

# China's Sovereign Wealth Funds: Problem or Panacea?

**Qingxiu Bu**\*

## Abstract

China's impressive economic growth has led to the accumulation of massive financial assets. The emergence of sovereign wealth funds (SWFs), as a governmental investment device for its excessive foreign reserves, symbolises a major rebalancing of economic power. With its investment portfolios drastically diversified for well-established financial institutions as well as some strategic sectors, a seminal debate seems centred on whether China's SWFs are in furtherance of purely commercial or geo-politically strategic purposes. Under the sophisticated hard laws associated with international initiatives, it is unlikely that the SWFs-related investment would distort the global financial system, and genuinely threaten national security, which assumption may only exist at a hypothetical level. The potential protectionism would inevitably retard the world economy's recovery, were it not to be proportionately addressed. A most significant necessity appears to be to strike a proportionate balance between sustaining the credibility of open investment environment and efficiently minimising implications of SWFs political arenas.

## Introduction

With the balance of global economic power shifting from west to east, the current financial crisis has rendered sovereign wealth funds (SWFs) as one of the primary sources of capital, which may change the economic and political landscape. China has created a far more sophisticated instrument of SWFs, which appears to blend political and financial welfare maximisation within a private-public system of economic organisation. When the interplay between the ownership and governing organs is taken into consideration, growing common fears have been sparked as to SWFs' potential use not only aiming at higher returns, but also pursuing geopolitical objectives. This might represent a potential threat to the national

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\* Dr Qingxiu Bu, LLM (magna cum laude, Soochow) LLM (Groningen) PhD (Birmingham), Lecturer in Law School of Law, Queen's University Belfast United Kingdom Email: [Q.Bu@qub.ac.uk](mailto:Q.Bu@qub.ac.uk); Adjunct Professor Centre of Transnational Legal Studies (CTLS London), Georgetown University

security of host countries. In this vein, the prominence of the state as an investor challenges legitimacy enshrined in the current international financial legal regimes. Regardless of multilateral approaches, such as the GAPP principles and OECD Guidelines made by international communities, there are key questions as to whether China's SWFs investments can be adequately-regulated under non-legal binding soft initiatives. The host countries' response in the form of hard laws might trigger the danger of sliding into protectionism. On the other hand, there is another side of the coin for SWFs, given a lack of any solid evidence suggests that SWFs have been used to undermine financial stability and compromise national security. Instead, evidence from the recent global financial crisis suggests the contrary. The perceived threats posed to host countries' national security seem to remain in the realm of the hypothetical. These tentative findings may enable the previous hypothesis to be challenged, in that the risks might have been overestimated. It is worth exploring these insights into the genuine potential problems related to the SWFs for the sake of stabilising global financial markets.

The paper starts with a general contextual setting where SWFs are conceived to be deployed strategically in pursuit of geopolitical goals, rather than based on purely commercial purposes. Part II ascertains that prerequisites to gaining insights into SWFs are clarification of the interweaving factors of state ownership, strategic investments and plausible resulting national security issues. Part III examines legal responses from both regional and national perspectives, given the challenge posed by SWFs for global monetary governance. Since most SWFs flows are directed towards the U.S. market, the U.S. legal parameters are particularly highlighted. Part IV articulates IMF and OECD's endeavours and underlies the fact that compliance with international initiatives is conducive to alleviate Western concerns. Part V briefly looks at whether the concerns could be mitigated through conservative SWFs

investments. The paper moves on to consider a few hypothetical issues in Part VI by explaining why the existing regulatory regimes in place could sufficiently screen out potentially threatening investments of SWFs, and considers whether the concerns remain in the realm of the hypothetical. In light of the lack of convincing empirical support for labelling the political dimension of SWFs, it is meaningful to examine what genuine risks are ahead in light of recipient countries' assessment of SWFs. A tentative conclusion would be that there is need to minimise the asymmetry of restrictions of SWFs investments and discretionary assessment criteria. It is advocated that sound corporate governance would be to the advantage of both SWFs holders and host countries, since it appears unrealistic to alter China's deep-rooted and combined model of integrating both political and commercial arenas. A most significant necessity appears to be to strike a proportionate balance between sustaining the openness of capital markets and efficiently reducing the implications of SWFs' political arenas. A well-framed corporate governance regime should underpin Chinese SWFs' efforts to gain trust and legitimacy in the global financial markets.

