public law, such as by passing a law conferring it those powers of influence. It has been much more common, however, for states to use the channel of company law to control companies by establishing a golden share.\textsuperscript{792} In either event, there is no reason why the matter should be dealt with under one legal branch alone. Although most legal considerations that arise under golden shares are of a

\textsuperscript{787} ibid 8.

\textsuperscript{788} In Germany, specific duties of state bodies as shareholders have been formulated and discussed as a public law requirement, Grundmann and Möslein (n 785) 625.

\textsuperscript{789} ibid.

\textsuperscript{790} ibid.

\textsuperscript{791} As it was the case in Commission v Belgium: ‘the special rights defined in Articles 2 to 5 shall attach to that share, in addition to the information rights attaching to ordinary shares in SNTC, only for as long as that share is owned by the state, which may assign it or transfer it only pursuant to prior legislative authorisation’ para 9 of the judgement.

\textsuperscript{792} It is noteworthy that Advocate-General Maduro in his opinion in joined cases C-463/04 and C-464/04 Federconsumatori [2007] ECR I-10419 293 has inquired whether public ownership of shares itself can constitute a restriction of the free movement of capital by dissuading investments from other Member States. He finds that ‘the mere fact that a public body owns shares in a company does not reduce the attractiveness of cross-border investments in that company, as long as investors in other Member States can be sure that the public body concerned will [...] respect the normal rules of operation of the market’ para 25.
company law nature, they may also raise issues of public law, such as the provision of public services, agency work, national security etc.

Golden shares or other ex post rights concern fundamental decisions, such as the dissolution of the company and other structural changes, but also management decisions of strategic importance, such as the sale of substantial assets or a shareholding, for which shareholder approval may be required. The line between fundamental decisions (typically within the competence of the general meeting) and management decisions (which normally the board decides upon) may not be the same in all Member States.

As discussed above, the Belgian Decree that specified the objectives of the Belgian golden share, and which was the object of discussion in Commission v Belgium, is the best-tested precedent in restrictions attached to ex post approval (or veto) rights. The relevant articles of the Belgian Decree provided that on the day on which the shares held by the state in the capital of the Société nationale d’investissement are transferred to one or more natural or legal persons in the private sector, the company will assign one share in the capital of the company known as Société nationale de transport par canalisations (SNTC) to the state (Article 1). According to the same article, the special rights remain attached to that share only for as long as that share is owned by the state and they would be exercised by the minister responsible for energy.

The said (golden) share would confer on the minister the right to oppose any transfer, use as security or change in the intended destination of SNTC’s system of lines and conduits which are used or are capable of being used as major infrastructures for the domestic conveyance of energy products, if the minister considers that the operation in question adversely affects the national interest in the energy sector (Article 3). Prior notice of the operations referred to in the above paragraph had to be given to the minister who could exercise his right of opposition within 21 days after receiving notice.

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793 Such as share ownership, control over a company’s business decisions, free movement of capital and establishment, see from n 796 onwards.
794 Some of those issues that are discussed below where relevant, for instance, from n 801 onwards.
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The golden share, moreover, conferred on the minister the right to appoint two representatives of the federal government to the board of directors of SNTC who would sit on the board in a non-voting advisory capacity (Article 4). According to the Decree, these government representatives were empowered to apply to the Minister for Energy, within four working days, for annulment of any decision of the board of directors of SNTC which they regarded as contrary to the guidelines for the country’s energy policy, including the government’s energy supply objectives. The application to the minister would have suspensory effect for eight working days, past which, the board’s decision would become final. In addition to the above Decree, Articles 1, 3 and 4 of the Royal Decree of 16 June 1994 laid down essentially identical rules concerning another Belgian company, the Société de distribution du Gaz SA.

The debate on golden shares has revived after several EU Commissioners accepted that they constitute the appropriate (although qualified) response to the threats posed by SWFs (see below chapter 6 n 1118). Certain forms of golden share may, therefore, be used to safeguard valuable industries from foreign state-controlled funds whose long-term objectives cannot be known to Member States. However, the use of golden shares for this purpose is not exempt from the strict conditions laid down by the Court rulings on free movement of capital. Member States have to satisfy all the essential requirements in order to justify any restrictions to free movement of capital. The example of the EADS can offer a helpful illustration of the difficulties of setting up a golden share in the context of EU law, even in strategically important companies.

In 2007, Germany expressed its intention to consider creating a golden share in EADS, a global pan-European aerospace and defence corporation and a leading defence and military contractor. This golden share would ensure the strategic influence of the French and German governments on the company. It has been reported in Der Spiegel that the motivation behind the possible creation of the share was the growing concern in Germany both about the increasing financial clout of countries such as China and Russia, ‘who are suspected of political motivations behind their investments’, and ‘über-capitalist private equity and hedge funds, which are popularly known as “locusts” in Germany because of their perceived tendency to strip firms clean, abandon less lucrative divisions
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and sell the most profitable. In the case of EADS, Germany's reaction was initially triggered by the 5% stake in the aerospace group EADS taken by VTB, a Russian state bank.

The share would be tantamount to a veto over major decisions by Europe's biggest aerospace and defence company. Accordingly, a working group was set up to discuss the proposal 'within the following months'. The golden share proposal was a new and a surprising German contribution to a debate launched by the French Government about a reform of the pact that binds EADS' shareholders and governs their voting rights. Had it been realised, the move would have given Berlin, which does not have a stake in EADS, a bigger say in decisions that might affect national security. It would also have allowed Paris, if it so chose, to sell its holding without losing its influence over the company.

According to Grube's statements (EADS' former Chairman) in August 2007, the proposal for a golden share would be made at the company's general meeting in May 2008. The golden share would help fend off any hostile takeover, which as he described it, is a 'legitimate concern' given EADS' role in national security. The European Commission rejected the idea as early as March 2008 and the plan was not implemented. Nevertheless, the idea was raised again by the EADS

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800 The current pact does not allow France to directly exercise the voting rights its 15% stake carries, or allow new shareholders in, ibid.
management in February 2011 as a possible solution to the question of balance of control between entities of German and French interests over the airspace manufacturer. The idea, which was seen as only one possible option among others, was not followed at the time; however, the issue of an EADS golden share may emerge again in the future.

The experience of Commission v Belgium makes it clear that, although seen with great suspicion, EU law and the Commission’s practice recognise states’ right to make use of golden shares, as long as it proportional and limited to the circumstances that would genuinely pose a threat to the provision of a social good. More specifically, should a golden share ever actually be used by France and Germany to protect EADS from foreign ownership, it would have to target (and be limited to) the facilities linked with national security, such as EADS’ role in national defence. Accordingly, it should avoid affecting the ownership or business decisions of EADS’ civil operations. It is now well established that the protection of a purely economic interest in a domestic firm is not in the justifications permitted under the exceptions to the Treaty’s free movement of capital rules. It is difficult, therefore, to envisage circumstances in which the protection of civil operations in EADS would justify the adoption of a golden share.

A possible argument that a golden share could be limited to specific business decisions, for example, the protection of sensitive information or intellectual property rights from exiting the EU, is unsatisfactory. First of all, such a scenario would have to assume that such assets or information cannot be protected through an ex post control, or through the firm’s own internal rules (in other words, assume that a golden share would indeed be a proportional and necessary response). Furthermore, in the event where a foreign shareholder acquires a firm’s total issued shares and thus owns all of the company’s assets,

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804 Which do not pertain to national security, such as the protection of IP rights.
805 In the event where a controlling shareholder influences the company rules to allow the disclosure of sensitive company information to a foreign government or foreign competing company, or influences business decisions in favour of moving the company factory plants abroad.
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including sensitive information and intellectual property, it is difficult to see how a national government could limit the use of those assets by their rightful owner. In short, in the case of EADS, creating a golden share would be a dubious strategy with considerable difficulties in its application.

All in all, in their interpretation of the Treaty rules on capital movements and freedom of establishment EU courts have shown consistency in their strict application of the concepts of proportionality and necessity. In addition, their application of proportionality has not been in the sense of balancing interests, but by using objective benchmarks such as transparency and legal certainty. The courts have now recognised the justification of public security, but refused to accept any purely economic ones.806

The following two sections demonstrate how the above case law has been applied in the circumstances created by the advent of SWFs, and examine in more detail the specific circumstances leading to the adoption of restrictive measures by Member States. The examples used are those of France, and Germany. In addition, Greece, is discussed more briefly.

2. National Measures

Germany and France, as well as Greece, have been chosen as case studies. These are not the only countries that merit analysis in this area. SWFs invest globally and many countries around the world adopt, or consider the adoption of, laws on foreign investment. The UK and the Netherlands, for example, are both attractive destinations for SWFs.807 Both maintain very open economies808

806 Biondi (n 745) 97.
807 Between January 1995 and July, the 2008 UK received $26 bn and the Netherlands $1.3 bn in SWF investments. The UK received the highest share of SWF investments in the EU while the Netherlands ranked 5th, Kern (n 101) 8.
808 According to a 2008 report by GAO for the USA Senate Committee on Banking, Housing, and Urban Affairs, they were the most open economies among the ones reviewed by the Committee (Canada, China, France, Germany, India, Japan, Netherlands, Russia, UAE, UK), United States Government Accountability Office, 'Foreign Investment -
and, although they have some form of market regulation in place,\textsuperscript{809} protectionist forces do not play a substantial role in those countries.\textsuperscript{810} In the UK, despite a rumoured takeover of Centrica, a major British energy company, by Russian state-owned Gazprom in 2006, the British government opted against making any changes to its investment review laws.\textsuperscript{811} In the Netherlands, there is no formal security review of foreign investments on grounds of national security. Moreover, SWF investments have never been a subject of intense public debate in either country. For all these reasons neither the UK nor the Netherlands would make appropriate case studies.

Numerous reasons make France, Germany and Greece useful as case studies: firstly, both France and Germany are sizeable and largely competitive economies that receive a substantial share of the EU-wide investments of SWFs. At the same time, each of these countries has had different experiences with regard to the place and role of SWFs in their economies.\textsuperscript{812} Greece can be usefully studied as offering an example of a smaller economy. It is noteworthy that Greece, as opposed to France and Germany, has suffered from chronic difficulty in attracting FDI and a general lack of competitiveness.\textsuperscript{813} Secondly, all three countries have introduced legislation to address national security and other issues deriving from investments by SWFs and other third country investment vehicles. The primary motivation behind the adoption of those laws was

\textsuperscript{809} In the UK, the Enterprise Act 2002 provides for a public interest review of foreign investments and the control of classified and sensitive technology. The Act tasks the Department of Business, Enterprise, and Regulatory Reform with recommending intervention on the basis of public interest when necessary. The DBERR was disbanded in June 2009 upon the creation of the Department for Business, Innovation and Skills (DBIS) which now has responsibility for the said review.

\textsuperscript{810} A list of transactions in the UK with a national security element for which the DBIS (see ibid) has issued intervention notices can be found here (none of which however involve SWFs): BIS, ‘Mergers with a National Security Element’ (Department for Business Innovation and Skills) <http://collections.europarchive.org/tna/20091002210316/http://www.berr.gov.uk/whatwedo/businesslaw/competition/mergers/public-interest/national-security/index.html> accessed 6.

\textsuperscript{811} GAO (n 808) 103.

\textsuperscript{812} And have also exhibited different forms of protectionism.

\textsuperscript{813} As discussed at n 913, Greece has been in the epicentre of a debt crisis that struck various Eurozone countries.
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protectionism present in each country in varying degrees, arising from particular circumstances. Thirdly, all of them, being EU Member States, must comply with the relevant EU legislation on free movement of capital, an obligation which Germany appears to have fulfilled better than France or Greece.

The analysis demonstrates that unilateral measures taken by individual countries are typically out of proportion to the reality of SWF threats. Such measures will almost certainly cause unnecessary harm through the loss of investment and the creation of economic distortions. Additionally, these measures risk bringing the respective governments before the EU courts and the imposition of costly fines.

It is possible to argue that the implementation by the case study countries of SWF related legislation was caused in part by the absence of comprehensive legislation at the EU level to address the issue of SWFs. National lawmakers may have been convinced they were doing nothing more than filling a legislative gap. However, as discussed in chapter 6, the European Commission opted for a non-interventionist approach even after the passing of the relevant laws in France, Germany and Greece. The Commission appears to have been convinced that SWFs do not pose risks serious enough to justify the adoption of hard regulatory instruments and, thus, the Commission chose the soft law approach of suggesting their own code of conduct. That the chosen national governments failed to follow such a facts-based approach suggests that they were guided in part by political considerations or protectionist doctrines.

The analysis of each country also touches briefly upon their Bilateral Investment Treaties (BITs) concluded with developing countries. BITs are implemented to offer foreign investors protection from discrimination and/or unlawful appropriation of their investment. They also aim to establish a settlement mechanism in the event of a dispute between the investor and the host nation. The conclusion of such treaties initially suggested that many investors from developed countries were not confident about the legal and political environment in low and middle-income countries.814 In this context,

Investment treaties played the role of a substitute for the quality of institutions or the political risk in a developing country. Today, developed nations seek foreign capital from developing ones. BITs may serve to reassure sovereign investors that they will not be discriminated against in developed western markets and will be offered parity with other investors. However, most treaties tend to provide for national security exceptions, or sometimes exclude entire sectors (such as telecommunications or energy) from SWFs’ ambit. In this sense, although BITs are a relevant consideration from the point of view of SWFs, they do not constitute a determinant factor in the SWF debate.

The conclusions of this chapter serve in the next one to support the case that if any further action against SWFs is taken, it would be preferable to do so at the EU, rather than the national level.

\textit{i. France}

a. French openness to foreign investments

France is regarded as one of the countries most open to foreign investment in the world. According to article L151-1 of the French Monetary and Financial Code, financial dealings between France and foreign countries are, in principle, unrestricted. Overall, the country ranked fifth in terms of the average value of FDI defined inflows worldwide between 2000 and 2006, while FDI stock as a proportion of GDP in France was 35% in 2006. Moreover, according to Deutsche Bank research, between January 1995 and July 2008 France attracted $3.8 bn from SWF investments, thus ranking third in the EU.

France has, moreover, concluded BITs with a number of third countries,

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816 For instance Singapore’s treaties with France, Great Britain, and the Netherlands limit the protection offered to investors to specifically approved investment projects, Tobin and Ackerman, (n 814) 11;
818 GAO (n 808) 53.
819 Kern (n 101) 8 chart 13.
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including many who manage SWFs, such as Qatar\(^{\text{820}}\) and Saudi Arabia.\(^{\text{821}}\) Those agreements offer a heightened degree of investment protection in the sense that they provide for ‘national treatment’\(^{\text{822}}\) but they also provide for exceptions to the rules against appropriation in the case of public utility.\(^{\text{823}}\)

It has been argued that France has not overcome a traditional preference for state intervention and a sometimes ‘reflexive opposition’ to foreign investment noting in particular the opacity under which certain privatisations have taken place in the past, thus creating the impression that not all foreign investors are treated equally.\(^{\text{824}}\)

One of the most notable legal cases concerning privatisation in France concerned the golden share case (see above) retained by the French government in *Société Nationale Elf-Aquitaine* by Decree No 93-1298 of 13 December 1993 to ‘protect national interests’.\(^{\text{825}}\) The golden share gave the government the following legal rights:

1. To require prior authorisation from the Ministry of Economy for any investor to own more than the ceiling of one tenth, one fifth or one third of the capital of, or voting rights in, the company; and

2. To oppose any decision to transfer or use as security the assets listed in the annex to the Decree.\(^{\text{826}}\)

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\(^{\text{822}}\) As opposed to simple mention to ‘fair and equitable’ treatment, national treatment offers foreign investors the same treatment as national ones, for example, see Article 4 paragraph 1 in the agreement concluded with Qatar.

\(^{\text{823}}\) Article 5.2 in the agreement with Qatar.

\(^{\text{824}}\) ibid.

The American Chamber of Commerce mentions, in particular, that sales of shares in public companies, such as Air France-KLM, Gaz de France, Électricité de France, Thales, Areva etc., are more often made through an ‘off-market’ bidding process.

\(^{\text{825}}\) *Commission v France* (n 747).

\(^{\text{826}}\) The assets in question being the majority of the capital of four subsidiaries of the parent company, namely Elf-Aquitaine Production, Elf-Antar France, Elf-Gabon SA and Elf-Congo SA, Article 2(3) of the Decree.
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In its 2002 decision, the CJEU reaffirmed the principle of free movement of capital and struck down the relevant provisions from the French law for failing to lay down sufficiently precise and objective criteria for approval of, or opposition to, these operations.\(^{827}\)

b. French ‘economic patriotism’

More recently, under former President Sarkozy, a number of actions by the French government were a continuation of Sarkozy’s predecessor’s policy of ‘economic patriotism’.\(^{828}\) Such a stance was also evident with regard to SWFs, which Sarkozy described as ‘aggressive funds’ from which French businessmen ought to be protected,\(^{829}\) while he has also expressed concerns over the lack of reciprocity within the home markets of many of the largest SWF holders.\(^{830}\) Such statements have contradicted other simultaneous messages by French government ministers inviting SWFs to invest in France.\(^{831}\)

As regards EU politics, in October 2008 in a speech before the European Parliament (EP), Sarkozy proposed that European countries should create their own SWFs to protect national companies from foreign ‘predators’ and act as political investors to thwart foreign purchases of European companies.\(^{832}\)

\(^{827}\) Commission v. France (n 747).


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In line with the ideas expressed in that speech, also in October 2008, while addressing French business leaders in Annecy (France), Sarkozy announced that France would establish a SWF to support companies of national strategic importance as he would ‘not be the French President who wakes up in six months time to see that French industrial groups have passed into other hands’.

The state-owned bank Caisse des Depots et Consignations (CDC) was chosen to form part of the defence of French companies against attacks by foreign state-owned investment funds. The CDC would, thus, be elevated to a ‘tool in this policy of defence and the promotion of economic interests essential to the nation’.

The French SWF was created in November 2008 under the name ‘Fond d’Investissement Strategique’ (FSI). It was set up to be partly owned by the bank CDC (51%) and partly owned by the French government (49%) and was endowed with EUR 20 billion, which consisted of 14 billion worth of stakes in French companies and 6 billion in cash. Its stated strategy was to support the development of small and medium sized enterprises with a strong potential for innovation and sector leadership, and to stabilise the capital companies deemed strategic to the French economy. It offers a high level of disclosure and also provides for Parliamentary supervision through the Commission de Surveillance of the CDC, composed of thirteen members of which five are members of Parliament (three deputies and two senators).

833 ibid.
835 The speech of 20 November 2008 at Montrichard served as the opportunity to announce its strategy and organisation.
836 Fiechter (n 709) 72.
837 ibid.
839 The Commission de Surveillance according to article L 518-4 of the French Monetary and Financial Code, guarantees the independence of the CDC and exercises control over the fund; it supervises the state of the coffers and the management of the fund. It also makes recommendations to the Director General of the fund, the Parliament and the Government, see (French speaking site):
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The creation of the French SWF itself, differs in many respects from the usual method of creation and operation of SWFs, firstly, in that France suffers from chronic fiscal deficits and a growing national debt, instead of surpluses which are typical in SWF managing nations. Moreover, the FSI is aimed primarily to invest domestically to protect the national economy, instead of investing abroad to diversify its economy or insulate it from volatile international commodity prices. The creation of such a fund, driven principally by political motives has been described as ‘hypocritical’ since a number of European countries, including France, condemn potential political, non-commercial motivations behind these funds, while at the same time creating SWFs with that same motivation. However during the financial crisis, as seen in chapter 2, many countries made use of their funds, essentially, to assist their domestic economies. The action taken by Sarkozy did no more than to formalise such a specific use of a SWF. As largely seen in the first three chapters, managing a SWF is mainly about government policy choices.

c. The French legal response


840 In 2010, France's budget deficit amounted to 7.1% of its national GDP and its public debt was estimated at 95.2% of its GDP. These figures are close to the OECD average for that period, namely, 7.7% deficit and 98.7% debt, For the deficit see,
For the debt see,

841 Singh (n 832).

842 See chapter 2, ‘Shifting focus on domestic issues’.

843 Such an action could well expand the definition of SWFs (discussed in chapter 1) to include this category of fund as well.
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Contrary to most other cases of national laws, France’s legal response was not triggered by a specific incident, rather, it was a calculated response to a wider phenomenon of increasing FDI and growing state capitalism. This section will deal with two relevant decrees, one issued in 2005 and a later one of 2012 making a number of amendments.

Firstly, France had always implemented a general screening procedure for FDI. Under article L151-3 of the Monetary and Financial Code, financial links with foreign countries (such as foreign investments) are subject to ex ante review by the Minister of Economics for reasons of public order, health, security, research, production or trade in any substances destined for military use or wartime equipment. The review may result in approval, rejection or conditional approval and may be appealed by the applicant foreign investor. The available evidence shows that under the powers conferred by this provision, nine applications were rejected between 1992 and 1994 for reasons of public order. Compared to the equivalent investment screening measures adopted in the USA, Japan and the UK, French measures achieved the highest number of transactions blocked (thus confirming that although France is an open economy it still maintains protectionist practices).

Legal developments in France more relevant to SWFs came later in 2005. In reaction to the Court’s judgement in Eglise de Scientologie, France issued the Decree No 2005-1739 of 30 December 2005 (codified at Articles R.153-1 to R.153-5). The 2005 Decree established a list of eleven protected sectors requiring ministerial authorisation for any attempt to purchase a controlling interest in a firm or acquire a branch of a firm whose corporate headquarters...