## **A Context**

The SWFs has been one of the hottest topics in global financial markets.<sup>1</sup> There is no universally accepted definition of a SWF. It was once defined as 'a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from official reserves of the monetary authorities.'<sup>2</sup> The International Monetary Fund (IMF) provides SWFs as

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<sup>1</sup> U Galani and S Nixon, 'Don't Fear the Sovereigns' *The Wall Street Journal* (26 January 2008) at B18

<sup>2</sup> U.S. Treasury Department, Remarks by Clay Lowery, Acting Under Secretary for International Affairs, on *Sovereign Wealth Funds and the International Financial System* (21 June 2007)

“Government-owned investment funds set up for a variety of macroeconomic purposes. They are commonly funded by the transfer of foreign exchange assets that are invested long term overseas.”<sup>3</sup>

If properly used, the SWFs may produce a stabilising force in the world’s financial system especially in the era of subprime and credit crisis.

Apart from the top priority for maintaining domestic stability and the survival of Chinese Community Party (CCP) regime, China has been investing heavily with its SWFs abroad to achieve both commercial and political aims. The soaring SWFs-based merger and acquisitions (M&AS) as well as equity investment is causing some unease and great suspicion among investment target nations, with a particular concern about the likely political impact of cross-border transactions. The creation of the China Investment Corporation (CIC) fuelled the heated debate as to whether China’s SWFs would serve as a source of market stability or a potential to disrupt the global financial market. In particular, Chinese SWFs have arguably been conceived as highly politicised, run in an opaque manner and used as an implementation of geopolitical strategies.

## **1. Sources of SWFs: Enormous Foreign Reserves**

Sustainable economic reforms associated with the policy of openness have generated rapid economic growth on a scale unprecedented in history. China has been accumulating rapidly a vast amount of international assets in the form of reserves and other holdings. Different from those nations’ dependence on raw-material export, the surplus is the consequence of the rapid transformation of China's economy under its dramatically successful policies of economic and financial reform over the past three decades. China has been experiencing a major inflow

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<sup>3</sup> M Allen and J Caruana, The Monetary and Capital Markets and Policy Development and Review Department ‘International Monetary Fund, Sovereign Wealth Funds-A Work Agenda’ (29 February 2008) 4

of foreign exchange due to its merchandise trade surplus and the continuing stream of foreign direct investment. The combination of China's net foreign direct investments (FDIs) inflows and overall trade surplus is financing the growth of its foreign exchange reserves.<sup>4</sup> Relying on an export-led growth model, China surpassed Germany to become the world's third largest economy in 2007 and world's biggest exporter in 2009<sup>5</sup>. China's economy is set to outpace Japan's in 2010 after growing a whopping 10.7% in the fourth quarter of 2009 at an annual rate of an impressive 8.7%.<sup>6</sup>

SWFs are ultimately bound to be the by-product of globalization opening a new path for China to better utilize its growing large balance of payments surpluses. The SWFs symbolise so clearly the shift in the balance of economic power to the emerging markets. The holding of governments' bonds appears highly liquid and safe but yield relatively low returns. It is not in China's long-term interests to divert domestic savings to accumulate low-yielding US debt.<sup>7</sup> The U.S. dollar depreciation along with the mounting-up opportunity cost of holding foreign exchange has precipitated the shift to riskier and potential higher return investments in equities or corporate merger and acquisitions (M&As),<sup>8</sup> which falls outside national regulatory regimes. The transformation is causing some unease among investment target nations,<sup>9</sup> with a particular concern about the likely political impact of these transactions.<sup>10</sup> The high-profile concern seems to be China's concealing of its attempts to obtain technology, resources, or expertise to benefit national strategic interests.