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844 And especially the other jurisdictions examined in this thesis, the USA, Germany and Greece.
845 Kern (n 43) 10.
846 Until 2008, only one case was blocked in the USA, while in Japan none was blocked since the 2002 revision of the Foreign Exchange and Foreign Trade Control Law of 1997. In the UK the powers under the relevant law have never been evoked to block a transaction. ibid.
847 Condemning France for maintaining a number of provisions in the French legislation laying down, in certain cases, a system of prior authorisation for direct foreign investments, n 761.
848 Article L 233-3 of the French Commercial Code, provides a definition of ‘control’ of a company by another one, based on 1. Controlling the majority of voting rights, 2. Effectively determining the decision taken by the company through the use of that voting power, and 3. Being able to appoint or dismiss the majority of the members of that company’s administrative, management, or supervisory structures. Control is also assumed when a company holds a fraction of the voting...
are located in France, or acquire more than one-third of the capital or voting rights of a firm whose corporate headquarters are located in France. Under the 2005 Decree, the Minister of Economy had two months to assess the investor’s request for authorisation, after which he issued an approval or denial.\textsuperscript{849} If no decision was taken within this limit, the authorisation was deemed to be granted. When deciding the national security implication of an investment, regard was also given, informally, to the percentage of the investing body that is owned by a foreign government.\textsuperscript{850} Failure to apply for a national security review when required could result in criminal and civil penalties.\textsuperscript{851}

The eleven sectors requiring approval were the following: 1. gambling and casinos; 2. private security; 3. research, development, or production of means to stem the unlawful use, in terrorist activities, of pathogens or toxins; 4. equipment designed to intercept correspondence and monitor conversations; 5. testing and certification of the security of information technology products and systems; 6. production of goods or supply of services to ensure the security of information systems; 7. dual-use items and technologies;\textsuperscript{852} 8. cryptology equipment and services; 9. activities carried out by firms entrusted with national defence secrets, in particular under the terms of national defence contracts or of security clauses; 10. research, production, or trade in weapons, ammunitions, powders, and explosives intended for military purposes or war materials; 11. activities carried out by firms holding a contract for the design or supply of equipment for the Ministry of Defence, either directly or as subcontractors, to produce an item or supply a service for one of the sectors referred to in points 7 to 10 above.\textsuperscript{853}

Companies based in EU Member States were subject to the same review process for sectors 8 to 11. As far as sectors 1 to 7 are concerned, more details were required from the potential (EU) investor, including the location where the

\begin{itemize}
  \item rights above 40\% and no other partner or shareholder directly or indirectly holds a fraction larger than its own.
  \item \textsuperscript{849} Article R153-8.
  \item \textsuperscript{850} GAO (n 808) 59.
  \item \textsuperscript{851} Art R165-2;
  \item \textsuperscript{852} The Ministry of Economy may also deliver opinions to investors if they are unsure whether the proposed investment is subject to review, Art R 153-7.
  \item \textsuperscript{853} As listed in Annex IV of European Council Regulation No. 1334/2000 of June 22, 2000.
  \item \textsuperscript{853} Article R153-2.
\end{itemize}
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An investor is a legal entity and details on the individuals and public legal entities that have ultimate control over the investing organisation. The place of residence (siège sociale) of a corporate investor under French law is determined by the location of its owners, without regard to its place of incorporation. The fact that an investor was a foreign state-owned enterprise or a SWF could be considered during the review process, although no specific rules or guidelines existed about this.

The Ministry of Economy had responsibility for determining whether security risks are present and whether these may be mitigated by imposing conditions for approving the transaction. For example, sensitive technologies may be kept in France, or where classified information was required to carry out the business, this may be available only to French citizens. The requirement to notify and the prior-authorisation arose not only when the initial investment was made, but also during any re-capitalisation, change in shareholding, or upon a resale of the investment. This aspect of the review distinguished the French from the German and American review system.

Half the cases reviewed in 2006 required mitigation agreements. The decision of the Ministry of Economy was subject to an appeal, although, considering that up to 2010, only two cases had been rejected (of a few dozen examined every year) the opportunity to appeal is rarely used.

Soon after France adopted this law, the EU Commission embarked upon its formal review process to investigate potential violations of the rule on freedom of movement of capital. As stated, although objectives of public policy, public security and national defence ‘may require measures that restrict the fundamental freedoms established by the EC Treaty’, the Commission expressed its concern that the authorisation procedure provided by the French Decree

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854 Article R 153-4.
856 Schweitzer (n 597) 268.
857 GAO (n 808) 58.
858 See below at 227.
859 GAO (n 808) 58.
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'lacked the required proportionality with regard to these objectives'. Special reference was made to the inclusion of casinos in the scope of the Decree as 'unsatisfactory'.

On May 7, 2012, the French government issued a second decree (the 2012 Decree) to address the Commission's concerns. The 2012 Decree revised the list of protected sectors by applying a stricter standard for non-EU investors and foreign-controlled French investors. For instance, it removed 'casinos' from the list, but only as far as EU investors are concerned. Moreover, it specified that only non-EU investors were to seek authorisation from the Ministry of Economy.

ii. Germany

a. German industry and foreign investments

Germany currently enjoys the position of being one of the most open investment location among the world’s large industrialised countries. In 2008 Germany is said to have received $5.1 billion of investment from SWFs, making it the second most popular destination in Europe, after the UK (which, as seen above, enjoyed a strong lead of $26 billion).

The German government and industry is known to actively encourage foreign investment in Germany, and German law treats foreign and national investors alike. Foreigners are also treated equally in privatisations and the

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861 ibid.
862 In 2010 Germany ranked seventh in the world on the OECD's FDI restrictiveness index (the index is based on equity restrictions, screening and approval requirements, restrictions on foreign key personnel, and other operational restrictions, such as limits on purchase of land or on repatriation of profits and capital), Blanka Kalinova, Angel Palerm and Stephen Thomsen, 'OECD’s FDI Restrictiveness Index: 2010 Update’ (2010) No. 2010/3 OECD Working Papers on International Investment 19.
863 Kern (n 101) 8.
864 Foreign-owned companies registered in the Federal Republic of Germany as a GmbH (limited liability company) or an AG (joint stock company) receive the same treatment under German law as German-owned companies,
investment-related problems foreign companies face are generally the same as for domestic firms.\textsuperscript{866} Similarly, foreign investors are generally subject to the same eligibility conditions as German investors for incentive programs.\textsuperscript{867}

Germany has BITs in force with 131 countries and territories\textsuperscript{868} including a number of countries which manage SWFs, such as Kuwait,\textsuperscript{869} China,\textsuperscript{870} Qatar,\textsuperscript{871} and Saudi Arabia.\textsuperscript{872} The more recent agreements provide for exceptions to the rules on ‘fair and equitable treatment’ for measures taken for reasons of public security and order, public health or morality.\textsuperscript{873} Interestingly, the agreement with Kuwait includes the Kuwaiti SWF, the KIA, in the list of investors to be accorded the protections provided in the body of the agreement.\textsuperscript{874} Moreover, the agreement with Saudi Arabia has given rise to one investment dispute before the International Centre for Settlement of Investment Disputes (ICSID)\textsuperscript{875} between a German corporation and the Kingdom of Saudi Arabia.\textsuperscript{876} The case,

\begin{itemize}
\item Germany, ‘Investment Climate’ (2011) Export.gov
\item ibid,
\item There are no special nationality requirements on directors or shareholders. In addition, investors need to register investment intent with any government entity only in the case of acquiring a significant stake in a firm in the defence or encryption industries.
\item ibid,
\item Such as high marginal income tax rates and labour laws that impede hiring and dismissals.
\item ibid,
\item Such as investment grants, credit programs and state guarantees.
\item ibid,
\item Of these, eight are with ‘predecessor’ states, such as the Soviet Union and Yugoslavia.
\item Agreement between the Federal Republic of Germany and the State of Kuwait for the Encouragement and Reciprocal Protection of Investments (signed 1994)
\item \url{www.unctad.org/sections/dite/iia/docs/bits/germany_kuwait.pdf} accessed 14 March 2012.
\item ibid,
\item \url{www.unctad.org/sections/dite/iia/docs/bits/china_germany.pdf} accessed 14 March 2012.
\item ibid,
\item ‘Abkommen zwischen der Bundesrepublik Deutschland und dem Königreich Saudi-Arabien über die Förderung und den gegenseitigen Schutz von Kapitalanlagen’, (signed 1996)
\item \url{www.unctad.org/sections/dite/iia/docs/bits/germany_saudiarabia_gr_arb.pdf} accessed 14 March 2012.
\item ibid,
\item ‘Agreement Between the Federal Republic of Germany and the State of Qatar Concerning the Encouragement and Reciprocal Protection of Investments’,
\item \url{www.unctad.org/sections/dite/iia/docs/bits/germany_qatar.pdf} accessed 14 March 2012.
\item ibid,
\item Such as the agreement with China (Protocol to the agreement, Article 1).
\item Article 1(3)\textsuperscript{b)ii}.
\item ibid,
\item An autonomous international institution sitting in Washington DC, established under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States with over one hundred and forty member states,
\item ICSID, \url{https://icsid.worldbank.org/ICSID/Index.jsp} accessed 23 January 2013.
\item ibid,
\item ibid,
\item Züblin AG v. Kingdom of Saudi Arabia (ICSID Case No. ARB/03/11).
\end{itemize}
however, was discontinued at the request of the claimant (the German company) before it was concluded.

Possibly no case other than that of Volkswagen (VW) is a better illustration of the CJEU’s scrutiny of capital restrictions and the Member States’ insistence on protecting major companies. The case of *Commission v Germany*\(^{877}\) involved the role of the state in the control of Germany’s largest car-maker. It is said that the VW case touches upon ‘the limits which EU law places on Member States when they attempt to organise the internal affairs of their companies’ and that through it, the Court is, in fact, creating a set of EU-based values on regulating companies, rather than purely safeguarding the interests of market integration.\(^{878}\)

The VW law (Volkswagengesetz) is a federal statute, based on a 1959 agreement between the Federal Republic of Germany and the Land of Lower Saxony\(^{879}\) deciding over the ownership at VW and protecting its employees from a large new shareholder.\(^{880}\) According to this agreement the Land would hold 20% of the shares in the company and enjoy a number of rights: (1) a provision capping the voting rights of every shareholder at 20% (section 2(1) of the VW law), (2) a provision implementing an 80% majority requirement for important company decisions (section 4(3) of the VW law) and (3) the right of the Federal State and of the Land of Lower Saxony to appoint two members to the company’s supervisory board, if, and as long as, the State and the Land were shareholders of VW (section 4(1) of the VW law).

The EU Commission investigated the matter and issued a decision in 2004 announcing that the above provisions violated the rules on free movement of capital in that it rendered investments in the company less attractive.\(^{881}\) The matter was ruled upon by the Court, which in 2007 agreed with the Commission and declared the contested provisions as incompatible with the free movement of capital.

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\(^{877}\) Case C-112/05 *Commission v Germany* [2007] ECR I-8995, the ‘Volkswagen case’.


\(^{880}\) Ringe (n 878) 12.

of capital. Interestingly, in anticipation of the Court's decision, Porsche prepared the ground for an eventual takeover bid should the law be revoked.882

The decision that the VW law violated the rules on free movement of capital, rather than free movement of establishment, is particularly important to third country investors. Since free movement of capital rules also apply to third country investors Ringe argues that they have a greater ambit than the rules on freedom of establishment, and as such, they also apply to SWFs.883 Furthermore, Schweitzer argues that extending the freedom of capital to third countries also extends that provision to the freedom of establishment.884 She cites the fact that the European Court has rejected propositions to interpret Article 56 EC (Article 63 TFEU) differently depending on whether it is applied in an intra-Union context or with regard to movements of capital with third countries.885

At the end of 2008, Germany amended the VW law, removing the right to nominate directors and the voting cap. However, it maintained the 80% special majority requirement for important company decisions and the rule that required a two-thirds majority of the supervisory board for a decision about the business location of the company. The new statute was soon criticised as potentially clashing with the rules on free movement of capital.886

Events following the publication of the Court's decision have been marked by a confrontation between the European Commission and Germany. German officials were quoted saying that the Commission would be ‘badly advised’ to lodge a complaint against the law and that it would be stepping on to ‘very thin ice’ if it chose to take on Berlin again.887 Nevertheless, the Commission soon

882 A fact which, alone, demonstrates the unattractiveness of large investments in the company under the existing regime. Until that moment Porsche had acquired somewhat over 50% stake in VW, with the prospect of raising it to 75%, a necessary condition for a takeover, Ringe (n 878) 386.
883 ibid 381;
It is equally argued by Ringe that free movement of capital is a 'larger' freedom than freedom of establishment because, unlike freedom of establishment, the free movement of capital provisions are not limited to investments that confer control, but also extend to direct and portfolio investments.
884 Schweitzer (n 597) 272.
886 Ringe (n 878) 37.
887 Statements made by Zypries, Germany’s former justice minister, in May 2008,
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brought new legal action against Germany, claiming that the new version of the law still violated EU law.888

Things then remained silent for some time. The inactivity was partly due to subsequent events taking place between VW and Porsche. The global financial crisis had overturned Porsche’s plans to take over VW. Instead, the new arrangement between the two car-makers was that Porsche would be sold to VW in two stages: VW would initially acquire 49.9% of Porsche, and it would purchase the remaining shares at a later date. Porsche Automobil Holding would likely receive about €8 billion ($11.2 billion) for the shares, which would allow it to pay off most of its debt. Since, to facilitate the deal, the Land of Lower Saxony had indicated it would agree to an Arab investment in the German carmaker,889 a Qatari SWF acquired a stake in the group.890 It is also interesting to note that the inactivity on the part of the Commission coincided with the election of the new Commission following the European elections of 2009 and the renewal of Barroso’s position as President.

Eventually, in November 2011, Brussels returned to the matter by suing Germany. It is reported that the German argument is that the CJEU ruling found the blocking minority only breached laws on the free movement of capital when seen in conjunction with the 20% voting cap, which had been scrapped.891 However, it is unlikely that the Court will accept this interpretation, since it tends to look at many factors as well as the general effect of the legislation when

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assessing potential obstacles to the free movement of capital. Based on its current case law,\textsuperscript{892} it is more probable that the Court will rule that the current amendments to the VW law do not comply with the general spirit of its original ruling. If Germany lost the case it would have to scrap the law and in addition pay a multimillion fine for late compliance.\textsuperscript{893}

b. The German legal response

The WV case is often seen as an exception to the generally open German economy. Foreign investment controls in Germany came in two waves, one concerning general security related matters and one adopted following rising concerns about SWFs.

Specific controls over FDI were adopted in 2004 reacting to concerns that German export control laws might be insufficient to protect national security interests in case of a foreign acquisition of a German company directly involved in that security.\textsuperscript{894} To this end certain provisions were introduced in the German Foreign Trade and Payments Act (\textit{Außenwirtschaftsgesetz}) of 1961.

Para 7, provided:

Protection of Security and External Interests:
(1) Legal transactions and acts in foreign trade payments may be restricted in order to
  1. guarantee the vital security interests of the Federal Republic of Germany.
  2. prevent a disturbance of the peaceful coexistence between the nations, or
  3. prevent a major disruption of the foreign relations of the Federal Republic of Germany.
(2) According to paragraph 1 above, the following may be restricted in particular [...]

\textsuperscript{892} See the analysis above from n 739 onwards.
\textsuperscript{893} Barker (n 822).
\textsuperscript{894} Schweitzer (n 597) 268.
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4. Legal transactions referring to industrial property rights, inventions, manufacturing processes and expertise relating to the goods and other objects [...].

5. Legal transactions on the purchase of resident companies which
   — produce or develop war weapons and other military equipment, or
   — produce cryptographic systems admitted for the transmission of governmental classified information by the Federal Office for Information Security Technology with the company's approval, or legal transactions on the acquisition of shares in such companies, in order to guarantee the vital security interests of the Federal Republic of Germany; this applies in particular if the political and security interests of the Federal Republic of Germany or the military security precautions are jeopardized as a result of the purchase [...].

The German legal framework has also provided for a notification scheme to the German government in the event of the planned acquisition of a German firm (or of an acquisition of 25% stake or more) active in the production of weapons and other military equipment or cryptographic systems. Once the notification is made, the transaction must be either approved or prohibited within one month.

Soon after the implementation of the legal framework above, in the context of the rising phenomenon of SWFs and state-owned companies, a public debate emerged in Germany on the impact and objectives of such entities.895 The German Chancellor, Merkel, said that ‘one can question whether these funds are solely concerned with attaining a high return on capital’ and ‘state-owned funds can also have politico-strategic aims in mind that could be problematic in sensitive areas’.896 Similarly, Koch, Minister-President of Hesse and one of the most influential Christian-Democratic Union (CDU) politicians, said towards the end of 2007, that Russian and Chinese investors ‘would be in a position to buy

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the whole DAX’. According to Merkel, this was a new phenomenon that had to be tackled ‘with some urgency’ and she called for ‘an EU-wide discussion about this’.

As a result, the review powers established by the previous law were expanded. A first draft of the proposed law, the new Außenwirtschaftsgesetz (AWG) and its implementing law, the Außenwirtschaftsverordnung (AWV), were issued in September 2007. The EU Commission then notified the German government that a distinction must be drawn between FDI coming from other Member States of the EU and FDI coming from non-EU states. Consequently, foreign state-controlled investors from other EU Member States had to be excluded from the scope of the proposed regulation. These amendments came into force on 24 April 2009.

Under the new scheme, the Federal Minister of Economics and Technology was empowered to review on a case-by-case basis any acquisition of a stake of 25% or more of any listed or non-listed German firm by a non-EU investor. The review aims to ascertain whether the acquisition endangers public order or security in the Federal Republic of Germany. It will be judged to do so only if a real and sufficiently severe danger can be identified which affects a fundamental interest in society. However, the law does not make any further specifications as to the nature of the danger or the fundamental interest to be protected. The German government has stated in the past that the ownership of the foreign investment fund (state or private) and its strategic interests will be taken into consideration in its assessment of the transaction.

Generally speaking, the 2009 amendment has a much broader application than the previous law, especially with regard to the sectors and types of firm

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897 Euractiv staff, ‘Germany plans’ (n 895); DAX is the stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.
898 Euractiv staff, ‘EU to consider’ (n 896).
901 para 53.
902 para 7(2) No. 6 AWG.
903 Gordon and Tash (n 414) 19.
involved that are subject to review. With regard to notification by the investor, the German review system also allows for some laxity in the sense that it does not contain any mandatory notification or prior-authorisation scheme. In fact, it rests upon the Federal Ministry of Economics and Technology itself, within three months of the transaction, to acquire all the relevant information and, if necessary, prohibit the acquisition. After the initiation of the review process, the Ministry has another two months to make its assessment, and then it may impose conditions (such as the suspension of voting rights) in order to clear the transaction. During this delay the investments affected by the law are held as 'pending'. Under the German legal ‘principle of abstraction’ (Abstraktionsprinzip) a personal obligation to pay or exchange goods or legal rights (e.g. through contract) is independent from the transfer of proprietary title of goods or legal rights. Thus, in an agreement for the transfer and assignment of shares, the transfer and assignment agreement remains in effect even though the underlying obligation does not.\textsuperscript{904} In the event of prohibition the contract is deemed null and void.\textsuperscript{905} In the event of clearance, the mutual obligations of each side of the transaction can be fulfilled.

Unlike the system established in the USA for determining security risks, which relies on contributions from both public and private actors,\textsuperscript{906} Germany assigns the main role for information finding to the government. However, all jurisdictions at some stage assign some responsibility for the provision of information to the foreign investor. In the case of Germany, the initial notification requirement pertains only to the narrow security review involving armaments and cryptology technology. The more general review procedure assigns the responsibility of initial information gathering to the government.\textsuperscript{907} Moreover, relevant information is collected from the Federal Cartel Office and the Federal Financial Supervisory Authority and these agencies receive

\begin{footnotesize}
\textsuperscript{904} For more see, Norbert Horn and others, \textit{German Private and Commercial Law} 1982, Clarendon Press 69-70.
\textsuperscript{905} para 31(3), AWG.
\textsuperscript{906} The responsibility lies with both the USA government, and the foreign investors themselves. The USA system is analysed in more details in the next section.
\end{footnotesize}
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information about acquisitions and takeover offers.\textsuperscript{908} In 2008 there was a press rumour that the coming adoption of the new legislation could be used to block the possible multi-billion euro takeover by Temasek of container shipping giant Hapag Lloyd, owned by German firm TUI.\textsuperscript{909} The bid from Temasek, which had publicly expressed interest in the company via its Neptune Orient Lines unit, was one of about half a dozen that TUI had received.\textsuperscript{910} The bid ultimately failed, reportedly because of a failure to agree on a price for Hapag Lloyd, rather than because of the effects of the new law.\textsuperscript{911} According to the American Chamber of Commerce in Germany, up until June 2011, no foreign companies had complained about difficulties under the amendment.\textsuperscript{912}

\textit{iii. Additional national measures}

In addition to France and Germany, other EU Member States have produced specific legislation to target SWFs. Greece is a characteristic example. Since the beginning of 2010 Greece has suffered a severe form of debt crisis caused from chronic public debt and budget deficits. The crisis effectively removed the country from international debt markets\textsuperscript{913} and has forced it to accept two rescue packages from a tripartite source, the International Monetary Fund (IMF), the European Central Bank (ECB) and the European Commission.\textsuperscript{914} The Greek

\textsuperscript{908} ibid 10.
\textsuperscript{909} As reported by the Financial Times Deutschland, Agence France-Presse, ‘Germany Moves to Block SWFs’ \textit{Industryweek} (Cleveland, 21 August 2008) <www.industryweek.com/ReadArticle.aspx?ArticleID=17121> accessed 27 December 2012.
\textsuperscript{910} ibid.
\textsuperscript{911} Deutsche Presse-Agentur, ‘Singapore Shipper NOL Denies Fresh Bid for Germany’s Hapag-Lloyd’ M&C (5 December 2011)
debt crisis makes the country a particularly interesting case study, since it could be argued that heavy handed government intervention combined with tough regulation (leading to a loss of FDI) helped cause Greece’s loss of competitiveness, leading to its financial crisis.915

The Greek government passed legislation in 2008 to regulate FDI in publicly held companies. Although Greece is not a major recipient of SWF investments,916 towards the end of 2007 the Greek government was alarmed by MIG’s growing stake917 in the country’s then public telecommunications operator (OTE). MIG, a private equity firm controlled in part by a Dubai state investment fund,918 was deemed by the Greek government to be an unsuitable investor to acquire a majority stake in OTE.919 The Greek government, therefore, in cooperation with the management of OTE, searched for possible ways to obstruct the advance of MIG.

Until 2008, privatisations in Greece were governed by Law 3049/2002 establishing an Inter-ministerial Privatisations Committee (IPC) tasked with the execution and supervision of the privatisation process. The new Law 3631/2008 imposed a requirement for prior approval from the IPC for any foreign investor

915 The crisis began when international markets deemed the country’s debt unsustainable. A variety of chronic factors had contributed to Greece’s competitiveness problems. Apart from protectionism and tough regulations, the Greek economy presented substantial administrative costs, high margins across most economic activities and rising labour costs, Antonio Garcia Pascual and Piero Ghezzi, ‘The Greek Crisis: Causes and Consequences’ (2011) CESIFO Working Paper, No. 3663, 4.

916 Between January 1995 and Jul 2008, Greece is reported to have received a mere $0.6 bn of SWFs’ investments, Kern (n 101), table 13.


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wanting to acquire voting rights of 20% or more of the total share capital in companies of national strategic importance.\textsuperscript{920} The law established certain criteria for the grant of approval by the IPC which aim to ensure a benefit for the Greek public. The criteria relate to the investor's experience in the sector and reputability, but also to its share ownership, its place of residence and level of transparency.\textsuperscript{921} In November 2008, the Commission announced its opposition to the measure declaring that it infringed Treaty rules on free movement of capital,\textsuperscript{922} and brought an action before the Court of Justice of the European Union against Greece on those grounds. The judgement of the Court condemning Greece was issued on 8 November 2012.\textsuperscript{923} The compatibility of the Greek measure, as well as other national measures, with EU law is discussed in the analysis below.

This section presented, first, the EU legal framework on the restriction of capital movements and, second, national measures of some EU member states designed to limit the investment activity of SWFs. Many non-EU countries, however, also receive a large amount of sovereign investments and have consequently implemented similar legislation. Of those countries, the USA is particularly important due to its regulatory openness and the attractiveness of its economy to foreign investors. It is therefore the focus of the next section.

B. THIRD COUNTRY MODEL

\textsuperscript{920} As laid down in Art 11(1), in conjunction with Art 11(2), of Law 3613/2008. Such companies are in particular those involved in energy and telecommunications.
\textsuperscript{921} Art 11(2) of Law 2613/2008.
\textsuperscript{923} C-244/11 Commission v Hellenic Republic.
1. Non-EU Countries

The first part of this chapter focused on EU law relevant to the regulation of the investments of SWFs as well as the measures adopted by EU jurisdictions. This part contains an analysis of a third jurisdiction, the USA, which has also adopted legislation that restricts SWFs. Various countries, such as Australia and Canada, have also adopted laws that target foreign investors and SWFs in particular. But, as shown, the USA is distinguished from other countries due to the attractiveness of its economy to all kinds of foreign investor despite recent developments there that have reignited debate about SWFs.

Third countries, naturally, are not constrained by external obligations such as those of EU law discussed in Section A. They are undoubtedly bound by international agreements and obligations in the context of the OECD and the WTO, but, as seen in chapter 4, these frameworks are limited in their application and lack the legal teeth to challenge legislation that limits foreign investments. Thus, third countries, such as the USA, enjoy an important autonomy when regulating SWFs. This discussion therefore provides an additional analytical standpoint: it enables the reader to observe how SWF issues are dealt with in jurisdictions not bound by EU law, but where SWF investments have also given rise to national security issues.

This section provides a discussion of the relationship between the USA and SWFs as well as the USA legal framework which governs them. In the final, third, section, a comparative analysis of the three EU countries’ and the USA’s legal frameworks controlling SWFs is provided.

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924 Australia has enacted the Foreign Acquisitions and Takeovers Act 1975 and the Foreign Acquisitions and Takeovers Regulations 1989. Under Australian law, the Foreign Investment Review Board reviews foreign investments to ensure that they are consistent with Australia’s national interest;
Canada adopted in December 2007 the ‘Guidelines – Investment by state-owned enterprises – Net benefit assessment’, which aims to ‘to encourage investment in Canada by Canadians and non-Canadians that contributes to economic growth and employment opportunities and to provide for the review of significant investments in Canada by non-Canadians in order to ensure such benefit to Canada’ (para 2).
925 This is a reference to the DPW deal examined below, n 936.
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i. The USA

a. The USA – the holy grail of SWF investments

The USA has been the prime target economy for SWFs worldwide before and during the crisis and for this reason it serves in this thesis as a comparative model. Before any analysis begins, several points need to be made. First, the USA has a different legal regime from the models discussed above, in that it is not part of a supranational legal structure as EU countries are. Second, the USA legal system is a federal one, divided between the state level and the federal level. The laws discussed in this section fall in the jurisdiction of the federal state.

Third, it is relevant to note that national security issues, already prominent in the USA political agenda, have been part of the debate regarding SWFs more often than in Europe.

As discussed in chapter 2, the USA market economy is targeted by some of the world’s largest SWFs, such as ADIA, while Chinese funds invest largely in USA government debt. Saudi funds also show a preference for dollar-denominated assets. According to Deutschebank the most common sectorial/regional preferred combination for SWFs is the financial sector in the USA. Moreover, during the financial crisis, SWFs from around the world continued to invest in troubled American companies, thus increasing the presence of SWFs in the USA market.

The USA has also been the target of past buyout attempts that caused great controversy and stirred debate on the nature and objectives of SWFs. In July

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926 For a historical review of the regulation of foreign investment in various sectors the USA, n 527.
927 The USA is composed of 50 states. According to the 10th Amendment to the Federal Constitution of the USA, all of them technically remain sovereign, although they have transferred considerable powers to the federal level under the Federal Constitution.
928 As stated by O’Brien, ‘concerns about national security issues have become particularly acute in the [USA]. The imperatives governing the ‘war on terror’ have sharpened the potential conflict between the benefits of global exchange and the impact on national security’; O’Brien (n 480) 1242.
929 See n 203.
930 See n 206, 207.
931 Sfakianakis (n 216).
932 Kern (n 101) 9.
933 See chapter 2, ‘Investing against the flow’.
2005, CNOOC made an $18.5 billion bid to buy a USA oil major, Unocal Oil Company. The move gave rise to intense scepticism based on the disadvantage American energy firms would suffer in competing with a SOE, the lack of reciprocity in the Chinese market as well as the status of China as a ‘Communist’ country. In August 2005, CNOOC announced that it had withdrawn its bid for Unocal, blaming ‘the unprecedented political opposition’ in the USA and a political environment that ‘made it very difficult [...] to accurately assess our chances of success’.

However, it was the so-called DWP deal in 2005 that sparked the greatest controversy around SWFs and SOEs. This case was an attempt on the part of DPW, a Dubai SOE, to acquire the London domiciled P&O, which was then the fourth largest ports operator in the world. As part of the sale, DPW would assume the leases of P&O to manage major USA port facilities in New York, New Jersey, Philadelphia, Baltimore, New Orleans, and Miami, as well as operations in sixteen other ports. The case was brought immediately to national attention and, despite executive support for the deal, various members of Congress, and senators from both parties expressed deep misgivings. Arguments touched mainly upon issues of national security and, in particular, the possibility of terrorists being smuggled from the Middle East into USA territory. The transaction was eventually blocked by the USA House Appropriations Committee in March 2006 and the next day, DPW released a statement saying they would turn over operations of P&O in USA ports to a USA entity. The eventual failure

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934 Pottinger and others (n 196).
935 ibid.
936 Frist, a USA Senator, said, ‘If the administration cannot delay the process, I plan on introducing legislation to ensure that the deal is placed on hold until this decision gets a more thorough review’, Jim Lehrer, ‘Port Sale Sparks Political Battle’ Public Broadcasting Service (Arlington, 2 February 2006) <www.pbs.org/newshour/extra/features/jan-june06/ports_2-22.pdf> accessed 11 January 2010.
937 Levin (n 449).
of the transaction was a catalyst for debate on reforming the existing legislation in the USA.\textsuperscript{940}

Attention focused on SWFs again when in May 2007 the Chinese government-controlled CIC took the largest external stake (9.9\%) in Blackstone Group LP in the form of non-voting units.\textsuperscript{941} This investment caused a stormy debate,\textsuperscript{942} for, among other reasons, Blackstone, through its holdings was, indirectly, one of the largest employers in the USA.

Compared with France and Germany, the USA does not have many BITs with countries managing SWFs, the only ones being with Bahrain\textsuperscript{943} and Kazakhstan.\textsuperscript{944} Interestingly, Singapore refused to enter into a BIT with the USA based on the latter’s model treaty because of its limits on performance requirements.\textsuperscript{945} More importantly, in the context of this thesis, the USA has, since March 2008, established an agreement on principles with SWFs from Singapore and Abu Dhabi, in particular the Government of Singapore Investment Corporation and Abu Dhabi Investment Authority.\textsuperscript{946} This non-binding agreement, reflecting the previous work of the IMF and the OECD in this area,\textsuperscript{947} has established a set of principles to be followed both by the investor and host country. For their part, the investors from Abu Dhabi and Singapore need to ensure that their investment decisions are based on commercial and not geopolitical criteria, and that their SWFs implement greater information disclosure, in areas such as purpose, investment objectives, institutional arrangements, and financial information – and particularly asset allocation,
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benchmarks, and rates of return over appropriate historical periods. On their side, the host nation commits not to erect protectionist barriers to portfolio or foreign direct investment; not to discriminate against investors; and to ensure predictable investment frameworks.

b. The Committee on Foreign Investment in the United States regulatory process

In 1988, the Exon-Florio provision of the Omnibus Trade and Competitiveness Act was passed as a response to the attempted acquisition of an American company, Fairchild Semiconductor Corporation, by the Fujitsu Corporation, a Japanese Company. In 1993, Congress expanded the Exon-Florio provision through the National Defence Authorization Act, known as the Byrd Amendment, which emphasised consideration of the national security implications of foreign acquisitions before a transaction could be cleared.

In general terms, the Exon-Florio provision authorised the President to investigate the impact on national security of mergers, acquisitions, and takeovers by foreign entities engaged in interstate commerce with the USA. Under this provision, the President could suspend or prohibit a transaction where he concluded that (i) There is credible evidence that the foreign interest exercising control might take action that threatens national security; and (ii) The provisions of law, other than the International Emergency Economic Powers Act, did not provide adequate and appropriate authority to protect national security.

The President delegated his investigative authority under the Exon-Florio provision to the Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee, chaired by the Secretary of Treasury. CFIUS was

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948 USA Treasury, ‘Treasury Reaches Agreement’ (n 443).
949 ibid.
created by President Ford through an executive order in 1975. He gave the committee the task of ‘continuing responsibility within the Executive Branch for monitoring the impact of FDI in the [USA] [...] and for coordinating the implementation of the United States policy on such investment’. A transaction could be filed for CFIUS review voluntarily, but any member of CFIUS could bring a transaction to the attention of the committee. Such a notification would initiate a 30-day consideration of possible national security concerns caused by the transaction, extended by another 45-day investigation if such concerns did arise. At the conclusion of the second period, a report would be sent to the President, who had 15 days to decide whether action was required on his part. No possibility of appeal was provided.

Although the CFIUS operated in secrecy, it has been said that historically there have actually been very few 45-day investigations, mainly because of government-led stances in favour of free access to markets. Until recently, therefore, CFIUS had chosen to adopt a narrow interpretation of the Exon-Florio provision by balancing multi-layered policy considerations ‘seek[ing] to serve [USA] investment policy through thorough reviews that protect national security while maintaining the credibility of our open investment policy and preserving the confidence of foreign investors here and of [USA] investors abroad that they will not be subject to retaliatory discrimination’. Moreover, historically, the willingness of parties to engage CFIUS proactively on the substance of the transaction has generally offset the need for further investigations beyond the initial review.

c. The Foreign Investment and National Security Act of 2007

955 ibid.
956 Thatcher (n 72) 2. And between 1988 and 1999, it is said that the President investigated only 17 of more than 1,200 companies that volunteered for review. Christopher Fenton, ‘[USA] Policy Towards [FDI] Post-September 11: Exon-Florio in the Age of Transnational Security’ 41 Colum]Transnat’l L 210.
957 Feng (n 443) 594.
958 Thatcher (n 72) 2.
The increase, however, in the number of review processes in later years, reinforced by the controversy caused by the DPW case, brought about calls, after 2005, for the tightening of the review process, culminating in the adoption of the Foreign Investment and National Security Act of 2007 (FINSA), which amended Section 721 of the Defense Production Act of 1950. This development essentially codified many of the CFIUS practices such as the voluntary nature of the negotiation, the review and investigation timeline and the negotiation of mitigation agreements, but also introduced a more onerous and burdensome review process by granting CFIUS extended powers to examine and identify potential national security compromises. The DPW case effectively triggered this legislation.

The main amendments brought by FINSA were: 1. the designation of a lead agency, i.e. a CFIUS agency, best equipped to deal with the transaction and to take the lead on behalf of the Committee on a proposed transaction;959 2. the expansion of the concept of ‘national security’ so as to include transactions involving critical infrastructure,960 energy assets and critical technologies;961 3. a presumption of a 45-day investigation for certain transactions when the acquirer is controlled by or acting on behalf of a foreign government or the transaction could result in the control of any ‘critical infrastructure’ by a foreign business; and 4. FINSA provides statutory authority for the mitigation procedure, which is to be monitored by the lead agency.962 If a party breaches a mitigation measure, the ‘Evergreen procedure’ allows CFIUS to reopen a previously reviewed transaction.

The criteria for the review under FINSA are (i) the acquiring country’s adherence to non-proliferation regimes, (ii) the relationship of the acquiring

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960 Under FINSA, critical infrastructure is defined expansively as any ‘systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security’, 50 U.S.C.A. app para 2170(a)(6).
962 By which to ‘negotiate, enter into, or impose, and enforce any agreement or condition with any party to the covered transaction, in order to mitigate any threat to the national security of the United States that arises as a result of the covered transaction’ 50 U.S.C.A. app para 2170(k)(5);
One known example in this respect was the decision of CIC to buy non-voting shares in Blackstone as the result of negotiations between the Chinese fund and CFIUS, n 198.
country with the United States, specifically on its record on cooperating in/with counterterrorism efforts, and (iii) the potential for trans-shipment or diversion of technologies with military applications, including an analysis of national export control laws and regulations.963

In November 2008, the USA Treasury Department issued final regulations governing CFIUS, clarifying certain aspects of the procedure.964 Among others, the regulations established that ‘covered transactions’ are ‘any transaction proposed or pending after August 23, 1988, by or with any foreign person, which could result in control of a [USA] business by a foreign person’.965 It also defined ‘control’ as ‘the power, direct, indirect, whether or not exercised ... to determine, direct, or decide important matters affecting an entity’.966 Finally, it clarified that CFIUS only considers the particular assets involved in a transaction, rather than designating the whole classes as ‘critical infrastructure’.967

FINSA, therefore, offers a unilateral framework for the government to deal with concerns about SWFs. The FINSA reform has been described by Kern as ‘one of the most demanding foreign investment processes among the industrialised economies – not least for sovereign investors’.968

C. ASSESSMENT

A. Lessons learned

965 ibid § 800.207, 70719.
966 ibid, § 800.204, 70718.
967 ibid, § 800.208, 70708.
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This chapter has reviewed the French, German and USA legal frameworks that apply to SWFs, and has also touched briefly upon the case of Greece. The following analysis examines these measures, incorporating also the conclusions drawn from previous chapters.

As it was explained in chapter 4, all investment control mechanisms entail a degree of protectionism (see table 4.2 above). This would be warranted if it were deemed necessary to protect national economies from the operation of harmful foreign investors. However, all the measures discussed above are excessive, in the sense that they go beyond what is needed to address any possible risk arising from the investments of SWFs. It has been argued in chapters 3 and 4 that although SWFs are in some respects different from regular investors, especially when it comes to their size or ownership, they are not generally a source of concern for recipient countries. On the contrary, their particular characteristics make them a positive and stabilising force in global markets, which enable them to withstand market downturns and invest with long-term perspectives.969

The mere existence and operation of SWFs should not be dealt with as a cause of concern for western countries. Rather, the growth of SWFs is the result of global imbalances and the rise of developing markets. As stated in chapter 4,970 such phenomena are best addressed not by regulatory instruments (such as a review of FDI), but by macroeconomic and foreign policy that aims to tackle those global imbalances.

Once this is accepted, it becomes clear why the majority of the investment screening mechanisms applied to SWFs impose costs on recipient countries in the form of loss of investment and entail an unnecessary expenditure of government resources for very little or no benefit. In addition, these mechanisms prevent the efficient allocation of resources and thereby increase costs for global markets.

Nevertheless, it is difficult to predict the future of these mechanisms. On the one hand, some countries may acknowledge the lack of need for such excessive mechanisms and repeal or amend them. Such a development occurred during the global financial crisis after 2008 when formerly sceptical governments began to

969 See chapter 2, Investing against the flow.
970 n 488.
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lure SWFs to their countries. On the other hand, such mechanisms may be maintained as they address a popular demand for security and protection from foreign financial predators and a demand for the supervision of financial markets. Such measures, in providing a buffer against calls for even more stringent regulation, may, in this limited sense, be beneficial.

\textit{i. Protectionism and costs}

Protectionism is clearly present in all the measures referred to above. As a result, these measures impose significant costs on the countries concerned in the form of lost foreign investment. The precise extent of those costs is not quantifiable, but they vary according to the degree of protectionism present in each law.

Countries differ, some maintaining a pre-approval system and others not. France and Greece require a request for authorisation by the prospective investor to the national authorities. This system can be time consuming and uncertain, to the detriment of investors. Moreover, the approval granted by the French Minister or the Greek Inter-Ministerial Committee may be a conditional one, meaning that the prospective investor may be forced to comply with additional requests before the transaction is carried out. The USA and Germany, however, do not have prior-authorisation regimes. But the American system provides for mandatory notification, whereas the German measure does not, assigning most of the obligation for the collection of information to the government. Thus, with respect to the notification and pre-approval systems, the German measure appears to be the most investor friendly.

Some measures examined in this chapter identify specific areas/industries where investments trigger the aforementioned review. Naturally, the broader the spectrum of the areas covered by the legislation, the greater the loss of foreign investment recipient countries will experience. In addition, some of the legislations examined are highly uncertain about the exact areas covered, thus complicating matters further for investors.

\footnote{Reuters staff, ‘Sovereign Funds Welcome in Germany’ (n 1002); Fotak and Megginson (n 478).}
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France has listed in detail a high number of specific industries liable to activate a review, stating expected ones, such as research, productions and trade in weapons and dual-use items, as well as more obscure ones, such as gambling, casinos and private security. Unfortunately this strict list remains in the 2012 Decree as far as foreign investors are concerned. Greece chose not to list specific industries, but rather has indicated the broad areas of energy and telecommunications, where investments (in particular those coming from third countries) require approval by the IPC. The USA law is even broader, originally providing for the possibility of review in any transaction raising ‘national security’ considerations. The law did not explain the term ‘national security’, but the FINSA amendment of 2007 gave some guidance by including ‘critical infrastructure’, ‘energy assets’ and ‘critical technologies’ in the areas to be reviewed by the CFIUS.\(^{972}\) Finally, the German amendment provides for the possibility of review in every sector of the economy. All in all, every example of national legislation discussed above, is either too broad or too uncertain about which protected economic areas trigger a review.

Most laws provide not only for specific areas, but also for specific percentages of share capital, the acquisition of which activates review. Germany and Greece establish rather low percentages (25 and 20% respectively), thus imposing tough restrictions on foreign investors willing to make significant investments in various areas. As far as Germany is concerned, one consequence of the abstraction principle in German private law\(^{973}\) is that should a share purchase agreement be implemented but later on prohibited, the agreement would have to be unwound.\(^{974}\) This, however, is not possible where 25% or more of the voting rights have been acquired not collectively but successively as many of the former shareholders may not even be known by name. Thus, the

\(^{972}\) n 963.