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<sup>4</sup> By the end of March 2008, Chinese foreign exchange reserves had reached U.S.\$1.68 trillion (SAFE 2008)

<sup>5</sup> John W Miller and Marcus Walker, 'China Dethrones Germany as Top Goods Exporter' *Wall Street Journal* (6 January 2010)

<sup>6</sup> A McCabe, 'China Set to Surpass Japan as World's Second Largest Economy' *Financial Post* (21 January 2010)

<sup>7</sup> James A. Dorn, 'Nationalistic Barriers' *South China Morning Post* (13 December 2007)

<sup>8</sup> 'China Allowed to Raise Stake in Blackstone' *New York Times* (16 October 2008); 'CIC to Invest \$500 million in Blackstone Fund' *Reuters* (19 June 2009)

<sup>9</sup> 'Asset Backed Insecurity' *The Economist* (17 January 2008)

<sup>10</sup> K Pistor, 'Sovereign Wealth Funds, Banks and Governments in the Global Crisis: Towards a New Governance of Global Finance?' (2009) 10 *European Business Organisation Law Review* 333, 352 at 337

To cater to the dramatic change, China set up its major SWF, the China Investment Corporation (CIC), on 29 September 2007, with assets worth \$200 billion to manage more aggressively a portion of China's over \$2.5 trillion in foreign reserves.<sup>11</sup> The establishment of CIC represents a ground-breaking attempt to diversify the investment of China's foreign exchange reserves more effectively. The CIC diversifies its investment portfolio in the global financial market to increase the risk-adjusted return on the external financial assets.<sup>12</sup> The strategic diversification may yield higher return and reduce the exposure to dollar fluctuation and interest rate instability.

## 2. Global Financial Crisis

SWFs' investment has increased exponentially since the outbreak of the subprime crisis in the summer of 2007, which may change the economic and geo-political landscape,<sup>13</sup> heralding a global power shift from the West to East. The global financial crisis has had a profoundly positive effect on China's SWF, to a certain extent, alleviating some of the CIC's international political problems. China's large stocks of foreign exchange reserves offer an effective insurance against capital account crisis.<sup>14</sup> The traditional long-term approach to investing has had a stabilising influence on global financial markets. The SWFs came at a critical time when risk-taking capital was scarce and market sentiment was pessimistic.<sup>15</sup>

Chinese SWFs' favourite target has been financial institutions. Morgan Stanley, for instance,

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<sup>11</sup> Bob Davis, 'Wanted: SWFs' Money Sans Politics' *Wall Street Journal* (20 December 2007)

<sup>12</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 (5) *Stanford Law Review* 1345, 1370 at 1348

<sup>13</sup> As Summers said, the cross-border SWFs have reversed the trend toward privatisation that swept over the globe in the past quarter century; L Summers 'Sovereign Funds Shake the Logic of Capitalism' *Financial Times* (30 July 2007) 9

<sup>14</sup> T Kato, 'Implications for Asia from the Global Financial Crisis and Policy Perspectives' Harvard Asia Business Conference (14 February 2009) accessed 6 February 2010

<sup>15</sup> LC Backer, 'Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience' (2009) 19 (1) *Transnational Law & Contemporary Problems* 101, 294 at 117

raised another \$1.2 billion from the CIC, which had invested \$5 billion to acquire a 9% stake in December 2007. With China's SWFs maturing into most influential strategic investors, the recession appears to have accelerated the trend toward a multi-polar world. Meanwhile, such SWFs may take advantage of western markets' predictable financial and legal systems, and acquire skills and brands that China would be unable to develop expeditiously.<sup>16</sup>

As the primary source of fresh capital for financial intermediaries, the global crisis has made SWFs explicit stakeholders in the financial system, which also gives substantial leverage.<sup>17</sup>

Although the fund struggled to overcome a series of managerial, financial, and geopolitical hurdles upon its creation, the financial crisis set the stage for a remarkable transformation. The financial crisis intensified the need for a less imposing system of regulation of inbound investment by sovereign entities.<sup>18</sup> The prevalent global financial problems have, to some extent, calmed down the critics over SWFs' motivation. Objectively, the global recession has provided China's SWFs with cover to invest in a way that met both their commercial incentives and China's political strategic goals. CIC has been able to invest in resource and commodity firms without drawing geopolitical attention. Nevertheless, it is still too early to say that the landscape for SWFs has been altered substantially by the great financial crisis. A paradoxical concern is still focused on whether the SWFs investments are driven by commercial or political motives.<sup>19</sup>

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<sup>16</sup> Jason Bui, 'Negocio de China: Building upon the Santiago Principles to form an Effective International Approach to Sovereign Wealth Fund Regulation' (2009) 39 (1) Hong Kong Law Journal 197, 217