\(^{973}\) Whereby the agreement for the transfer and assignment of shares remains in effect even though the underlying obligation is not;
Horn and others (n 904) 69-70

\(^{974}\) FTS Global Markets staff, ‘Germany Re-acts to Sovereign Wealth Funds’ Issue 30 November/December 2008
25% threshold does not make sense.\textsuperscript{975} It is relevant to note that the attendance at shareholders’ meetings ranges on average between 50 and 80\% of shareholders, and that German corporate law requires at least a 75\% majority of the share capital present for the passing of special resolutions,\textsuperscript{976} compared to a simple majority of votes cast for ordinary resolutions.\textsuperscript{977} Against this background, possession of as little as 10\% of the voting rights often puts a shareholder in the position to block resolutions in a general shareholders’ meeting of listed corporations because decisions are taken on a majority basis.\textsuperscript{978}

France and the USA, on the other hand, provide for a review only in cases of ‘control’. The American law states that the review applies to any ‘merger, acquisition or takeover’ which results in foreign control of any [USA] person.\textsuperscript{979} The definition of ‘control’ provided in the CFIUS 2008 regulation\textsuperscript{980} remains unclear. To some extent, it reflects the definition found elsewhere in USA law, such as the Securities Act Rules, which define control as ‘the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise’.\textsuperscript{981} Under this definition, control could also be achieved by as little as 10\% of a company’s voting rights. At the same time, section 2(a)(9) of the USA Investment Company Act 1940 defines control as ‘the power to exercise a controlling influence over the management or policies of a company [...]’\textsuperscript{982} and presumes such control to exist when one controls 25\% or more of the company.\textsuperscript{983}

\textsuperscript{975} ibid.
\textsuperscript{976} For example resolutions to amend the articles of incorporation, section 179 para. 2 of the German Stock Corporation Act (\textit{Aktiengesetz}), or to waive preemption rights, section 186(3) \textit{Aktiengesetz}, will require a majority of 75\% of the share capital represented at the time of the vote.
\textsuperscript{977} s 133(1) \textit{Aktiengesetz}.
\textsuperscript{978} FTS Global Markets, ‘Germany Re-acts’ (n 974).
\textsuperscript{979} 50 U.S.C.A. app 2170(a)(3).
\textsuperscript{980} ‘The power, direct, indirect, whether or not exercised ... to determine, direct, or decide important matters affecting an entity’, § 800.204 p 70718 of the 2008 Regulation.
\textsuperscript{981} This definition is found in Rule 405 defining the terms used in Securities Act Rules 400 through 494 or terms used in Securities Act registration form.
\textsuperscript{983} ibid, although it is a rebuttable presumption.
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This confusion results from the absence of a ‘bright line’ test, such as is present in the German and Greek legislation. Its absence may grant the USA administration valuable flexibility in reviewing FDI, but, at the same time, it increases the uncertainty for the overwhelming majority of investors and their consulting law firms. It is indicative that upon the proposal of the regulations in the USA in April 2008, a number of commentators complained that the standard was too ‘nebulous’ and advocated the adoption of a ‘bright line control test’ based on a particular amount of stock ownership and/or the composition of the board of directors. The CFIUS replied that, given the national security purposes of section 721, it would be inappropriate to adopt such a bright line test, as it would make it ‘too easy to circumvent the statute’. To this argument, one may reply that the definition of control in the USA regulation not only applies an unjustifiably low threshold, but also makes it impossible for future investors to predict their position vis-à-vis the legislation. In these circumstances, a bright line test, even one substantially higher than the ones found in the German and Greek legislation, would have been preferable.

In France, under the 2005 Decree, approval by the authorities was required only in cases of an attempt to purchase a controlling interest, thus generally targeting transactions of 40% or majority stakes. This is more in line with the general definition of ‘control’ found in French law, which usually requires voting rights above 40%. This approach had advantages in that it provided for a high percentage triggering the review and at the same time preserves some valuable flexibility for the authorities responsible for carrying out the review. However, the 2012 Decree established a threshold test under which the acquisition of more than 33.33% of the stock or voting rights of a company having its registered office in France requires the approval of the authorities.

984 As stated in the Department of Treasury’s Regulations, USA Treasury, ‘Regulations Pertaining to Mergers’ (n 964) 70704.
985 Feng (n 443) 186.
986 ibid.
987 Hardly any security risk can arise from the ownership of 10-25% of shares in a company.
988 Article L. 233-3 of the French Commercial Code, See n 848 for the definition.
989 And where no other shareholder directly or indirectly holds a fraction larger than its own.
990 Article R. 151-3.
The point about certainty in the legislation reveals a wider observable deficiency in the aforementioned national laws, namely, the general vagueness of terms used and the absence of strict definitions. In particular, the meaning of ‘national security’ in the USA, French and German legislation as a basis for review remains unclear. The position in the German law is somewhat clearer as it is specified that public order, or security, shall be considered in danger only if a real and sufficiently severe danger can be identified which affects a fundamental interest of society. However, the extremely wide range of application of the German law renders it impossible to predict what may be covered by this definition, let alone provide for comprehensive examples in the legislation. Similarly, the Greek law fails to clarify the meaning of ‘public benefit’ as the standard underlying the criteria for approval, despite the small number of potential industries and companies covered by it. It, thus, appears from the pieces of legislation examined, that authority rests upon executive departments and offices to determine on a case-by-case basis whether a transaction poses a threat to national security or the public benefit. The risk resulting from these uncertainties is that foreign investors will seek opportunities in other markets with less ambiguous regulatory standards.

In addition, all the laws considered are making specific reference to third countries when stating that the origin and ownership of the investment entity is an important factor in the assessment of the transaction. Third country investors are not only targeted as potentially dangerous investors, but are also placed at a disadvantage when competing with domestic companies for mergers and acquisitions. It has been argued, for example, by Cox, that the possibility of review is advantageous to the domestic USA companies when they compete against foreign ones in takeover bids: not only must foreign companies consider the possible time delay of up to 90 days, but must also factor in the cost that the

991 para 7(2) No 6 AWG.
992 Which can apply to any company operating in any industry.
993 Feng (n 443) 504.
994 Such as Section 7(2) No 6 AWG.
transaction might be disallowed.\textsuperscript{995} As a result, the control comes at the expense of the competitiveness of FDI,\textsuperscript{996} and might lead to informal boycotting of specific countries and lead to a similar backlash in those countries against the USA.\textsuperscript{997}

In addition, it is highly likely that legislators will fail in their objectives to protect domestic economies from security and other risks. Taking USA law again as an example, it is argued by Pistor that with China holding 20\% of the USA budget deficit, ‘the notion that CFIUS could control foreign influence on [USA] soil by scrutinising individual investment projects is somewhat curious’.\textsuperscript{998} Furthermore, it is stated correctly that many of the anticipated investments may well be below the control threshold stipulated by the CFIUS regulations anyway; even those that are within the scope of ‘control’ may avoid oversight as the immediate investors will be USA-based financial intermediaries rather than foreign SWFs.\textsuperscript{999} A similar criticism would certainly apply equally to the German and Greek measures.\textsuperscript{1000}

The above analysis, makes clear that the regulatory instruments are overly protectionist and suffer from major deficiencies. Nevertheless, some present fewer problems than others. The German response, in particular, is lighter than the French and Greek, as it does not contain a pre-approval system. German officials themselves have compared the new legislation to a minimalist version of the CFIUS,\textsuperscript{1001} although they have made clear that their proposal is still much less strict than other SWF regulatory systems.\textsuperscript{1002}

\textsuperscript{996} ibid, also argued by Feng (n 443) Pt VI.B.
\textsuperscript{997} Cox (n 995).
\textsuperscript{998} Pistor (n 429) 291.
\textsuperscript{999} ibid 299.
\textsuperscript{1000} France provides specific criteria for identifying foreign-controlled French investors and generally places them in the same category as foreign investors, see Article L. 233-3 of the French Commercial Code.
Nevertheless, some commentators within Germany quickly expressed their disapproval. The General Secretary of Germany’s International Chamber of Commerce (ICC), Pohlenz said that the plan to regulate foreign investors could lead to lower FDI in Germany and trigger limits on German investment in other parts of the world. The chief of the Federation of German Industry, Schnappauf said that Berlin’s new laws sent ‘the wrong signal’ for Germany as a place for investment. In his view, Germany, as the world’s leading export nation and a key provider of foreign investment, ‘is heavily dependent on open markets’, and foreign investment underpinned more than two million jobs in Europe’s largest economy. However, it has been said that the law is unlikely to affect Germany’s top position in the world on market openness: German officials have reassured that the law will only be used in ‘extremely rare’ circumstances and that ‘the majority of foreign investments will not be affected’. The impact of FDI laws is determined by how they are applied, rather than their strict letter.

**ii. Compatibility with EU law**

Naturally, as EU Member States, France, Germany and Greece, must comply with EU law on free movement of capital as interpreted by the CJEU.

France and Greece have failed to pass the scrutiny of the Commission. The French government did not challenge the Commission’s decision and decided to embark upon an amendment of the law. It can be assumed that the second Decree was made largely in cooperation with the Commission, although a final response is still pending.

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1004 n 862; and Kalinova, Palerm and Thomsen, (n 862) table 1.
1005 Euractiv staff, ‘Germany Unveils Law’ *Euractiv* (Brussels, 21 August 2008) <www.euractiv.com/financial-services/germany-unveils-law-block-foreign-takeovers/article-174818> accessed 28 December 2012; However, the meaning of ‘majority of foreign investments’ can only be ascertained by the application of the measure over a long period of time.
1006 See the discussion above n 739 onwards.
1007 See above for France, n 861 and Greece, n 922.
Since Greece took no action to comply with the Commission’s decision, the matter was referred to the CJEU. The Court ruled that the restriction in the Greek law was intended to apply only those shareholders who are able to exert a definite influence over the management and control of such a company and, thus, restricted only the freedom of establishment and not the free movement of capital.\(^{1008}\) Moreover, the Court ruled the scope of its application to be too discretionary (which is difficult for the courts to control)\(^{1009}\) and it does not address specific threats to the country's national strategic interests.\(^{1010}\) This need not concern the Greek government unduly as it was recognised by Greece's former Finance Minister, Alogoskoufis, that the law was an *ad hoc* measure designed to apply exclusively to the case of OTE.\(^{1011}\) The Greek measure therefore differs considerably from the French and German ones which were of general application.

It is interesting to note that, following the adoption of this measure, MIG withdrew its participation in OTE and sold its 19.5% stake to Deutsche Telekom (DT) which became the largest shareholder of the formerly public telecommunications operator.\(^{1012}\) MIG’s withdrawal is invoked by the Commission to argue that the law had the effect of driving away FDI.\(^{1013}\) However, it should also have been recognised by the Commission that the measure was never formally applied to review MIG’s investment, as the latter’s interest in OTE never exceeded the 20% benchmark. Also, the law was applied successfully on the investment of DT. As such, there is no concrete proof that the law unduly restricts foreign investors. This alone may not suffice to render the Greek law compatible with the Treaty rules on free movement of capital, but it should have carried weight in the Court’s review of the law’s compatibility with

\(^{1008}\) *Commission v Hellenic Republic* (n 923) para 23.

\(^{1009}\) Ibid, para 75.

\(^{1010}\) Ibid, para 78.

\(^{1011}\) Statement by George Alogoskoufis, former Finance Minister of Greece (personal communication 24 January 2009); As seen above (n 919), the intention of the Greek government was to protect OTE from MIG, a private equity firm controlled by a Dubai state-owned fund.


\(^{1013}\) n 922.
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EU law.

Germany passed the Commission’s scrutiny without any requirement for amendments. This fact distinguishes the German case from those of France and Greece. It proved crucial that the German government had constructed its legislation in cooperation with the Commission and thus ensured its compliance with EU law from an early stage.

Nevertheless, the Federation of German Industry has insisted that the German law would be in breach of EU legislation on the free movement of capital, unless there is further explanation.1014 Schweitzer has argued that the approach chosen by the German legislator does not comply with the EU law requirements of predictability and legal certainty, since it does not specify the ‘kind of threat that could lead to a prohibition’ and, as such, confers too much discretion to the Minister for the Economy.1015

In addition to the above difficulties, it needs to be explained why France’s inclusion of ‘casinos’ in its 2005 Decree is described as ‘unsatisfactory’ by the Commission, while the German review procedure can freely apply in the entire spectrum of the economy. It also remains debatable to what extent countries should be able to target third countries or cite the public ownership of the investment entity as grounds for review. As stated above,1016 free movement of capital rules apply to third countries as much as to investments from other EU Member States.

It is, however, possible that a measure targeting third country investors can make reference to their ownership status (‘state-owned’) as a ground for review without falling foul of the Treaty provisions on ownership. Article 345 TFEU (previously 295 EC) establishes the principle of neutrality vis-à-vis private or public ownership. Although a national foreign investment law that discriminates against public investors from other EU countries would violate the rules on free movement of capital, this principle cannot be transferred to non-EU investors as well, since the ownership of a foreign investor might be relevant in assessing

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1014 Euractiv staff, ‘Germany unveils law’ (n 1005).
1015 Schweitzer (n 597) 279.
1016 n 41.
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their objectives.1017

Overall, it can be argued that the national measures examined above present too many difficulties, and too often the governments adopting such measures are influenced by perverse incentives, such as popular pressure to fend off so-called foreign economic predators. As a result, the measures adopted may hinder economic efficiency and the efficient allocation of capital. While it is true that investment screening mechanisms may act as a buffer against calls for even more stringent laws, when these are out of proportion and do not take into account the real nature of SWFs, they are bound to do more harm than good. Against this background, it is shown in the next chapter that, although not without difficulties itself, a supranational response is more desirable.

Table 5.1

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<th>Regulatory models</th>
<th>India</th>
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This table represents a simplified classification of the investment review mechanisms implemented in various countries.

1017 Schweitzer (n 597) 286.
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Note that the pre-administrative approval system in France and Greece can be equated to the system of investment caps applied in India. It is also noteworthy that the incentive-type scheme, examined in chapter 4, has not been followed by any of the countries examined.

CONCLUSION

This chapter analysed four national regulatory instruments, those of France, Germany, Greece and the USA, that deal with the national security implications of SWF investments. The first three jurisdictions are also EU Member States. The EU rules on free movement of capital form the basis for examining the legality of those instruments from an EU point of view. As seen above, the CJEU has interpreted the exceptions to the free movement of capital for public security reasons in a very narrow way, thus making it difficult for Member States to apply investment screening laws on the investments of SWFs.

Of the measures examined in this chapter that were adopted by EU Member States, two, France and Greece, have provided for pre-approval of certain investments and one, Germany, applies an ex post security review. It is indicative that the Greek measure was adopted following the rapid purchase of shares by a private equity firm of the country's public telecommunications organisation, while in France and Germany the measure was adopted in response to the wider phenomenon of SWFs and was construed to be of general application. France, despite legislating to restrict SWFs, has responded by also creating a national SWF itself.

The European Commission has expressed its opposition to the French and Greek measures and although Greece has defended its measure before the European Court, France has agreed to amend its law. No disagreement has arisen between the Commission and Germany over the legality of the German law,
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although there has been strong opposition from Germany against the abolition of the German law defending VW from foreign ownership.

Looking outside the EU, the USA is not bound by any supranational regulations with regard to FDI, other than international laws in the context of the WTO and the OECD. Although a security review system existed before, its provisions were tightened following the attempted takeover of USA ports by a large Dubai firm. The USA system does not contain a pre-approval mechanism but provides, instead, for an ex post review by a specialised body, the CFIUS.

Analysing those measures from the viewpoint of lessons learned from the previous chapters, they all appear excessively protectionist. In particular, those measures impose particularly tough regulatory standards on global investors and do not take into account the reality of SWF investment behaviour. As such, they deter investment and threaten to reduce the beneficial impact of the global allocation of capital. It can be assumed, therefore, that countries implementing security reviews are often unduly influenced by misinformed public perceptions about so-called foreign predators. It may therefore be valuable to examine the possibility of establishing a supranational regulatory framework to deal with SWFs. This is the topic of the next chapter.
CHAPTER SIX

Supranational Regulatory Models

INTRODUCTION

The previous chapter dealt with the effects of adopting unilateral measures to address the concerns caused by the operation of SWFs. It was seen that the impact of those measures can deter FDI coming from SWFs, and thus affect the efficient allocation of capital and harm host economies. In this chapter, supranational regulatory frameworks are examined. These are typically produced by international or transnational institutions in the form of Codes of Conduct (CoCs), and in some cases with the cooperation of SWFs as well. This chapter argues, that, although not without problems themselves, such efforts present fewer downsides than their national regulatory alternatives, especially when they are of voluntary nature.

The chapter begins with an outline of the distinction between national and supranational responses to SWFs. It then continues into an analysis of the CoC model. Specific supranational instruments are then examined and assessed, namely those produced by the OECD, the IMF and the EU. An analysis is also offered of various reactions to those CoCs as well as of the benefits and drawbacks of those instruments, accompanied by a number of proposals to improve their effect. To this end, the chapter discusses the recent experience of the implementation and the relative success of the UK Corporate Governance Code. Finally, the chapter explores the relation between the regulation of SWFs and the current regulatory structure for hedge funds in the EU.
1. National vs Supranational

The analysis of national legislation in the previous chapter begs the question of whether a response taken at the supranational level would be preferable. Such an initiative is usually led by a supranational institution and it may involve various interested governments and SWFs. Supranational responses present important differences when compared to national ones. Firstly, supranational bodies are perhaps more immune to short-term political considerations such as a possible momentary suspicion towards foreign investments. As a result, measures adopted by such an entity can offer greater objectivity, focus on longer-term benefits and resist frequent changes in the law. A supranational response can thus produce a more stable regulatory regime, offer foreign investors greater assurances and create a more welcoming investment climate.

Secondly, the objectivity of a supranational effort, removed from national political considerations, could also appeal more easily to SWFs and include them in the rule making process, thus equating this process to that of self-regulation. The participation of SWFs does not only provide the regulator with a greater degree of expertise but, more importantly, increases the chances that the rules will be more easily accepted by those targeted by the regulation.

Thirdly, supranational responses are harmonised. The heterogeneity of various national investment review standards could impose undue costs of compliance on SWFs and hence affect the efficient flow of capital. Moreover,

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1018 Whether it is the European Commission, the OECD or a body established under the United Nations.
1019 Such calls are sometimes reflected in the unjustified negative press that foreign investors receive or in the negative speech held many political actors (see n 421 for more). It is often the case that such general attitudes inform the policy decisions of national governments, as in the case of the USA.
1021 As the ones examined throughout the previous chapter.
1022 Mattoo and Subramanian (n 680) 16.
monitoring the compliance of supervised entities at the supranational level can also benefit from economies of scale and can be cost-effective.

Fourthly, national responses can offer greater flexibility than supranational ones. A government may wish, for example, to adopt a more restrictive regime towards specific countries as retribution against the limited access to their markets. Indeed, although developed countries in Europe and North America maintain a high level of market openness to all foreign investors, the same does not hold always true in the opposite direction. This lack of reciprocity may lead western governments to opt for national measures to limit the level of market openness to those countries; France’s former President expressed this concerns related to SWFs.

Lack of reciprocity, however, does not constitute a sound basis for the adoption of national measures. Protectionist laws can have adverse effect on a country’s national economy, whilst simultaneously running the risk of causing further protectionist backlashes abroad. Nevertheless, the EU Commission has also expressed at times the willingness to counteract protectionism against EU firms in foreign markets, thus demonstrating that is it not entirely impervious to the problem. In 2012 it proposed a regulation levelling the playing field for European businesses in international procurement markets, using an instrument to target countries that discriminate against EU businesses in the market for public procurements. Under the proposal, the Commission may use mechanisms that restrict foreign access to the EU market, in the event of repeated and serious discrimination against European suppliers.

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1025 For a more detailed discussion about the effects of protectionism see chapter 4 ‘The avoidance of investment protectionism’, and about protectionism towards SWFs in particular see n 363.

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in non-EU countries. Such action would be taken only if the non-EU country does not engage in negotiations to address market access imbalances. The wording of the proposal ensures that these powers would be used only in extreme cases, thus avoiding serious negative effects to the economic interests of EU Member States. As far as the case of SWFs is concerned, similar action can also be taken with regard to transnational direct investments under Article 64(3) TFEU.1027 This way, if needed, the Commission can address the concerns of many Member States about lack of investment reciprocity. At the same time, this possibility constitutes a defence against pleas to counteract lack of reciprocity with national measures and proves that supranational responses can also be flexible.

It was mentioned in chapter 41028 that the adoption of binding supranational rules for SWFs would necessarily involve the WTO. This way, the WTO’s Dispute Settlement Body could be used to issue binding rulings on members that violate the agreed rules.1029 Nevertheless, it was argued that regulatory action through the WTO (or the EU for that matter) would face considerable difficulties. It was explained, in particular, that any attempt to establish a security review of investments in various industries at the international level would be hampered by the difficulty of establishing a common definition for SWFs and a list for sectors under review but also by the inability of a supervisory body to enforce the agreed rules.1030 Given these difficulties, the position taken in this thesis is that hard regulation, such as investment screening and security review mechanisms, should not be adopted at the supranational level. Different options, such as the adoption of a CoC can prevent most of the abovementioned implementation problems and the ensuing economic inefficiencies that they can cause. This option is analysed in greater detail below.

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1027 The Council, acting in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament, adopt measures which constitute a step backwards in Union law as regards the liberalisation of the movement of capital to or from third countries’.
1028 n 680.
1030 Enforcement would be difficult because SWFs would attempt to escape their governance structure to evade the definition of SWFs and thus escape the rules altogether. For more see, chapter 4, at 178.
2. Codes of Conduct as a Regulatory Option

A CoC is defined by the International Federation of Accountants as a set of:

‘principles, values, standards, or rules of behavior that guide the decisions, procedures and systems of an organization in a way that (a) contributes to the welfare of its key stakeholders, and (b) respects the rights of all constituents affected by its operations’.1031

Compliance with the principles of the CoC is usually voluntary and, thus, it can be described as a ‘soft law’ instrument.

Intervention in the form of a CoC may not always be necessary. According to the ‘Coase Theorem’, when trade of externalities is possible, there are no transaction costs and all parties are free to bargain, then the market is always able to efficiently accommodate possible imperfections in the most efficient way, leading to an efficient outcome and market allocation, regardless of the initial allocation of property rights and without any regulatory intervention.1032 In this context, the legal system’s role should be limited to assigning and protecting property rights and letting the market work toward efficient solutions.1033

Under this theory, the concerns surrounding SWFs,1034 on the one hand, and the protectionist backlash in recipient countries on the other, may be freely arranged through the negotiations of the parties in question. While SWFs may, for instance, commit to more transparency and to commercially driven

1033 ibid, see in particular 19–28, ‘The legal Delimitation of Rights and the Economic Problem’; In the current case, saying that the law should ‘protect property rights’ should not be understood as protecting property rights of public companies against foreign purchasers. Instead, it refers to the protection of the rights of all interested parties: the state, national private individuals as well as those of foreign investors who buy shares in western companies.
1034 Namely, the concerns and suspicions with regard to their investment motives and to the stability of the financial system.
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investments, recipient countries may commit to equal treatment to all foreign investors and open markets. Similar commitments could also be made by countries managing SWFs.1035

However, market forces alone may not suffice for the creation of a platform of decision-making between SWFs and host governments or, in the parlance of the Coase Theorem: the real world does involve significant transaction costs.1036 This is why market forces need to be complemented by government action in the form of bringing together SWFs and host countries and of establishing an agenda for discussion. Although action may be initiated by an individual government, the role played in this context by the OECD, the IMF and EU has been critical (see below, n 1066 onwards). The input of these institutional or intergovernmental authorities, however, does not necessarily alter the character of the rule-making process, which can, in essence, be a negotiation among interested actors. Notably in the case of the IMF CoC, this rule-making process is equated to that of self-regulation.

CoCs, as policy tools, are usually entered into on a voluntary basis, meaning that the negotiating members were not compelled to participate by a central decision maker. Rather, a central body provided its members with an opportunity to negotiate and agree on a set of rules. This method of setting international standards is common given that the drafting of command-based tools is, in most cases, unrealistic beyond the national level.1037 Such command-based tools were the topic of discussion in chapters 4 and 5 where they were rejected as either unworkable (some of the theoretical proposals in chapter 4) or inefficient (the regulatory responses in chapter 5). A mixed policy choice would be to maintain the voluntary character of the CoC, but render it binding only towards those SWFs that do not demonstrate any willingness to gradually adopt them voluntarily. This is the model that Bassan suggests should apply to the

1035 Mezzacapo (n 422) 41.
1036 Such as the interest of SWFs in remaining secretive and the lack of weight of a single country to initiate a discussion on transparency.
1037 Morgan and Yeung argue that the absence of democratic rule-making institutions that can legitimately establish and enforce legally binding commands across and within nation states constitutes the main hurdle in utilising command-based techniques at the supranational level. The difficulties of promulgating binding legal standards are a characteristic example, Morgan and Yeung (n 1020) 313.
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IMF’s CoC, GAPP. GAPP, which is analysed further below, is a CoC produced by the IMF in collaboration with some of the world’s largest SWFs. This document is, to date, arguably the most comprehensive instrument to deal with SWFs. The approach suggested by Bassan, however, would risk jeopardising the entire effect of GAPP. As explained above with the case of the WTO, entrusting an institution to establish and enforce binding rules for SWFs would be ineffective due to the fact that a number of sovereign entities do not accept the label of a SWF. Those SWFs would, incidentally, also be the ones targeted by Bassan’s proposal. Furthermore, countries that manage SWFs would always retain the freedom to modify the structure and arrangement of state entities at any point in time in order to escape the definition of SWFs and consequently the regulatory regime altogether. In some cases, state-owned enterprises, or even the ruler’s private wealth, could be used to carry out the same activities SWFs perform today. In addition to the above, Bassan’s proposal would also encourage discrimination against specific SWFs based on one-sided subjective grounds. It is equally important to emphasise the negative consequences of such an endeavour for global investment, especially in a post-crisis recovery context. In short, endeavours such as GAPP can only have broad acceptance if they remain voluntary. Enforceable instruments can only come from unilateral actions such as the national laws examined in chapter 5. Although, in the aftermath of the GFC, the trend has been to move away from self-regulation and towards command and control-type regulation, the particular nature of the regulation of SWFs (as explained in the present and previous chapter), make self-regulation a necessary option.

The voluntary character of a CoC, however, does not suffice to prevent all potential obstacles to the accomplishment of the code, especially when made at the supranational context. Disagreements of a political nature can still erupt in particular for those with no legal personality nor governance rules and not accountable to any controlling body, that aim to control participated companies, Bassan (n 615) 52-53.

\[1038\] n 1078.

\[1039\] n 1078.

\[1040\] n 706.

\[1041\] n 44, 45.

\[1042\] Cross reference, chapter 2, n 363.

\[1043\] See, for instance, at chapter 6 ‘SWFs and the Regulation of Hedge Funds’. 
between members. It is argued by Morgan and Yeung that the avoidance of conflict among participants at the level of standard-setting can be achieved by narrowing down the focus of activity to a highly specific level. This technique is often applied in many CoCs and it was also followed in the instruments by the OECD and the IMF addressed specifically to SWFs (see below). It is also argued that standard-setting can be better achieved where the activity in question is performed by a ‘community of shared fate’. Such is one where the failure of one participant may have catastrophic effects on the entire community and thereby threaten the well-being of each individual participant. In those cases it is normal to observe the emergence of consensual mechanisms of regulating against the potential harms from the targeted activity. As stated by Morgan and Yeung, this degree of interdependence between supranational participants characterises international financial markets. Despite the apparent polymorphy of SWFs, it is not difficult to envisage them as a ‘community of shared fate’. Their portrayal in the press as well as the national debates shaping the relevant regulation is such that lack of transparency in only a fraction of them can cause reputational damage to all of them. In the event of wrongdoing by a SWF this interdependence is even more obvious, since the actions of a single SWF, depending on the seriousness of those actions, can incur significant backlash against all SWFs investing in foreign markets.

The content of the CoC is an equally important issue. The creation of a CoC for SWFs cannot be isolated from the wider debate about the regulation of the financial sector that dominated public discourse over the last few years. Even before the issuance of the IMF principles and the EU Commission’s guidelines for SWFs, another CoC on the subject of transparency was published in 2007 on request by the British Venture Capital Association. The Guidelines for Disclosure

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1044 Morgan and Yeung (n 1020) 316.
1045 ibid.
1046 ibid.
1047 ibid.
1048 See discussion in chapter 3, n 474.
1049 As were the scenarios described in chapter 3, e.g., stealing critical national information, damaging employment or affecting financial stability in host economies.
1050 One example relates to the debates caused by the commercial strategies of DPW in the USA and the advances of Gazprom in Europe, described in chapter 2, n 201.
and Transparency in Private Equity, advocated enhanced reporting requirements for UK portfolio companies and private equity firms. The Guidelines include SWFs in the ambit of their recommendations of transparency, on the basis that they are sufficiently ‘private equity-like’. Subsequently five common principles for financial reform were agreed by the G20 countries as part of their global response to the GFC: These were: (i) strengthening transparency and accountability, (ii) enhancing sound regulation, (iii) promoting integrity in financial markets, (iv) reinforcing international cooperation, and (v) reforming international financial institutions.

It was in this wider context that the G7 finance ministers in 2008 suggested that the IMF, the World Bank, and the OECD draft a set of principles that sovereign investors could use in managing their SWFs. Specifically, a draft memorandum of the G7 ministers tasked the IMF, World Bank and OECD with the creation of best practices ‘in such areas as institutional structure, risk management, transparency and accountability’. Although the CoC on SWFs preceded the conclusions of the G20 summit, both can be seen as part of the wider international efforts to establish sound principles in the financial sphere.

The principles deemed necessary to govern the wider financial sector post-crisis, namely: risk management, transparency and accountability, became also the subject of the CoCs that applied to SWFs. This realisation becomes more interesting considering that SWFs were not perceived as a cause of the GFC. This concurrence, therefore, must be due to different reasons: firstly, transparency, accountability and risk management were deemed to be

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1053 See n 532.

1054 For more see, n 410.


1056 G7 countries are Canada, France, Germany, Italy, the USA, Japan and the UK.


1058 After the advent of the crisis, SWFs were not even seen as a threat to the wider financial sector any more, but rather, as a stabilising force, see chapter 2, n 407.
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universally accepted principles. Secondly, it was possibly believed that if SWFs remained opaque, in the future they could become a threat to the global financial system.\textsuperscript{1059}

A final consideration begs the question of why limit the CoC to SWFs and not extend it to other entities, such as hedge funds or institutional investors.\textsuperscript{1060} It has been claimed that any regulation applying to SWFs could benefit their immediate competitors, namely hedge funds.\textsuperscript{1061} A reply to this observation might be that although SWFs are not a uniform block themselves\textsuperscript{1062} the main concerns that arise from SWFs do not apply to other investment vehicles. These concerns mainly arise from their status as public entities and their unusually large size, which understandably may necessitate a more focused approach to SWFs.

Nevertheless, some form of regulation already exists for most investment entities other than SWFs. Institutional investors in particular, such as pension funds and insurance companies, are subjected to a strictly regulated regime\textsuperscript{1063} and thus raise fewer issues of transparency. Hedge funds, on the other hand, until recently remained largely unregulated and obscure from the point of view of regulators. This omission is largely remedied today: a more stringent regulatory regime is also applied to hedge funds and other alternative

\textsuperscript{1059} As it was seen by the discussion at chapter 3, on the potential negative effects of SWFs.
\textsuperscript{1060} See chapter 2 ‘SWFs vs. Hedge Funds’, the comparison between SWFs and hedge funds and institutional investors.
The KIA argued that ‘such regulation would also be unfair unless also applied to hedge funds, private equity, pension funds and other pools of capital’,
\textsuperscript{1062} See chapter 1 ‘Broad and narrow definitions’ for an analysis of the similarities and differences between the various SWFs.
\textsuperscript{1063} See for instance, in the USA context, the Employee Retirement Income Security Act of 1974 (Pub. L. No. 93-406, codified in part at 29 USCS § 1002 \textit{et seq.}) applying to pension funds; the Investment Advisers Act of 1940 (15 U.S.C. § 80b-6) for institutional advisors;
See also,
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investment funds in the EU and the USA.\textsuperscript{1064} Given the close relationship between SWFs and hedge funds,\textsuperscript{1065} it can be argued that the more transparent hedge funds become, the less able SWFs are to rely on the opacity of hedge funds in order to avoid regulation themselves. In other words, SWFs will increase their reporting only to the extent that their competitors, notably hedge funds, do so as well.\textsuperscript{1066}

The policies of the IMF/OECD and of the Commission applying to SWFs are next examined in turn.

\textit{i. OECD/IMF}

The effort to establish an international regulatory framework for SWFs was primarily led by the OECD, which opened the way for the IMF to elaborate on the issue even further. Before the adoption of the IMF CoC, the OECD had issued its Guidelines on the Corporate Governance of state-owned Enterprises in 2005.\textsuperscript{1067} These Guidelines intended to offer advice to governments on how to manage effectively companies that were under their ownership. They included advice on transparency and disclosure,\textsuperscript{1068} and on the state’s appropriate ownership policy (with regard to efficiency, accountability and professionalism).\textsuperscript{1069}

What followed was a number of policy initiatives from OECD, this time specifically focused on SWFs. The first came in October 2007 in the form of an investment newsletter contemplating the possibility of international rules applying to SWFs.\textsuperscript{1070} The OECD Investment Committee followed by publishing a

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\textsuperscript{1064} See below, n 1235, 1244.

\textsuperscript{1065} See n 160, 1061.

It was also stated in an interview by Echarri, Secretary-General of the European Private Equity and Venture Capital Association, that disclosure regulation for private equity will benefit their direct competitors who are often backed by SWFs, Euractiv staff, 'Private Equity: EU Proposals Set to Favour Sovereign Funds' Euractiv (Brussels, 6 July 2009) <www.euractiv.com/financial-services/private-equity-eu-proposals-set-favour-sovereign-funds/article-183742> accessed 27 December 2012.

\textsuperscript{1066} See argument at 291-292.


\textsuperscript{1068} ibid 16 and 41–46.

\textsuperscript{1069} ibid 13 and 23–31.

\textsuperscript{1070} OECD, 'Are New Rules Needed?' (n 55).
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report to the G7 countries on SWFs and recipient country policies.\(^{1071}\) This document highlighted the beneficial impact of SWFs on the global economy and recognised the legitimacy of national security concerns although it stated that these cannot be a cover for protectionist policies.\(^{1072}\) The OECD suggested that security-related investment safeguards should be made as open as possible\(^ {1073}\) and that investors and home countries can ease concerns through greater transparency.\(^ {1074}\)

The OECD policy initiatives continued with a declaration on SWFs and Recipient Country Policies in 2008,\(^ {1075}\) and with a publication the same year, collecting the main OECD policy instruments that apply to SWFs and recipient countries.\(^ {1076}\) These two policy documents largely reinstated the conclusions of the April Report to the G7 countries.\(^ {1077}\)

Arguably, the most important step in the process of the supranational regulation of SWFs came in October 2008, when the IWG of SWFs published the GAPP, also known as the Santiago Principles.\(^ {1078}\) This was the result of a long process of reflection led by the IMF and the G7 over the impact of SWFs on financial stability and the potentially political character of their investments.\(^ {1079}\)


\(^{1072}\) Ibid 2-4.

\(^{1073}\) Ibid 4, without however explaining this point in great detail.

\(^{1074}\) Ibid 6.


\(^{1077}\) Although the October publication included older OECD instruments on international investments that were also of relevance to SWFs.

\(^{1078}\) IWG, ‘GAPP’ (n 691).

\(^{1079}\) As Norton says, issues to be considered in the 'Work Agenda' included the relation of SWFs (i) to financial stability and currency exchange rate impact, (ii) to possible geo-political issues, such as the likelihood of government policy direction of these funds and a rise of protectionism among home or target countries and (iii) to risk management issues, including matters of transparency, accountability and governance,
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The purpose of GAPP was to promote those accepted principles and practices that establish appropriate governance and accountability standards regarding the investment practices of SWF. A distinctive feature of GAPP, as opposed to the policy tools of the OECD and the EU Commission (see below), is that they were drafted with the participation of some of the world’s largest SWFs, thus amounting to a self-regulating initiative.

GAPP consist of 24 practices and principles in three key areas to be implemented by SWFs: (i) legal framework, objectives, and coordination with macroeconomic policies; (ii) institutional framework and governance structure; (iii) investment and risk management framework where SWF managers were encouraged to disclose more information. GAPP left it to each individual SWF to assess their implementation, and disclose their assessment to the public.

The object of SWFs should not be to project state power. Instead, according to Principle 19 it is to ‘maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds’. If investment decisions do not comply with this goal, then the goal of the fund’s investment policy ought to be disclosed. It is suggested by Backer that such deviation from the suggested model might open that fund to special regulation. SWF management ‘should be consistent with what is generally accepted as sound asset management principles’ (Principle 19(2)).

GAPP reaffirmed the distinction between private and public funds. While the objective of the private funds lie in the maximisation of their owners wealth, public ones may have a wider array of objectives, namely, macroeconomic ones. This view of GAPP suggests, however, that the attainment of macroeconomic objectives is limited to economic ones and does not extend to political goals. Moreover, a number of principles encouraged the separation between the entity and the sovereign. This is supported through the establishment of clear objectives for the fund, the division of roles and responsibilities, and provisions


By ‘political goals’ it is meant to aim to increase one country’s strength in the political sphere, at the cost of other countries. This is distinguished from purely macroeconomic objectives that are limited to the economic sphere, such as boosting a country’s employment, supporting pension obligations etc.
on independence and the maximisation of risk-adjusted financial returns.\textsuperscript{1082} This may be accomplished at a functional level,\textsuperscript{1083} for example, through a legal specification of roles and responsibilities.

The main aim of GAPP is, therefore, to make the sovereign entity act like a private one. The fund, for example, should not use special information it has because of its connection to the government when competing with other private firms.\textsuperscript{1084} Furthermore, it should exercise its ownership rights in a manner that is consistent with the objectives and investment policy of the fund and protects the financial value of its investment.\textsuperscript{1085} This policy goal is understandable. As it was seen in the first chapter, the novelty of the SWF phenomenon consists in the exercise by the sovereign of a public activity\textsuperscript{1086} in a manner traditionally used by private actors.\textsuperscript{1087} To the extent that SWFs behave like private actors themselves they may be viewed as a benign instrument and participate in global financial markets. This insistence on the ‘private actor’ is not unknown as it widely used in the EU law of state aids, where an action by the state is compared to that of a private actor under the similar circumstances to determine whether it is compatible with the common market.\textsuperscript{1088}

However, while directing SWFs to adopt the conduct of a private investor, GAPP does not require the funds to hire outside managers. Instead, it is the fund’s investment policy that ‘should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored’.\textsuperscript{1089} Similarly, GAPP do not require SWFs to adopt a particular structure, as long as they maintain a clear division of responsibilities for their

\textsuperscript{1082} See in particular Principles 1, 6, 8, 15, 19, 20 and 21.
\textsuperscript{1083} Backer, ‘Sovereign Investing in Times of Crisis’ (n 73) 127.
\textsuperscript{1084} Principle 20.
\textsuperscript{1085} Principle 21.
\textsuperscript{1086} Investing state proceeds to obtain returns with a view to supporting macroeconomic objectives.
\textsuperscript{1087} Through the participation in financial markets, profiting from dividends or the resale of shares at a profit. As pointed out by Backer, the state’s interference in this sector until recently was limited to its regulatory control, Backer, ‘Sovereign Investing in Times of Crisis’ (n 73) 131.
\textsuperscript{1088} The test aims to discover whether an undertaking has received a benefit which it would not have received in ‘the normal course of events in the private market’, Case C-256/97 DMT [1999] ECR I-3913, opinion of AG Jacobs at para 31.
\textsuperscript{1089} Sub-principle 18.
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members. This approach indicates a result-based concern\textsuperscript{1090} on the part of the code drafters, as opposed to a formalistic approach, in order to provide SWFs the flexibility to adopt the requirements of the code without compromising their traditional preferences for specific modes of governance.

In addition, GAPP requires that SWFs comply with regulatory accounting and auditing standards that apply in each country.\textsuperscript{1091} This requirement is provided in return for not subjecting them to additional disclosure requirements, such as their size or their positions. This requirement creates a positive upward pressure on the transparency level of SWFs and its implementation would be a welcome development. For example, the Monetary Authority of Singapore issued the updated Code of Corporate Governance\textsuperscript{1092} requiring publically listed companies to disclose in their annual reports how they are complying with the provisions of the code. The Singaporean code formalises the board's responsibilities for risk governance and internal controls,\textsuperscript{1093} but also establishes a higher standard of transparency in many areas of a fund's activity, such as board selection and appointment,\textsuperscript{1094} remuneration,\textsuperscript{1095} delegations of authority\textsuperscript{1096} and conflicts of interest.\textsuperscript{1097}

\textit{ii. Reactions to the IMF CoC}

The publication of GAPP has been the most decisive step so far in the establishment of global rules for SWFs. It would, therefore, be useful to examine the reactions to this development.

Firstly, although a number of funds took part in the preparation of this

\begin{flushright}
\textsuperscript{1090} Focusing on the behaviour of the fund.
\textsuperscript{1091} See principles 11 and 12.
\textsuperscript{1092} Monetary Authority of Singapore, 'Code of Corporate Governance' 2 May 2012
\textsuperscript{1093} Principle 11.
\textsuperscript{1094} Principle 4.
\textsuperscript{1095} Principle 9.
\textsuperscript{1096} Principle 1.
\textsuperscript{1097} Principles 2-4.
\end{flushright}
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CoC,\textsuperscript{1098} others remained skeptical of the effort to intervene in the operation of SWFs. One such example was the managing director of KIA, Al-Saad, who questioned the code’s contribution to market efficiency and claimed that ‘complete transparency would raise more questions than answers’.\textsuperscript{1099} Other funds from Russia, Saudi Arabia and Kuwait have described it as unnecessary since their investments are already strictly commercial in nature.\textsuperscript{1100} Officials from a Chinese fund have even described the entire effort as ‘stupid’.\textsuperscript{1101} Opposition was also observed from the governor of the Central Bank for the UAE who issued a statement on behalf of thirteen countries, which argued that the IMF did not have the requisite expertise to produce a set of best practices for SWFs.\textsuperscript{1102}

Despite the voluntary nature of the CoC, the reaction by SWFs and various state officials is indicative of the subtle force of such CoCs. For instance, the KIA’s claim that a CoC ‘will handcuff SWFs’,\textsuperscript{1103} (although unrealistic) demonstrates, to some degree, the pressure that the CoC exerts over sovereign investors’ governance and general behaviour. It is highly likely that this was, indeed, the purpose behind the Kuwait Declaration of 2009\textsuperscript{1104} establishing an international forum for SWFs, namely to create some kind of group/peer pressure on

\textsuperscript{1098} The countries that showed their support for the preparation of the code where as diverse as China, East Timor, Libya, Norway, Russia, the USA and the United Arab Emirates.


\textsuperscript{1101} Referring to a Chinese SWF,


\textsuperscript{1102} IMF, ‘Statement to the International Monetary Fund by His Excellency Sultan Al-Suwaidi, governor of the Central Bank of the United Arab Emirates’ International Monetary and Financial Committee, Seventeenth Meeting, 12 April 2008 \url{www.imf.org/External/spring/2008/imfc/statement/eng/uae.pdf} accessed 10 November 2012, 7;

The stance of a number of them on the matter changed, however, as the Emirati SWFs later supported the efforts of the IMF. Note also that Al-Saad on May 1 2008 stated that the KIA would probably agree to the IMF guidelines, Behrendt (n 257) endnote 24.