<sup>17</sup> K Pistor, 'Sovereign Wealth Funds, Banks and Governments in the Global Crisis: Towards a New Governance of Global Finance?' (2009) 10 European Business Organisation Law Review 343, 351

<sup>18</sup> W Schomberg and D Lawsky, 'EU to Consider Sovereign Wealth Fund Voluntary Code' *Reuters* (23 February 2008)

<sup>19</sup> R Schroeder, 'Policy Needed for Sovereign Funds, Paulson Says' *Market Watch* (20 October 2007)

### 3. Paradoxes

With the world's current financial stability on the decline, the SWFs raise profound implications over the international financial system in terms of SWFs' *pros and cons*. China's SWFs appear to be providing a source of stability since struggling major financial firms have received much needed injections of capital.<sup>20</sup> Meanwhile, the investment strategies underlying these SWFs are perceived to be driven by political rather than pure business determinants.<sup>21</sup> China's SWFs are facing increased skepticism and scrutiny in the West due to fears that they blurred the line between finance and politics.

#### *(a) Pros: Softening the Global Financial Crisis*

Given the positive role the SWFs are taking as providers of much-needed liquidity, the SWFs are likely to have a stabilising rather than a disruptive effect on international financial markets.<sup>22</sup> The capital infusions through SWFs have softened the effects of the subprime mortgage crisis, lowering the cost of equity and reducing long-term U.S. interest rates.<sup>23</sup> The SWFs also provide U.S. companies and investors with better access to emerging markets.<sup>24</sup>

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<sup>20</sup> CIC invested \$5 billion in Morgan Stanley on 19 December 2007, not long after the financial firm announced it was writing off \$9.4 billion of loss-making mortgage investments.

<sup>21</sup> LC Backer, 'Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law' (2008) 82 (5) *Tulane Law Review* 1801, 1868 at 1859

<sup>22</sup> Nuno Fernandes, 'Sovereign Wealth Funds: Investment Choices and Implications around the World' <<http://ssrn.com/abstract=1341692>> accessed 28 March 2010: Using data on over 21,000 SWF holdings between 2002 and 2007, Fernandes finds that firms with higher SWF ownership have a stabilizing effect on financial markets.

<sup>23</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 (5) *Stanford Law Review* 1345, 1368

<sup>24</sup> 'Sovereign Wealth Funds: Asset-backed Insecurity' *The Economist* (17 January 2008)

The SWFs contribute stabilising the global financial system and underpin confidence as a whole through offering a fresh source of investment and market liquidity.

‘The sovereign funds are safer and less risky owners than private equity because they can live with lower leverage and lower returns.’<sup>25</sup>

The IMF First Deputy Managing Director John Lipsky observed that:

‘From the viewpoint of international financial markets, SWFs can facilitate a more efficient allocation of revenues for, commodity surpluses across countries and enhance market liquidity, including at times of global stress.’<sup>26</sup>

SWFs most frequently have long-term investment horizons and rarely place investments with leveraged funds.<sup>27</sup> Meantime, the heavy SWFs investment makes China have a direct stake in its continuing prosperity and thus SWFs may promote better political relations through stronger economic ties.<sup>28</sup> The SWFs, as a catalyst, are driving China’s capital markets to integrate into the global mainstream, which renders market liberalism to take a solid hold in China.

#### (b) Cons

Although conceived as a critical factor in the recovery from the global economic downturns of 2008,<sup>29</sup> there is dissonance on its possible negative facets:

‘SWFs might pose a threat to the integrity of global markets because SWFs do not play by the same rules applicable to private investors and on which the markets are traditionally constructed.’<sup>30</sup>

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<sup>25</sup> Henry Sender, ‘Silence Not Golden for Sovereign Funds’ *Financial Times* (London, 17 January 2008)

<sup>26</sup> IMF Survey, ‘IMF Intensifies Work on Sovereign Wealth Funds’ *IMF Survey Magazine* (4 March 2008) <<http://www.imf.org/external/pubs/ft/survey/so/2008/POL0348A.htm>> accessed 18 March 2010

<sup>27</sup> Clay Lowery, Acting Under Secretary for International Affairs, ‘Sovereign Wealth Funds and the International Financial System (21 June 2007) <<http://www.treas.gov/press/releases/hp471.htm>> accessed 21 March 2010

<sup>28</sup> Mark E. Plotkin, ‘Foreign Direct Investment by Sovereign Wealth Funds: Using the Market and the Committee on Foreign Investment in the United States together to Make the United States More Secure’ (2008) 118 *Yale Law Journal Pocket Part* 89

<sup>29</sup> P Rose, ‘Sovereigns as Shareholders’ (2008) 87 *North Carolina Law Review* 83, 93

The SWFs portfolios' shifting to more diversity than traditional reserves holdings has stoked fear that China might pursue geopolitical goals. What really matters is the *de facto* extent to which the SWFs are a tool of politics. What leverage the Chinese will build with these governments or what access to natural resource reserves that will gain is a political question open to speculation.<sup>31</sup> The next section highlights the conceived threats arising from SWFs and their implications.

## **B Are China's SWFs investment politically & strategically driven?**

China's vast SWFs are suspected to be managed in furtherance of political agendas. CIC's inseparable affiliation with a communist regime may have aggravated more suspicion apart from serious concerns stemming from its opaque nature in SWFs investments. Recent high-profile investments by SWFs have given rise to various concerns, such as transparency, national security, and protectionist measures. As Markheim observed, the enormous financial leverage might be deployed in ways that would compromise those host countries' national security.<sup>32</sup> Such arguments seem consistent with Gilson and Mishaupt's finding that "government attempts to ensure that company-level behaviour results in country-level maximisation of economic, social and political benefits."<sup>33</sup> Prerequisites to gain SWFs' insight are to clarify interweaving logics between state ownership, strategic investments and plausible resulting national security issues.

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<sup>30</sup> J Heskett, 'What is the Future of State Capitalism' Harvard Business School–Working Knowledge (2 May 2008)

<sup>31</sup> SR Weisman, 'Overseas Funds Resist Calls for a Code of conduct' *New York Times* (9 February 2008)

<sup>32</sup> Daniella Markheim, 'Sovereign Wealth Funds and U.S. National Security' (March 2008) <[www.heritage.org](http://www.heritage.org)> accessed 13 March 2010

<sup>33</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 (5) *Stanford Law Review* 1345, 1346

## 1. Is Chinese SWFs' state ownership intertwined with strategic investments?

State intervention might constitute the sort of impediment to the international financial market, which is particularly applied to China having a history of mixing politics and business.<sup>34</sup> The prevalent and dominant state ownership is undertaken in the form of the State Administration of Foreign Exchange (SAFE). SWFs have been commonly perceived as facilitating the pursuit of strategic objectives, such as access to energy resources, geopolitical influences and high-technology that China would not be able to develop expeditiously on its own.<sup>35</sup> It is conceived that SWFs' diversification into higher-yielding assets itself reflects Chinese political options and national policies.<sup>36</sup> A most controversial issue arises as to whether it is possible to isolate the political aims from commercial objectives.

### *(a) State ownership*

Although Keynes held that international cash flows are always political,<sup>37</sup> what a receipt state usually craves for is that SWFs' investment decision-making gets independent from Chinese government. The Westerners are not accustomed to government ownership, and it seems opaque in terms of China's traditional state ownership, motives and decision-making process.<sup>38</sup> Epstein and Rose arguably opined that U.S. has determined not to accumulate sovereign wealth for equity investment purposes based on the belief that private investment is

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<sup>34</sup> Dianna Farrell, Susan Lund and Koby Sadan, 'The New Power Brokers: Gaining Clout in Turbulent Markets' (McKinsey Global Institute, San Francisco 2008) 18

<sup>35</sup> J Politi, 'Sovereign Funds Face US Threats' *Financial Times* 14 February 2008

<sup>36</sup> Cornelia Hammer, Peter Kunzel and Iva Petrova, 'Sovereign Wealth Funds: Current Institutional and Operational Practices' (2008) IMF Working Papers WP/08/254 1, 22

<<http://www.imf.org/external/pubs/ft/wp/2008/wp08254.pdf>> accessed 26 March 2010

<sup>37</sup> JM Keynes, 'National Self-Sufficiency' (1933) 22 (4) *The Yale Review* 755, 769