\textsuperscript{1103} AFX News staff (n 1061).

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governments to adopt the requirements of GAPP. Norton describes this process as 'club law'.

Various experts in the field explored the influence of the code on the autonomy of SWFs. Behrendt stated, for example, that by voluntarily submitting to GAPP, ‘IWG members ceded their autonomy to establish governance arrangements in line with their individual needs and preferences’. In a way, according to Behrendt, ‘they made a conscious decision to limit the reach of their “sovereignty”’. Backer, on the other hand, supports a different interpretation of GAPP. Backer looks at a particular provision requiring IWG members to maximize risk adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds. This provision could be understood as influencing the investment policies of the funds. In his view, however, this provision does not function as a restriction, but rather, ‘as a trigger for the application of transparency rules’. As he argues, GAPP ‘do not limit the use of SWFs for any purpose, from the application of political embargoes and national policy projected abroad’, as long as these policies are disclosed.

The objective of disclosure of investment policies is to curb in practice any motivation for politically driven behavior from sovereign investors. The effect of the disclosure, however, is contested by Rose who argues that that GAPP does not offer necessary assurances as it falls short of condemning non-commercial investments. This view, however, does not do justice to the spirit of the CoC which shows a clear preference for the private-type behaviour over the public one. It also neglects the practical effects of disclosing political objectives which would result in the marginalisation of a SWF from global markets. In short, requiring SWFs to disclose their policies as required by GAPP is equivalent to condemning non-commercial behavior. The requirement of disclosure is where

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1105 Norton (n 1079) 655.
1107 Ibid.
1108 Principle 19.
1109 Backer, ‘Sovereign Investing in Times of Crisis’ (n 74) 135.
1110 Ibid 132.
1111 Rose, ‘Sovereigns as Shareholders’ (n 474) 162.
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the said ‘club law’ or ‘peer pressure’ comes most vigorously into play.

Rose also discusses the issue of political accountability of the members of the IWG that produced GAPP. Accountability of SWFs, given the absence of formal fiduciary ties, is primarily political. Principle 10 requires that they create an accountability framework in the relevant legislation charter or management agreement. Yet, according to Rose, the fact that many SWFs are products of regimes that are not democratic begs the question of whether internal political accountability exists for the mismanagement of many SWFs. It is, moreover, noted that sovereign investing is not subject to other resolution mechanisms that exist for other types of economic disputes between sovereigns, such as tariff disputes. It is true that immediate compliance of all SWFs with the CoC should not be expected, especially on matters that concern internal accountability for SWF members. Rose, in this regard, proposes to establish dispute resolution mechanisms for sovereign investments too. However, any aggressive solution to address this deficiency such as the one proposed by Rose, could risk compromising the progress made so far: putting aside the fact that such an intervention would not be accepted by SWFs, it is also seen (below) that SWFs are not completely unresponsive to their commitments under GAPP albeit made voluntarily. If anything, it is preferable to allow a process of natural integration of GAPP in the governance of SWFs instead of attempting to set up a binding resolution mechanism.

iii. The European ‘Common Approach’ to SWFs

The European approach to SWFs (the Communication) was prepared in the same period as the IWG and it was influenced by the principles that shaped

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1112 See discussion at n 261 onwards.
1113 ‘Mismanagement’ in this sense is probably meant not only in economic terms but must also include the exploitation of a SWF for political aims, Rose (n 474).
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the general debate about the regulation of SWFs. The 2008 Communication put an end to a period of confusion as to the EU Commission’s position with regard to the phenomenon of the proliferation of SWFs. A number of contradicting statements made by various Commissioners before the publication of the Communication indicated a disagreement over the legality of national security measures aimed at SWFs.

Initially, in July 2007 former Trade Commissioner Mandelson, in the context of Barclays’ decision to seek funding from China to support its ABN Ambro takeover bid, warned against eyeing foreign state investments in major transactions as something inherently suspect and denied the characterisation of China Development Bank’s move as ‘political’. Mandelson, nevertheless, made qualified comments about a possible solution to have a European ‘golden share’ to vet foreign takeovers.

Soon after, however, it was acknowledged by the Former Enterprise and Industry Commissioner Verheugen that ‘the question that must be discussed is how can we defend our strategic interests without violating our most important principles of the free movement of capital in the internal market’. According to European Voice, Verheugen implicitly criticised Mandelson who had earlier suggested that golden shares might be a viable way of protecting key industries. He noted, however, that the EU was entitled to protect its interests under the WTO rules and that the USA was ‘using those instruments in a very broad way’.

Mandelson himself, referred back to the issue in November 2007 by stating that foreign state investments into European and USA assets of strategic

1116 The Commission’s Communication makes reference to the parallel development of rules for SWFs by the IMF and the OECD, ibid 6.
1119 ibid.
1121 Noting that the Commissioner in charge for such matters were those for Competition and the Internal Market, ibid.
1122 ibid.
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importance should be subject to transparency rules. However, he acknowledged
some difficulties in determining precisely which sectors needed protection.\textsuperscript{1123} He explained, ‘what we need is a set of principles agreed internationally – a sort
of code of conduct for investors and recipients of investment – that will establish
the ground rules for the global investment of sovereign wealth’.\textsuperscript{1124} He added
that, to this purpose, Europe and the USA had a common interest in working
together.\textsuperscript{1125} Mandelson’s words have been seen as a retreat from his defence of
the Chinese move to buy a stake in Barclays’ takeover bid for ABN Ambro a few
months earlier.\textsuperscript{1126}

The most explicit statements regarding this issue were arguably made by the
Former Commissioner for Internal Market and Services, McCreevy. He believed
investments which have the potential to compromise national security could be
blocked. As he stated, ‘it is often forgotten that a Member State is entitled to
restrict Treaty freedoms on the basis of legitimate national security
concerns’.\textsuperscript{1127} According to McCreevy, this was true in respect of all investments,
be they from SWF, state-controlled companies, private companies or whoever.
He added that a number of Member States have measures in place that restrict
investments, for example in the defence sector, and that not long ago the
Commission had proposed certain controls on investment in the energy
sector.\textsuperscript{1128} He concluded by suggesting that ‘we also require investors in our
financial institutions to be “fit and proper”’.\textsuperscript{1129}

\textsuperscript{1123} Juliane Reppert-Bismarck, ‘Mandelson Urges Rules on Foreign State Investments Into EU,
[USA]’ \textit{Mlex} (Brussels, 8 November 2007) (registration-based).
\textsuperscript{1124} Peter Mandelson, ‘EU-US: Confronting global challenges’ \textit{SPEECH/07/691} Washington, 8
November 2007.
\textsuperscript{1125} ibid.
\textsuperscript{1126} Reppert-Bismarck (n 1123).
\textsuperscript{1127} Charlie McCreevy, ‘Meeting of the ALDE (Alliance of Liberals and Democrats for Europe)
\textsuperscript{1128} ibid;
This is a reference to Directive 2009/72/EC concerning common rules for the internal market in
electricity (OJ L211/55), and Directive 2009/73/EC concerning common rules for the internal
market in natural gas (OJ L211/55) also widely known as the ‘Keep Gazprom out Directives’.
Under Articles 11 of both Directives, if a transmission system owner or operator, controlled by
a person or persons from a third country, requests a certification in one of the Member States, the
national authorities shall conduct a special control procedure in cooperation with the
Commission. They may refuse the certification if, among others, the certification puts at risk the
security of energy supply of the Member State.
\textsuperscript{1129} ibid.
Finally, in December 2007, the former Economic and Monetary Affairs Commissioner, Almunia, said foreign state-backed investment funds are a great opportunity although there is a need to increase transparency on their investments. He said that protectionism should be avoided, but that general suitable rules were needed for fund managers, for the owner countries and for countries where investment takes place. At the same time, he added that host countries must ‘define clear rules on whether to set exceptions to the general criteria of freedom of movement of capital’.

Therefore, whilst the Commissioners maintained their beliefs to market openness, their statements conversely encouraged the belief that SWFs posed specific risks to host countries. Similarly, while members of the Commission warned Member States against adopting protective measures, at the same time they recognised that those states could benefit from exceptions to the rules on free movement of capital. This inconsistency in the rhetoric of the EU Commission may have supported the view that EU law was incomplete and unable to deal with the effects of SWF and, thus, encouraged the adoption of measures at national level.

The Commission’s stance was made clearer in December 2007 when the President of the Commission, Jose Manuel Barroso, stated that there were ‘good reasons for an EU common approach on the issue of SWFs, both inside the EU and internationally’, however, he added, at this stage, ‘the Commission [did] not favour legislative action, but it [considered] that some ground rules or guidelines on governance and transparency could be useful’. This position, although recognising the need for fresh rules to oversee the growth of the SWF phenomenon, simultaneously left no doubt that the Commission considered the fundamental principles of the Treaties as sufficient to deal with the investments of SWFs.

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1131 ibid.
1132 ibid.
1133 Lewis Crofts, ‘No EU Legislation for Now on SWFs’ Mlex (Brussels, 5 December 2007) (registration-based).
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Ultimately, the Commission responded by introducing in February 2008 a CoC for SWFs in the form of a Communication.1134 Communications are policy documents with no legal effect, but which enable the Commission to set out its own thinking on a topical issue.1135 The Commission’s Communication advocated principles such as the clear allocation and separation of responsibilities in the internal governance structure of a SWF, the disclosure of the investment policies and objectives of SWFs as well as the disclosure of the general principles governing a SWF’s relationship with the governmental authority (section 4.3(a)).1136 According to the Communication, transparency practices that could be considered would include the annual disclosure of investment positions and asset allocation; the exercise of ownership rights; the disclosure of the use of leverage and of the currency composition; the size and source of an entity’s resources and the disclosure of the home country regulation and oversight governing the SWF (section 4.3(b)).1137 The Commission also underlined the need to observe the principle of proportionality, a well-established EU legal principle (section 4.2)1138 and also makes reference to article 63 TFEU (formerly article 65 EC) on the free movement of capital and the exceptions that may be invoked.1139

The similarities between the Commission’s Communication and GAPP are easily noticeable, especially as regards the issue of transparency and the separation of responsibilities in the governance of SWFs. It becomes therefore clear that the principles that shaped the two instruments formed part of a broader public debate about the regulation of SWFs and the financial world in general.

Given the new competences of the EU on foreign direct investment under the TFEU,1140 it can be expected that the EU will intervene more decisively in the

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1134 Commission, ‘A Common European Approach’ (n 1).
1137 ibid 11.
1138 ibid 9.
1139 But also to the ability of the EU to adopt by unanimous decision measures that restrict free movement of capital.
1138 ibid 6.
1140 chapter 5, on Articles 206-207 TFEU, at 190.
laws of Member States that restrict FDI, without, however, changing its overall stance.

Having analysed the three main transnational soft law instruments for SWFs, namely those of the OECD, the IMF\textsuperscript{1141} and the European Commission, the chapter can move on to the analysis of the prospective advantages and shortcomings of each of those regulatory tools.

3. Can GAPP and Other CoCs Offer an Appropriate Regulatory Response?

The purpose of this section is to examine whether the CoC system, and GAPP in particular, can ensure that the rules established for SWFs are observed. CoCs, as soft law instruments, are distinguished from binding legislative tools of dealing with SWFs and, as such, they present a different set of efficiencies and inefficiencies. An analysis of the negative and positive aspects of the CoC model must take into account a number of factors. Primarily, it depends on the observer's stance towards transparency.\textsuperscript{1142} Gilson and Milhaupt, for example, have cast doubts over the effectiveness of demanding more transparency for sovereign investors, arguing that 'lack of transparency is not in itself the problem, and as a result transparency cannot be itself the solution'.\textsuperscript{1143}

Encouraging transparency for SWFs, however, can help silence voices calling for protectionist policies. As said by Halvorsen, the former finance Minister of Norway stated, transparency can 'build trust' in the international financial system.\textsuperscript{1144} Furthermore, the disclosure of information about a SWF's business plans and governance structure could dissipate concerns of target countries over the degree of political interference in the investment decisions of SWFs.

\textsuperscript{1141} As seen above at n 1067 onwards, the OECD was the first to propose rules for SWFs, a work that the IMF subsequently picked up and developed even further.

\textsuperscript{1142} See the discussion about the place and role of transparency in chapter 4, n 596 onwards; 'Transparency' here should be understood widely: transparency of governance structure, business plans and investment goals.

\textsuperscript{1143} According to Gilson and Milhaupt the fundamental problem is that sovereigns have different interests from private investors and, as such, (quoting Truman) they 'call into questions our most basic assumptions about the [...] functioning of our economies and the international financial system', Gilson and Milhaupt (n 156) 3.

\textsuperscript{1144} Halvorsen (n 167).
development could open the path for SWFs to invest further into sectors deemed to be of national strategic importance, such as telecoms and energy.\textsuperscript{1145}

Nevertheless, even if transparency is accepted as a regulatory objective, GAPP, like forms of CoCs, still present a significant weakness in the sense of the absence of any formal enforcement mechanism.\textsuperscript{1146} No SWF is under any obligation to implement or observe any of those principles, not even those funds that took part in the preparatory work of the IWG. Although under national self-regulatory models the law may intervene in a facilitative capacity by enforcing mutual agreements,\textsuperscript{1147} such enforcement cannot be easily implemented at the supranational level where compliance is usually reliant upon the parties’ willingness to observe the agreed rules.\textsuperscript{1148} The absence of appropriate enforcement mechanism thus risks rendering those commitments ineffective.

This concern, although a valid one, should not be overstated. Enforcement, just like standard-setting, differs significantly depending on whether it is made at the national or supranational level. At the supranational level, both the drafting of command-based tools and the enforcement of the agreed rules are, in most cases, unrealistic or at least unworkable. International commitments, even when drafted as binding rules, are left to Member States to implement them in the domestic setting. This ‘internalisation’ may encounter interpretative difficulties when national officials attempt to translate global standards into domestic reality, or may even be blocked entirely because of a lack of political will.\textsuperscript{1149} The refusal by the Thatcher and Labour governments to honour their commitments under the International Labour Organisation (ILO) Conventions despite their ratification by previous UK governments is an illustrative example in this respect.\textsuperscript{1150} On the other hand, informal resolution practices such as by

\textsuperscript{1145} For example, it is unlikely that a SWFs that uses external managers be subject to political influence since that alone would jeopardise the final performance of the managers which determines their salary and bonuses. For a concrete example, Abu Dhabi Investment Authority, ‘An Introduction to ADIA’, ADIA, Governance, January 2009, p 6.

\textsuperscript{1146} Below there is an analysis of various supplementary mechanisms to replace formal enforcement.

\textsuperscript{1147} Morgan and Yeung (n 1020) 95.

\textsuperscript{1148} ibid 313.

\textsuperscript{1149} ibid 326.

\textsuperscript{1150} A number of complaints were taken to the ILO Convention supervisory bodies in Geneva which, however, failed to alter UK policy, ibid.
persuasion and negotiation can prove to be quite pervasive. The relevance of the ‘community of shared fate’ mentioned above is not limited to the level of standard-setting but may also be extended to the stage of enforcement. The fact of belonging in a ‘community of share fate’, such as the one of SWFs, can incentivise members to supervise potential non-compliance and use persuasion and negotiation to ensure that compliance. An effective implementation of the agreed rules can also have symbolic value as it may allow individual SWFs to invoke it in order to advertise their ‘business ethos’ to the rest of the financial world. In this sense, the model of a voluntary CoC presents elements found in the competition approach to regulation, which relies on market forces for the implementation of the agreed rules.

i. The experience of the UK Corporate Governance and Stewardship Codes

An example portraying the above contention is the application of CoCs in the area of corporate governance in the UK. The current code, the UK Corporate Governance Code is the result of a long process of development that begun with the publication of the Cadbury Report in 1992. The UK Corporate Governance Code, until 2010 known as the ‘Combined Code’, is generally seen as an example of a successfully implemented voluntary code of practice. Its focus is on board effectiveness, the establishment of non-executive directors and the division of board members’ responsibilities, the accountability of the board through business reporting and audit, remuneration of executives and

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1151 Ibid 328.
1152 Although a major difference being that the competition approach relies on the facilitative role of the law to provide a stable institutional framework that ensures the freedom and security of economic transactions, for example, the system of tradable emission licenses, ibid 91.
1154 For the history of the UK Corporate Governance Code see, Lowry and Reisberg (n 442) 207–214.
1155 Sections A and B.
1156 Section C.
1157 Section D.
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relations of the board with shareholders.\textsuperscript{1158} The UK Corporate Governance Code is considered internationally to be one of the premier benchmarks of good corporate governance practice, while many companies both in the UK and elsewhere seek voluntarily to comply with the Code’s requirements as evidence that they observe good corporate governance practice.\textsuperscript{1159} Its approach shares many common features with that of GAPP, in the sense that it promotes a division and strict delineation of responsibilities at the head of the company\textsuperscript{1160} and an improvement of financial reporting and audit function.\textsuperscript{1161} The UK Corporate Governance Code is today incorporated in the listing rules of the London Stock Exchange (LSE), requiring listed companies to comply with its recommendations or state reasons for non-compliance.\textsuperscript{1162}

Another CoC adopted in the UK alongside with the UK Corporate Governance Code is the 2010 Stewardship Code\textsuperscript{1163} which aims to set out good practice for institutional investors on engagement with investee companies. The Stewardship Code recognises the responsibility of institutional investors to promote the long-term sustainable operation of the company for the benefit of all stakeholders.\textsuperscript{1164} It is based on seven broad principles (and associated guidance), a number of which could also inform future amendments of GAPP, either as improvements to the current text of GAPP or as a separate appendix. Some of them are: disclosing how stewardship responsibilities are discharged;\textsuperscript{1165} managing conflict of interests;\textsuperscript{1166} establishing guidelines on how shareholder value is protected and enhanced;\textsuperscript{1167} willingness to act collectively with other investors where appropriate \textsuperscript{1168} and a disclosure of voting

\textsuperscript{1158} Section E.

\textsuperscript{1159} Max Barrett, ‘The end of “comply or explain”? Corporate governance in the United Kingdom and Ireland and the impact of CRD IV’ (2012) Vol 27(1) JIBLR 4.

\textsuperscript{1160} UK Corporate Governance Code, Principle A.2.

\textsuperscript{1161} ibid, Principles C.1 – C.3.

\textsuperscript{1162} LR 9.8.6(5) – RL 9.8.6(6).

This approach is discussed in further detail below at n 1192.


\textsuperscript{1164} Lowry and Reisberg (n 442) 229.

\textsuperscript{1165} Principle 1.

\textsuperscript{1166} Principle 2.

\textsuperscript{1167} Principle 4.

\textsuperscript{1168} Principle 5.
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activity. These principles, which are designed to apply to large shareholders, could be adapted to apply to the realm of SWFs when they invest in large corporations not only in the UK, but also at the supranational level. This possibility would also address questions arising in the UK as to the applicability of such a code in a country where 41.2% of the shares quoted in the stock market are beneficially owned by overseas investors.

Interestingly, the self-regulatory enforcement approach to corporate governance followed by the UK government since the first publication of the Cadbury Code appears to have had overall positive results. Significant levels of compliance with the code had emerged as early as 1995, albeit with lower levels among smaller companies. This positive trend had continued until 2000, when 93% of a sample of FTSE All Share Index companies had a board made up of one-third or more of non-executive directors. By 2006, the available evidence showed that compliance with the Combined Code continued to improve: although only 28% of companies surveyed were completely compliant with all provisions of the code, overall compliance amounted to 98%. Finally, the annual survey of compliance by FTSE 350 companies carried out by Grant Thornton in 2010-2011 showed that 50% of companies claimed full compliance.

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1169 Principles 6 and 7.
1170 See the comments made at n 1223, 1227.
1172 The issue of the applicability of such a code to a market with a strong presence of overseas investors, especially in the context of rising SWFs, is also mentioned in Arad Reisberg, 'The Notion of Stewardship from a Company Law Perspective' (2011) Vol 18(2) JFC 138-139.
1175 There were in total only 58 reported exceptions (i.e. reported instances of non-compliance with a particular provision of the Code) across the companies surveyed. This means that the wide majority of companies are complying with almost, but not quite, all of the Code provisions. Sarah Ray, 'Combined Code: Compliance Improves' (2006) PLC <http://plc.practicallaw.com/7-204-1241> accessed 10 November 2012.
1176 This report was compiled in the last quarter of 2010, based on publicly available data for 35 companies with ordinary shares listed on the Main Securities Market (MSM) of the Irish Stock Exchange. The authors have omitted MSM-listed companies whose primary listing is on a market.
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compliance with the code. Of those remaining, 80% comply with all but one or two of the code’s 48 provisions.\textsuperscript{1177} It is illustrative that 80% of FTSE 350 companies already adopting annual re-election of all directors, up from only ten per cent in 2010.\textsuperscript{1178} Data also showed that compliance levels on the FTSE Small Cap were generally consistent with those of larger companies (see table 6.1 below).\textsuperscript{1179}

\textit{Table 6.1: UK Corporate Governance Code compliance}

<table>
<thead>
<tr>
<th>Code requirement</th>
<th>FTSE 350</th>
<th>Smaller companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate Chairman and CEO</td>
<td>96%</td>
<td>95%</td>
</tr>
<tr>
<td>Minimum independent NEDs</td>
<td>80%</td>
<td>99%</td>
</tr>
<tr>
<td>Minimum audit committee composition</td>
<td>92%</td>
<td>89%</td>
</tr>
<tr>
<td>Recent and relevant financial experience on audit committee</td>
<td>93%</td>
<td>94%</td>
</tr>
<tr>
<td>Minimum remuneration committee composition</td>
<td>91%</td>
<td>82%</td>
</tr>
<tr>
<td>Minimum nomination committee composition</td>
<td>94%</td>
<td>95%</td>
</tr>
</tbody>
</table>

(FRC ‘Impact and Implementation’ 2011, 12)

As regards the Stewardship Code, although it is still early to evaluate its final impact, the sign-up to the Code by 234 asset managers, asset owners and service providers in its eighteen months of life is said to have been beyond the FRC’s expectations.\textsuperscript{1180}

outside the UK and Ireland, and which have opted to comply with the corporate governance regime applicable to their primary listing.


\textsuperscript{1178} As suggested by the UK Corporate Governance Code, para B7.1, ibid 14.

\textsuperscript{1179} ibid 11.

\textsuperscript{1180} ibid 4.
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Areas where the FRC considers there is room for improvement in the implementation of the UK Corporate Governance Code include reporting on how conflicts of interest are managed and the use of proxy voting agencies, and reporting by audit committees is said to be often unenlightening. A similar criticism was made by the EU Commission in a 2009 study on Member State reception of corporate governance codes (the 2009 study), where it stated that in over 60% of cases where companies chose not to apply recommendations, they did not provide sufficient explanation. A possible solution to this shortcoming is offered by the Commission in a 2011 Green Paper on corporate governance. The Green Paper mentions the example of the Swedish Corporate Governance Code which requires companies to state not only the reasons for departure of the rule but also describe the solutions applied instead. The Green Paper, moreover, recommends greater monitoring to addressing this particular deficiency. Another problem identified by the Commission’s Green Paper is the difficulty of protecting minority shareholders in companies with one large dominant shareholder and that the ‘comply-or-explain’ rule is not effective in those cases. This deficiency, it is suggested, may be remedied through an enhanced disclosure of ‘related party transactions’. Finally, concerns have been expressed in the past that the Corporate Governance Code’s increased prescriptiveness and rigidity observed in its 2008 version came

1181 ibid 5.
1182 ibid 4.
1186 Commission, ‘Green Paper’ (n 1184) 3;
1187 Commission, ‘Green Paper’ (n 1184) 16.
1188 ibid 17;
1189 In any event, this issue does not apply to SWFs (which are state-owned).
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at the expense of its reputed flexibility.\textsuperscript{1189} This criticism could be evoked again on the code’s latest 2010 and 2012 versions given its even greater attention to detail and augmented prescriptiveness.\textsuperscript{1190} On the other hand, it is equally noteworthy that the code’s 2012 version appears to place greater weight on the long-term success of the company than seen under the previous codes.\textsuperscript{1191}

Despite various shortcomings, it is demonstrated by the Commission’s 2009 study on national codes that the ‘comply-or-explain’ approach remains widely supported by regulators, companies and investors. The fact that the totality of EU Member States\textsuperscript{1192} have implemented some form of corporate governance code supported by a ‘comply-or-explain’ obligation in their national system since the UK’s Cadbury Code first introduced it, is illustrative enough in this respect.\textsuperscript{1193}

The overall success of the code is also exhibited by its reception by the EU’s corporate governance policy. In 2006, the European Commission issued Directive 2006/46/EC,\textsuperscript{1194} introducing the comply-or-explain principle for the first time in European law. The Directive introduced the requirement for companies with securities traded on a regulated market to publish a corporate governance statement. The statement shall contain at least a reference to the code that the company is subject to, and/or all relevant information about the corporate governance practices applied beyond the requirements under national

\textsuperscript{1189} Marc Moore, ‘The end of “comply or explain” in UK corporate governance?’ (2009) 60 NirLegalQ 90; The author notes that by insisting on the division of leadership responsibilities, and by not recognising sufficiently the possibility of a strategic non-compliance, the code ignores the board members’ over-riding positive legal duty of ensuring the promoting the long-term success of the company for the benefit of its shareholders, see 96, 100.


\textsuperscript{1191} See ‘Governance and Code’ points 1 and 4; ‘Preface’ point 4; A1; A4; D1; Schedule A; This is in line, arguably, with section 172 CA 2006, establishing a duty to promote the success of the company.

\textsuperscript{1192} The study mentions the exception of Ireland (which applies the UK Corporate Governance Code) and Greece. Since the publication of the study, Greece implemented its first corporate governance code applying the ‘comply-or-explain’ requirement, see SEV, ‘Corporate Governance Code For Listed Companies’ (2011) Hellenic Federation of Enterprises <www.sev.org.gr/Uploads/pdf/SEV_CGC_ENG_2011_FINAL%20_MARCH_2011.pdf> accessed 31 January 2013.

\textsuperscript{1193} See RiskMetrics Group and others (n 1183) 24, for a description of the ‘comply-or-explain’ requirement implemented in different EU Member States.

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Additionally, companies shall provide information internal control and risk management systems, antitakeover bid measures and key powers of shareholder meetings. The European Corporate Governance Forum had also expressed strong and unanimous support for the comply-or-explain approach in 2006, as it judged it ‘best suited to take into account the variety of situations of individual companies’. More recently, the EU included a ‘comply-or-explain’ obligation in the founding regulation of the European Securities Market Authority (ESMA). Under Article 16 of the regulation, ESMA is empowered to issue recommendations and guidelines to companies, which those companies must either comply with, or state the reasons for non-compliance. It seems that, despite the various deficiencies identified, ‘comply-or-explain’ has become an established EU practice. Overall, as the 2009 study published by the EU Commission concludes, ‘the “comply-or-explain” regime should not be abandoned. It should be strengthened’. 

**ii. Compliance with GAPP**

The evidence of implementation of the Combined Code/UK Corporate Governance Code is quite encouraging as far as general self-regulatory approaches are concerned. It would certainly be unlikely to expect similar results with GAPP taking effect so quickly, as GAPP and the UK Corporate Governance Code differ considerably in the conditions of their application. However, it would not be wholly unrealistic to observe a similar effect in due

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1195 Article 1.7.1(a)(i).
1196 Article 1.6(7a), 1.7.1(d) and 1.7.1(e).
1197 Commission ‘Statement of the European Corporate Governance Forum on the Comply-or-explain Principle’ (2006) Internal Market,
1199 Article 16(3).
1200 RiskMetrics Group (n 1183) 18.
1201 In particular, the UK CoC is a national instrument applying to corporations and some of its provisions are backed by the force of the law, while GAPP is a supranational instrument, with no compulsory measures and applying to national governments.
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course, which may be reinforced by a number of policy additions to GAPP\textsuperscript{1202} and developments in the wider financial sector.\textsuperscript{1203} In this context, it is important to note that GAPP is not a set of ideals that SWFs will struggle to reach, 'but an inventory of best practices that already exist'\textsuperscript{1204} as is the case with the UK codes seen above. This means that GAPP do not require SWFs to adopt any practice that is not already being followed by at least one other SWF. This fact makes it difficult for SWFs to argue that the CoC’s standards of accountability and transparency are a costly burden. It is equally important that GAPP is constructed in a broad way so as to provide SWFs with sufficient flexibility in their manner of implementation as long as the spirit of the code is complied with. In short, it can be expected that since SWFs have signed up to GAPP, they should observe ‘a process of competitive emulation’\textsuperscript{1205} amongst them.

For the time being, the available evidence on compliance to GAPP shows mixed results: while overall compliance is still lacking, many encouraging signs can already be observed. According to the Behrendt Report on the progress in the implementation of GAPP by SWFs, conducted for the Carnegie Endowment for International Peace, compliance with GAPP eighteen months after their publication remained low.\textsuperscript{1206} The Behrendt Report (see table 6.2) identified four different categories of compliance. The first category included funds that fully comply with the Principles,\textsuperscript{1207} all of which were established in democratic countries (New Zealand, Australia, Ireland and Norway). This first group represented nearly $500 billion in assets under management—some 20% of the total assets under management by the Principles’ signatories.\textsuperscript{1208} The second

\textsuperscript{1202} As it is argued below at 283-286, such as formalising the process of compliance monitoring and introducing a ‘comply and explain’ component to the code.

\textsuperscript{1203} See the next section ‘SWFs and the Regulation of Hedge Funds’.


\textsuperscript{1205} ibid.

\textsuperscript{1206} Behrendt (n 1106) 7.

\textsuperscript{1207} Each provided sufficient and detailed information about its policy objectives, governance arrangements, funding and withdrawal arrangements financial positions, and overall investment policy, including information about non-financial and non-economic considerations that might drive investment behaviour.

\textsuperscript{1208} ibid 6.
group included the bulk of the funds, each of which reached approximately 60%.\textsuperscript{1209} This group represents nearly $1.2$ trillion in assets under management—some 50% of the total assets under management by the Principles’ signatories.\textsuperscript{1210} The third group, which included two Russian funds and the two funds from Kuwait and Qatar, represented nearly $500$ billion in assets under management, some 20% of the total assets under management by SWFs.\textsuperscript{1211} These institutions provided only basic information about how they observed GAPP. Finally, the fourth group, representing the remainder of some US$200$ billion assets under management, included funds for which only very limited or no data could be obtained.\textsuperscript{1212}

\textit{Table 6.2: Santiago [GAPP] Compliance Index as of March 2010}

\begin{footnotesize}
\begin{enumerate}
\item All provided at least basic information that covers most of the Principles but struggled to explain how their checks and balances system shielded them from their governments political considerations, ibid 7.
\item ibid.
\item ibid.
\item ibid.
\item ibid.
\end{enumerate}
\end{footnotesize}
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Behrendt made the hypothesis that ‘the distinct local political institutions of each country transcend SWFs’ governance, accountability, and transparency commitments and have a measurable impact on their compliance with [GAPP].’ He then tested this hypothesis side by side to the democracy index 2008 (see below, chart 6.1).

_Chart 6.1: Compliance with Santiago Principles by Democratic Institutions (2008)_

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1213 This index, which represents the author’s estimate, is based on relevant data accessed from January 2010 to March 2010 and provided by SWFs, the IWG, and the IMF. The author acknowledges a number of factors in this assessment that affect data accuracy, such as availability and accessibility. A more thorough description of the establishment of the Santiago [GAPP] Compliance Index is provided at, Sven Behrendt, ‘Gulf Arab Sovereign Wealth Funds: Governance and Institution Building’ (2010) 11th Mediterranean Research Meeting, European University Institute: Florence & Montecatini Terme.

1214 Behrendt (n 1106) 9.
Drawing from the democracy index above, it is not surprising to see that SWFs established in countries with democratic institutions tend to be more transparent and accountable.¹²¹⁵ As the author affirms, governance and government effectiveness explains a SWF’s compliance to a limited extent.¹²¹⁶

Overall Behrendt draws pessimistic conclusions from his findings. He believes that the GAPP process has lost its momentum, especially since attitudes towards SWFs have shifted.¹²¹⁷ It cannot be denied that the compliance levels, as reflected in the Behrendt Report, are unsatisfactory. This, however, does not constitute a reason to abandon the entire effort. The progress recorded in the Behrendt Report took place within a short period from the conclusion of GAPP. It is natural to expect institutional change to be slow, especially when it happens on a voluntary basis and it takes place in countries with varying traditions of governance and administration. If anything, the results of the Behrendt report constitute an additional reason to formalise the task of reporting the compliance progress of SWFs by entrusting it to the International Forum of Sovereign

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¹²¹⁵ This point has been made before in chapter 2, see table 1.3 and the analysis below.
¹²¹⁶ Behrendt (n 1106) 12.
¹²¹⁷ He believes, however, that it is important to enforce it, as ‘in the long run, a more accountable global financial system is more robust’, ibid 13.
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Wealth Funds (IFSWF).\textsuperscript{1218} This institution is the best placed to carry out this task as it is charged with the organisation of SWF meetings and can thus cover the additional monitoring costs through the contributions of SWFs and the IMF.\textsuperscript{1219}

4. Additional Recommendations Advocated by this Thesis

The following suggestions aim at remedying the lack of any form of monitoring of the implementation of the code by SWFs and at completing the existing regulatory framework for SWFs with certain additions. The ultimate goal is to enhance governmental and market confidence towards SWFs by demonstrating the SWFs are not suspect of political influence or market destabilising effects and, at the same time preserve their competitiveness against other market participants.

Firstly, a monitoring system of the application of GAPP would be essential. This system could draw principles from the Behrendt Report and the SWF Institute transparency index. More specifically, successful implementation of a GAPP principle could be represented with a certain percentage point (such as 4\%) in a scale from 0 to 100\%. The level of implementation of each principle would be reflected by the amount granted for each, i.e. 1\% for poor implementation to 4\% for complete implementation.

Moreover, such a monitoring system could go beyond the simple production of periodic progress report and draw elements from the UK Corporate Governance Code and its ‘comply-or-explain’ principle. Paragraph 9.8.6 R of the UK Listing Authority’s listing rules require UK companies to produce an annual statement of how the listed company has applied the main principles of the UK Corporate Governance Code, and a statement as to whether the company has

\textsuperscript{1218} As the IWG has been renamed in its meeting in Kuwait City in May 2009.

\textsuperscript{1219} It is noted that in July 2011, the IFSWF has published a report on its members’ experience in the application of GAPP. This report, however, does not consist in any form of monitoring, but rather, a written record of members’ discussions on the incorporation of the principles in their internal governance structure. It is nevertheless a step in the right direction. IFSWF, ‘IFSWF Members’ Experiences in the Application of the Santiago Principles’ (2011) Report prepared by IFSWF Sub-Committee 1 and the Secretariat in collaboration with the Members of the IFSWF <www.ifswf.org/pst/stp070711.pdf> accessed 12 December 2012.
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complied with all relevant provisions of the Code, any provisions it has failed to comply with, as well as the reasons for that failure. As specified by the UK Corporate Governance Code, a failure to comply can be justified ‘if good governance can be achieved by other means’ and for that reason ‘it should be explained clearly and carefully to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result’.\textsuperscript{1220} This approach is generally perceived by companies to be more about mind-set culture than box-ticking: there is no absolute right answer, and the obligation to explain rests as much as on those who are doing well as on those who are doing badly.\textsuperscript{1221} Moreover, the ‘comply-or-explain’ approach is said to satisfy both smaller shareholders who cannot directly ask the company for information, as well as larger ones who see those explanations as the foundation for more dialogue.\textsuperscript{1222} Based on this model, SWFs could also be offered, in the context of GAPP, with a choice between complying or producing a statement of progress, or an explanation for their failure to comply. Such an idea would, naturally, face enforcement difficulties. In the UK the choice between complying or explaining is enforced through the LSE’s listing rules (although, through the FRC’s coordination efforts). In the supranational context of SWFs no equivalent enforcement mechanism exists.\textsuperscript{1223} Nevertheless, there is no reason why SWFs would refuse to produce such reports voluntarily if this becomes an acceptable practice within the IFSWF. Even if weakly enforced, the introduction of this element in the monitoring system of the IFSWF could foster a culture of dialogue and a higher degree of accountability among SWFs. In this context additional percentage points could also be added or removed based on the quality of ‘comply or explain’ reports.

The introduction of GAPP should be seen not as the culmination, but rather as the starting point of an endeavour to render SWFs more transparent and accountable. This view would be more consistent with the idea behind the follow

\textsuperscript{1220} UK Corporate Governance Code, ‘Comply or Explain’ para 3.
\textsuperscript{1222} ibid 8.
\textsuperscript{1223} And as explained thoroughly in chapter 5 it would be unadvisable to enforce it through unilateral national measures, for example, as a condition for carrying out investments within a jurisdiction.
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up to the IWG which gave birth to the Kuwait Declaration and the IFSWF, namely, that transparency and accountability for SWFs is an on-going process.¹²²⁴

In this context, the IFSWF could consider the adoption of a stewardship-type code for SWFs in the future. This could be added as an appendix to GAPP to guide the relationship between SWFs and investee companies. It could focus on minimising potential conflict of interests between the interests of SWFs’ home governments and host economies and establishing guidelines for the protection of shareholder value and the participation of SWFs in shareholder meetings. A disclosure of voting activity could also be mandated. The application of the stewardship code would be left to individual SWFs and the management of investee companies (and thus would preferably not make part of the monitoring grading system).

It has also been argued by Norton that the IFSWF should seek further links to the financial markets and to the global policymakers responsible for global financial stability, including ‘affiliate’ status with the International Organization of Securities Commissions (IOSCO).¹²²⁵ The IFSWF and its members, he adds, need to be tied into and committed to the IMF’s bilateral surveillance initiatives of financial stability analyses and should explore ongoing technical assistance programs for its members through the IMF, the World Bank and the OECD as to upgrading their governance structures and as to some form of voluntary periodic assessments.¹²²⁶

The work of the IFSWF, therefore, can significantly contribute to a more satisfactory integration of SWFs to the global financial and regulatory system. The work of the IFSWF can also be evaluated in conjunction with additional actions taken at the supranational level to enhance the supervision over the

¹²²⁴ IWG-SWF (n 1218).
¹²²⁵ Norton (n 1079) 654. (IOSCO) is an association of organisations that regulate the world’s securities and futures markets. Many of the world’s stock exchanges and financial supervisory authorities have established links with IOSCO as ‘ordinary’, ‘associate’ and ‘affiliate’ members. For more, see: IOSCO, <www.iosco.org/> accessed 6 November 2012.
¹²²⁶ Norton (n 1079) 654.
operation of SWFs, but also in conjunction with the regulation of parallel investment entities, such as hedge funds. These matters are dealt with in the following section.

5. SWFs and the Regulation of Hedge Funds

An examination of all the available regulatory frameworks for SWFs in the previous and the present chapter has led to the conclusion that that those that are structured on a voluntary basis and at the supranational level are preferable to existing binding instruments adopted by national governments. Their voluntary nature may not bring immediate results, but they can serve to encourage the pre-existing tendency of SWFs to move towards greater transparency and accountability.

In addition to the CoCs, there are also other means available to regulators to boost the tendency for increased transparency and accountability in SWFs. One significant tool would be to promote a greater level of transparency in financial markets, and thus step up pressure on other entities to follow suit. It was seen, for example, above, that SWFs react negatively when equivalent transparency obligations are not imposed on other investment vehicles, such as hedge funds. This stance is justifiable to the extent that SWFs compete with hedge funds in financial markets and fear that transparency requirements might place them at a competitive disadvantage. It is not equally justifiable when used as a pretext to preserve their current governance structures. In either case the unregulated status of similar financial actors enables SWFs to resist pressure for greater regulation and supervision. In this context, the regulation of hedge funds could play the role of a yardstick for transparency in SWFs. More regulation

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1227 Such as the ones mentioned above (Stewardship Code, institutionalisation of monitoring and the introduction of a ‘comply-or-explain’ principle).
1228 See the discussion in chapter 1 ‘There is a clear trend towards openness’, where it was demonstrated that there is a genuine trend among SWFs towards increasing transparency.
1229 n 160, 1061.
1230 See also n 294.
1231 As seen above in chapter 2, the relationship between SWFs and hedge funds is not always that of competition in an open market. SWFs usually have different investment horizons to hedge funds, and often even invest through them, n 250.
applied to hedge funds could result, even indirectly, in more regulatory principles also being observed by SWFs voluntarily. The latest regulation for hedge funds adopted in the EU and the USA in the aftermath of the GFC, discussed below, can serve as a good example in this respect.

Hedge fund regulation is designed to address systemic risk caused by the investment behaviour of hedge funds. Such systemic risk, as demonstrated by the recent GFC exceeds the scope of any national jurisdiction. As a result, negative externalities arising from hedge fund behaviour can easily affect other countries too.\(^{1232}\) Therefore, in order for hedge fund regulation to be meaningful it needs to be transnational. In the past, various forms of self-regulatory instruments have been introduced which were not dissimilar to the ones attempted today with SWFs.\(^{1233}\) However, since the GFC, hard regulation was deemed necessary in both the EU and the USA. In this context, it is argued that the incentive structure on either side of the Atlantic favoured a degree of harmonisation of hedge fund regulation to avoid regulatory arbitrage.\(^{1234}\)

In the EU, the Directive on Alternative Investment Fund Managers (AIFMD) was published in July 2011.\(^{1235}\) Its aim was to create a comprehensive and effective regulatory and supervisory framework for alternative investment fund managers within the EU.\(^{1236}\) AIFMD introduces rules relating to most aspects of the operation of hedge funds, such as capital requirements, remuneration policies, valuation and delegation, as well as increased transparency to investors and competent authorities. The directive requires the disclosure to investors of

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\(^{1234}\) Engert (n 1232) 355-364.


\(^{1236}\) Alternative investment funds are not limited to hedge funds. Under Article 4(1)(a) of the Directive they are defined as any ‘collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to Art 5 of Directive 2009/65/EC’ (the UCITS Directive).
the fund’s investment strategy and objectives, valuation and redemption policies, valuation, custody, administration and risk management procedures, and fees, charges and expenses.\textsuperscript{1237} Thereafter, the fund manager must also submit to investors a report containing the fund’s balance sheet, income statement, activity report and auditor’s report.\textsuperscript{1238} The fund manager, in addition, must make significant disclosures to the competent authorities. These disclosures concern the percentage of its portfolio assets which are subject to special arrangements arising from their illiquid nature, any new arrangements for managing liquidity, and the current risk profile of each fund.\textsuperscript{1239} An alternative investment fund manager is also required under the directive to inform regularly the competent authorities on the principal markets and instruments in which its fund trade, their principal exposures and important concentrations of risk\textsuperscript{1240} as well as the use of short selling.\textsuperscript{1241} In the event of acquisition of control, AIFMD requires the fund manager to ensure that the fund discloses to the company, its shareholders and employees relevant information in relation, for example, to the intentions with regard to the future business of the company and to the financing of the acquisition.\textsuperscript{1242} AIFMD also includes specific rules to mitigate risks to the long-term health of companies linked to ‘asset stripping’.\textsuperscript{1243}

In the USA, reporting requirements for hedge funds and private equity were adopted in July 2010 as part of the Dodd-Frank Act.\textsuperscript{1244} The reforms made in this area are consistent with those enacted later in the EU with the AIFMD. The Dodd-Frank Act requires hedge fund managers to file regularly with the SEC all information deemed necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the newly

\textsuperscript{1237} Art 20(1).
\textsuperscript{1238} The fund manager must also submit these reports to the competent authorities in its home Member State, Art 19(1)–(3).
\textsuperscript{1239} Art 20(2) and Art 21(2).
\textsuperscript{1240} Art 21(1).
\textsuperscript{1241} Art 21(2)(d)–(e).
\textsuperscript{1242} Arts 27–29.
\textsuperscript{1243} Meaning the process of buying an undervalued company with the intent to sell off its assets for a profit. Art 30.
created Financial Stability Oversight Council (FSOC). The FSOC will focus on the hedge funds’ assets under management; leverage; credit exposure; counterparty risk trading and investment positions; valuation policies and procedures; types of assets held; side letters; trading practices, as well as any other information that the SEC deems to be ‘necessary or appropriate’.1246

Hedge funds are rarely systemically important1247 and, just like with SWFs, their behavior is not perceived as one of the roots of the recent GFC.1248 But a powerful argument is made that the world’s economies cannot afford to wait for incontestable evidence of an actual systemic problem before acting, because then the regulatory response will be too late.1249 A similar line of argument could also be invoked with regard to the regulation of SWFs: regulation is established in order to avert future crises. However, the case for hedge fund transparency differs from that of SWFs. In the case of hedge funds, the point is to reduce the risk to systemic stability,1250 for SWFs it is to alleviate concerns for national security. Nevertheless, both types of regulation can also serve to bolster investor confidence1251 and thus bring additional benefits in the operation of financial markets. On the other hand, it is important to keep in mind that regulation usually impacts each sector differently. It is reported that compliance costs deriving from AIFMD could be significant for hedge funds, whereas...
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compliance with GAPP does not appear to be particularly costly for SWFs.1253

There is still not sufficient experience with the AIFMD to prove or disprove its success as a regulatory structure. In fact, concerns persist on the part of market participants who feel that this directive in many respects is unworkable and the one-size fits all approach fails to recognise the manner in which different alternative fund business models operate.1254 Concerns are also expressed over the directive’s overly protectionist stance as this may drive alternative fund managers to exit Europe and effectively preventing non-European managers, administrators and depositaries from servicing alternative funds being marketed in Europe.1255 On the other hand, it is stressed by Ferran, that the central place of the alternative industry in financial markets warrants the adoption of some form of regulation,1256 and the industry’s quick recovery from its decline is enough to silence concerns about the industry’s viability under the new regulations.1257 Moreover, as she says, the principles laid down, such as proper disclosure to investors, regular reporting of investment performance, independent valuation and segregation of assets, are ‘basically sound’ and in conformity with the wider industry standards. 1258 Ferran underlines her concern over the overly prescriptive and inflexible approach of the directive,1259 but she notes that full evaluation of AIFMD’s significance must also be postponed until it is possible to compare its effects to those resulting from similar regulatory developments elsewhere.1260 In addition, it is worth pointing out that ESMA has undertaken to clarify and adapt many of the provisions of the directive through a process of public consultations.1261 Although those consultations may not touch on central

1253 See above, n 1204, 1205.


1255 ibid.


1257 Ibid.

1258 Ibid (n 1256) 411.

1259 Ibid 410.

1260 ibid 412.

1261 Such as those on key concepts of the AIFMD
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aspects of AIFMD, it can be hoped that various drawbacks of the current framework will be addressed in the future.

More importantly, the above legal developments in the EU and the USA may have a significant impact by substantially increasing the benchmark of transparency, not simply in the area of private funds and alternative investment funds, but in the wider financial world. This is also supported by the fact that SWFs often evoke competition with hedge funds to defend their right to remain opaque.\textsuperscript{1262} In other words, the existence of this legislation could drive other investment funds not directly targeted by the regulation, such as SWFs, through a process of competitive emulation to increase their transparency levels. In this event, one could speak of a positive spill-over effect of AIFMD and the Dodd-Frank Act in the domain of SWFs.

It is not uncommon for legislation enacted in the EU or the USA to extend its effect beyond those that it was designed for. It has been reported in April 2012 that sweeping new hedge fund regulations in Switzerland were an example of the growing impact of AIFMD, even before its final legislative shape has been formulated and passed into law.\textsuperscript{1263} It would not be surprising to observe similar spill-over effects, not only territorially, but across different types of funds, thus extending the effects of AIFMD to SWFs.\textsuperscript{1264}

The results of such a spill-over effect could be assimilated to the conclusions

\textsuperscript{1262} n 106, 1061.
\textsuperscript{1264} On a related tone, see also Awrey, who predicts in his paper that the AIFMD is ‘a harbinger of things to come’, thus reinforcing the view that the AIFMD may have generated a momentum in the field of financial regulation in Europe, Awrey (n 1247) 127.
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of a 2012 survey by Hofstra University\textsuperscript{1265} on the impact of the Dodd-Frank Act on hedge funds. One of the findings of the survey was that Dodd-Frank rules driving increased transparency while increasing investor demand for information have been broadly positive for the hedge fund industry. It is reported that due diligence process, risk management procedures and reporting requirements all have increased investor acceptance of hedge funds, allowing them to become increasingly mainstream investment vehicles for institutional and individual investors.\textsuperscript{1266} Judging from the results of the above survey, it would not be surprising to observe a similar stance by SWFs towards the principles contained in the CoCs examined above. Reporting and governance rules for SWFs could enable sovereign investors to improve their reputation and links with the rest of the financial world,\textsuperscript{1267} in the same way the Dodd-Frank rules have been positive for hedge funds.


\textsuperscript{1266} Post-crisis, investors required increased information and transparency regarding a firm’s due diligence and risk management, and their requirement regarding a firm’s audit firm, ibid 4.

\textsuperscript{1267} This would allow SWFs to reduce protectionist backlashes against their investments and enable them to enhance their cooperation with other investment vehicles, for instance, as joint ventures or investment consortia.
CONCLUSION

This chapter presented and analysed various supranational regulatory frameworks, known as CoCs that can be applied to SWFs. The aim was to build on the conclusions drawn in the previous ones and offer a viable and efficient structure for the regulation of SWFs, namely for the introduction of greater transparency and accountability in the governance of SWFs.

First, a comparison was made between national and supranational responses where the advantages of the second approach were exposed. Then, the chapter continued into an analysis of the CoC model before specific supranational instruments were examined and assessed, namely those produced by the OECD, the IMF and the EU. It was seen that these codes mainly advocate transparency, the establishment of some form of accountability and the division of responsibilities in the functioning of SWFs. It was also argued that these instruments should be viewed in the context of the wider debate about regulating the global financial sector post-crisis.

Various reactions to those CoCs were also offered as an example of the concrete impact of the codes on SWFs and the academic community. While assessing the benefits and drawbacks of those codes, it was argued that the voluntary nature of those codes is not a major setback to its application since a slow implementation of those principles in the governance of SWFs is already underway. However, more could be done to formalise a monitoring mechanism to assess the progress in the implementation of the code by SWFs.

Finally, the chapter has also explored the relation between the regulation of SWFs and the current regulatory structure for hedge funds in the EU to argue that regulation of comparable investment entities, such as hedge funds, can have a positive impact on the transparency levels of SWFs as well.

Overall, this final chapter illustrated that, although not without problems themselves, supranational responses to SWFs which are constructed on a voluntary basis present fewer downsides than their national legal alternatives.
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As such they constitute the most efficient and viable model for regulating SWFs at this point in time.
CONCLUSION

It is time to take stock of the significance and contribution of this thesis in a wider context indicating, in particular, the lessons that can be drawn from the research. These should guide policy on SWFs and foreign investment regulation in general. There is a recap of the specific recommendations for policymakers which have been made throughout this thesis and, finally, a number of projections about the future of SWFs and their regulation are presented.

1. Significance and contribution of this research

The significance of this research is that it provides a basis for regulating some of the world’s largest investment funds. The rapid growth of SWFs, in an uncertain economic environment, means that SWFs are playing a pivotal role in fostering growth in financial markets and will continue to do so. More importantly, SWFs may play a critical role in safeguarding financial stability in the future, as they did during the GFC in 2008–2009. In this context, it is understood that preserving the competitiveness of SWFs and allowing them to allocate their capital efficiently, whilst aiming to reduce potential negative effects, is essential to the functioning of financial markets.

The contribution of this thesis is that it provides an integral analysis of SWFs and uses the results of this analysis to justify the adoption, or not, of regulatory instruments. The thesis examined both theoretical proposals and ones actually implemented in various countries. Such research and analysis, with a view to making regulatory conclusions, appears not to have been carried out before. The thesis has taken economic as well as political considerations into account to reach its conclusions, whilst aiming to preserve the necessary distance from recent events to scrutinise them with objectivity. The majority of other works on SWFs
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which have been published during the described events lack this necessary perspective.

The regulatory conclusions of this analysis cover all types of sovereign investors that operate as described in the first two chapters; namely, those that allocate government revenue to a special fund and then use this revenue to invest internationally in long-term securities. The regulatory options explored could also apply to certain public pension funds or even state-owned enterprises.

The applicability of the conclusions is limited by two important factors explained in detail in the body of this thesis. These factors are, first, the extreme opacity of the most SWFs, which limits the amount of information available, and second, the current volatility of the global economy, which impedes the task of drawing conclusions about the operation of SWFs. Both limitations have been addressed so as to minimise their effect on the conclusions of the thesis. Firstly, transparent SWFs have been used as proxies for the entire SWF community, and a significant amount of information has been collected from financial reports and financial news to counter the secrecy of others. Secondly, this research has observed SWFs as well as the attitudes of recipient governments over long periods and has analysed them both at times of economic growth and slump (i.e. from 2000 to 2008 for periods of economic growth, and 2008 onwards for periods of crisis), to arrive at solid conclusions about the behaviour of SWFs and host economies.

2. Lessons drawn

The research carried out in this thesis suggests a number of lessons about the operation of SWFs and the principles that should inform future policy-making. Firstly, it is recognised that SWFs are opaque institutions which may sometimes (although rarely) include national – as opposed to purely economic –

\[^{1268}\text{Such events include the heightened national security concerns discussed widely during the period until 2008 when SWFs exhibited rapid growth, and the global financial crisis which totally altered the debate and attitudes on SWFs.}\]
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objectives in their investment strategies.\textsuperscript{1269} At the same time, it is recognised that SWFs are conservative, passive and long-term investors, a fact which counterbalances many of the concerns identified.\textsuperscript{1270} More importantly, SWFs have so far exhibited clear signs of progressing towards greater transparency, which is an effective way of neutralising some concerns. \textsuperscript{1271} Greater transparency, moreover, can improve the reputation of SWFs and consolidate their place and role in the global financial system.

Secondly, the debate about regulating SWFs is directly linked to the opacity of SWFs and the difficulty of evaluating their investment strategies and long-term objectives. It is submitted in this thesis that there is no unanimity among commentators as to the merits of transparency for SWFs. While some commentators maintain a more principled approach towards transparency (claiming that transparency should be sought because it is a sound principle in itself),\textsuperscript{1272} others see it as a means to alleviate concerns.\textsuperscript{1273} Others still believe that it is not relevant at all.\textsuperscript{1274} In short, there is no unanimity as to the basis for requiring SWFs to become more transparent. In this thesis, it has been accepted that transparency for SWFs may help dissipate concerns about the investment motives of SWFs, and, as such, it may be a sound objective. That said, heightened transparency becomes problematic to the extent that it places SWFs at a competitive disadvantage against their immediate competitors, such as hedge funds.\textsuperscript{1275}

Thirdly, building on the above conclusion, it is argued that the degree to which SWFs will become transparent in the future will be directly proportional to the degree that similar requirements are imposed on hedge funds and other similar investment entities.\textsuperscript{1276} In this context, recent hedge fund regulation

\begin{footnotesize}
\textsuperscript{1269} Chapter 3, at 123.
\textsuperscript{1270} Chapter 2, at 75-80.
\textsuperscript{1271} Chapter 1, at 53-56.
\textsuperscript{1272} n 605, 606.
\textsuperscript{1273} n 602.
\textsuperscript{1274} n 611.
\textsuperscript{1275} See arguments made at 175, 287.
\textsuperscript{1276} See argument at 291-292.
\end{footnotesize}
implemented in the EU and the USA requiring the dissemination of information by such funds may exert a positive spill-over in the domain of SWFs as well.\textsuperscript{1277}

Fourthly, it is submitted that SWFs have significant positive effects on their target countries and the global financial system in general.\textsuperscript{1278} Moreover, the negative effects, supported by a number of commentators, appear to lack a solid basis. There is, currently, no record linking SWFs to any form of national security threat. Indeed such funds aim primarily to remain low profile and, therefore, often act hyper-cautiously. With regard to their economic impact, the analysis of their impact at a micro (individual companies) and macro level (economy at large) shows no actual costs that should make them a special subject of regulatory intervention.\textsuperscript{1279} On the other hand, SWFs may bring indirect costs, in the sense that they may create strong protectionist backlashes in their host countries and they may increase the political leverage enjoyed by their respective governments.\textsuperscript{1280} It is explained, however, that regulation is hardly the appropriate instrument to deal with these indirect costs.\textsuperscript{1281}

Finally, SWFs are deeply image-conscious entities. Not only do they aim to shun negative connotations in their commercial practices, they also highly object to being discriminated against through the use of foreign investment regulatory instruments or being portrayed as ‘bad investors’ by the national media. As such, SWFs are more likely to opt for jurisdictions where they will not be subjected to additional legislation or attract intense criticism by the press. On this basis, it is concluded that increased protectionism may harm both foreign investors and host economies by distorting the investment climate and the efficient allocation of capital.\textsuperscript{1282} At the same time, national bodies made responsible for conducting national security reviews of foreign investments may be overburdened in fulfilling such a task, thus, weighing excessively on national administrations.\textsuperscript{1283}

\begin{footnotes}
\item 1277 ibid.
\item 1278 See discussion at 105-110.
\item 1279 Chapter 3.
\item 1280 Discussed at 126-128, 133-135.
\item 1281 As argued at 153.
\item 1282 Chapter 5, at 237-243.
\item 1283 at 185.
\end{footnotes}
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3. Recommendations for policy makers

The abovementioned findings, established in the body of the thesis, can be used by policymakers to set principles behind regulation of SWFs. Firstly, it is shown that any enacting of national measures for the financial sector should be accompanied by a cost-benefit analysis to assess the impact of those measures on economic activity.\textsuperscript{1284} In addition, when politically sensitive issues, such as foreign state investments are concerned, regulation should not be primarily driven by political or short-term considerations, as these may seriously hamper economic activity.\textsuperscript{1285} Such adverse effects are particularly harmful during times of economic distress, as the one currently being experienced by many western economies.

Secondly, national regulators should limit themselves to goals that are achievable by regulatory measures. More specifically, governments should not try to expand the ambit of regulatory activity to sectors that are normally dealt with by foreign or macroeconomic policy.\textsuperscript{1286}

Thirdly, regulations at a national level are inadequate to address the SWF phenomenon. National responses to SWFs depend largely on the prevailing conditions of each national economy, as well as the historic record of each country in dealing with foreign investors and SWFs in particular. Perceived threats to a country’s national security can also play a role in formulating a response to SWFs. National measures might seem to offer flexibility, but in practice rarely deal adequately with SWFs. They are often unduly influenced by popular perceptions and xenophobic concerns about foreign economic predators. Consequently, national responses are often overly protectionist and increase costs unnecessarily.\textsuperscript{1287} It has been submitted, for instance, that the USA and Germany are among the most attractive destinations for SWFs, although their governments often aim to keep their national champions out of the ambit of foreign investments.\textsuperscript{1288} In the USA, in particular, issues of national security have

\begin{itemize}
\item \textsuperscript{1284} at 180.
\item \textsuperscript{1285} See analysis at 250-252.
\item \textsuperscript{1286} See at 153.
\item \textsuperscript{1287} As argued at 237-243.
\item \textsuperscript{1288} Such as the VW in Germany and energy companies in the USA.
\end{itemize}
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appeared on the political agenda, even if unwarranted, and have framed the debate on SWF regulation. France and Greece, on the other hand, have always exhibited a degree of economic protectionism.\textsuperscript{1289} The extent of protectionism and regulation of economic activity may be related to the economic setbacks recently observed in countries such as France and Greece in particular. Moreover, most of the measures analysed lay down vague regulatory standards, either with regard to the industries protected, or the behaviour that is under regulation, thus generating a highly uncertain environment for foreign investments. Measures taken by France and Greece were struck down by the European Commission, which declared them disproportionate to the objectives pursued and thus incompatible with the free movement of capital.\textsuperscript{1290} Taking all the above into account, it is argued in this thesis that national measures adopted to respond to SWFs should be abolished or amended substantially to reflect the real benefits and the lack of costs created by the operation of SWFs in western economies.

It is established that supranational responses involving the participation of SWFs are preferable as regulatory options, as they present fewer distortions and better advance the mutual interests of sovereign investors and host countries.\textsuperscript{1291} Such frameworks, structured in the form of CoCs, have already been introduced by the OECD, the IFSWF (under the aegis of the IMF) and the EU Commission. It is seen that, of those frameworks, the one prepared by the IFSWF (GAPP or ‘Santiago Principles’), involving the participation of SWFs, constitutes the most effective platform for establishing rules for SWFs.\textsuperscript{1292} As a general rule, supranational responses rarely succeed in creating a legally binding framework and they are more often structured for voluntary compliance. This is the case with GAPP,\textsuperscript{1293} which is largely left to SWFs to incorporate into their internal structure. Attempting to impose binding rules\textsuperscript{1294} in this context would be futile.

\textsuperscript{1289} \textsuperscript{n 521, 522.}
\textsuperscript{1290} \textsuperscript{n 861, 922.}
\textsuperscript{1291} \textsuperscript{at 2450-252.} Chapter 6.
\textsuperscript{1292} \textsuperscript{But also the frameworks proposed by the OECD and the European Commission.}
\textsuperscript{1293} \textsuperscript{Such as, the compulsory dissemination of information and the adoption of specific governance structures.}

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Such an endeavour would, firstly, be hampered by the reluctance of relevant stakeholders\textsuperscript{1295} to be subjected to binding rules and, secondly, it would not prevent them from devising ways to evade the spirit of those rules following their adoption.\textsuperscript{1296} While it is true that the voluntary nature of the GAPP (and other CoCs) may not bring immediate results, it may serve to encourage the pre-existing tendency of SWFs to move towards greater transparency and accountability. Nevertheless, a number of amendments should be made to the current form of GAPP with a view to strengthening its effect and rendering it more efficient. In particular, the IFSWF should include a monitoring mechanism and a ‘comply and explain’ element, as found in the UK Corporate Governance Code, as well as an appendix to GAPP guiding the relationship between SWFs and target companies along the lines of the UK Stewardship code.\textsuperscript{1297} It is also stated that the functioning of the IFSWF would benefit considerably from developing links with financial market actors and regulators, and also from obtaining ‘affiliate’ status with the IOSCO.\textsuperscript{1298}

4. What does the future hold for SWFs and national regulations?

From the body of this work, a number of predictions can be made about the future of SWFs and their regulation. Firstly, SWFs will almost certainly continue to increase in number and size, as well as influence.\textsuperscript{1299} Therefore the debate on the impact and regulation of SWFs is expected to intensify in the future.

With regard to their investment strategies, SWFs are expected to show an increasing preference for joint ventures with private entities, as opposed to making individual investments.\textsuperscript{1300} Western policymakers can, moreover, benefit from the creation of partnerships between national investment funds and third country SWFs.

\textsuperscript{1295} Namely the SWFs and/or their managing governments.
\textsuperscript{1296} at 177-178.
\textsuperscript{1297} at 274.
\textsuperscript{1298} n 1225.
\textsuperscript{1299} at 45-47.
\textsuperscript{1300} n 380.
Sovereign investors are also likely to become more engaged with the management of their target companies, although not to an extent where they may raise concerns about the political involvement of foreign governments in the management of western corporations.\textsuperscript{1301} Moreover, SWFs will also seek to take advantage of developing economic sectors, for instance, by increasing their portion of capital allocated in the field of alternative energy.\textsuperscript{1302}

The tendency of SWFs towards greater transparency will probably continue, with existing SWFs scoring higher in future transparency ratings.\textsuperscript{1303} However, there is no guarantee that similar transparency will also apply to the early stages of future newly created funds.

Considering host economies, protectionist tendencies which, during the current economic uncertainty, have been silenced, will most likely revive in the future.\textsuperscript{1304} The EU Commission and the CJEU should continue to apply the same policies against national measures that restrict SWFs. At the same time, in the context of the debate on SWFs, the issue of global imbalances should be addressed through the use of appropriate tools, such as foreign diplomacy and macroeconomic policy.

\textsuperscript{1301} For instance, participating in voting procedures may be acceptable, although in many cases demanding board representation could appear more problematic.
\textsuperscript{1302} n 382, 383.
\textsuperscript{1303} Such as the Linaburg-Maudell Transparency Index, n 155.
\textsuperscript{1304} See, for instance, n 519.
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