<sup>38</sup> Mark Plotkin, 'Foreign Direct Investment in the United States together to Make the United States More Secure' (2008) 118 *Yale Law Journal Pocket Par* <<http://the-pocketpart.org/2008/11/17/plotkin.html>> accessed 12 March 2010

likely to produce greater returns and then greater national prosperity.<sup>39</sup> The SWFs run contrary to the longstanding conception of promoting a private sector and market-based global financial system. Bremmer was even concerned with re-emergence of “state capitalism” which would reverse the privatisation that industrialised economies have been undertaking for past decades.<sup>40</sup> Another similar pessimistic observation was made that “the era of free market unleashed by Margaret Thatcher and reinforced by Ronald Reagan in the 1980s is fading away.”<sup>41</sup> In particular, the tenets of socialism with Chinese characteristics may not be compatible with the Western norm of corporate governance. Such suspicion might well be interpreted as to whether China’s government will seek to advance political objectives and further to level the playing field via their SWFs-related investments. As Buiter observed:

“[I]f and to the extent that these SWFs are large enough to be systemically important, a failure by one or more of them-or even a significant loss suffered by one or more of them-could drag a significant number of counterparties in to the abyss and thus endanger financial stability worldwide.”<sup>42</sup>

As one of the most prominent SWFs in the world, CIC is a sole ministry-level state-owned enterprise (SOE) under the direct auspices of the State Council.<sup>43</sup> CIS’s outbound investment implements the latter’s strategic policies in a commercial or financially prudent manner.<sup>44</sup> Inevitably, the SWFs investment has been integrating into China’s political interests in a way that is grounded in the notion of advancing state interests in a profit maximising way.

*(b) Government/Regulators vs. Private Sectors*

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<sup>39</sup> Richard A. Epstein and Amanda M. Rose, ‘The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow’ (2009) 76 *The University of Chicago Law Review* 111, 134 at 125

<sup>40</sup> I Bremmer, ‘State Capitalism Comes of Age’ *Foreign Affairs* (May/June 2009)

<sup>41</sup> Jeffrey Garten, ‘How to Live with the Reality of State Capitalism’ *Financial Times* (15 January 2008)

<sup>42</sup> W Buiter, ‘Taming Sovereign Wealth Funds in Two Easy Steps’ *Financial Times* (22 July 2007)

<sup>43</sup> The CIC is responsible directly for China’s State council, which is the highest executive and administrative body, conferring it with a cabinet ministerial standing.

<sup>44</sup> LC Backer, ‘Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience’ (2009) 19 (1) *Transnational Law & Contemporary Problems* 101, 294 at 282

The divisions on which the current regulatory framework is based—public versus private, political versus commercial—may no longer serve as a touchstone of economic activity by states.<sup>45</sup> This would inevitably generate more problems and ambiguities in OECD countries' investment review process.<sup>46</sup> There is a general concern that private investors may be at systemic disadvantages because SWFs have access to information that is barred from the public. As Cox observed,

“It is the asymmetry of access to information between the market participants that might ultimately dissuade participation in markets, which would be problematic.”<sup>47</sup>

If private investors believe they are at an informational disadvantage, this could cause them to lose confidence in the markets and could even theoretically cause a market collapse.

A most highly-debated concern arises as to whether CIC's operation could be based on purely commercial grounds or used to achieve Chinese political or strategic goals, with the latter one likely undermining confidence in global capital markets. China attempts to ensure that using SWFs may maximise its national multiple geo-political, as well as economic strategies, such as competing more effectively, extracting technology and achieving influence. The investment coordination in financial or wealth maximization is blended with political objectives directed by the state. CIC is perceived to necessarily act to maximise its political

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<sup>45</sup> J Xiang, 'Inevitability and Necessity to Develop SWFs in China' (2009) *International Journal of Business & Management* 82, 83

<sup>46</sup> DH Rosen and T Hanemann, 'China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications' (Policy Brief, No. PB09-14, 2009) Peterson Institute for International Economics <<http://www.iie.com/publications/pb/pb09-14.pdf>> accessed 10 February 2010

<sup>47</sup> Christopher Cox, Chairman of the SEC, 'The Role of Government in Markets' (John F. Kennedy School of Government, Harvard University, 24 October 2007) <<http://www.sec.gov/news/speech/2007/spch102407cc.htm>> accessed 29 March 2010

capital, and cannot participate in the market in the same way as a private individual.<sup>48</sup> Despite its separate legal entity status under the Company Law 2006,<sup>49</sup> the Communist Party Committee seated with the CIC is bound to render it inherently political.<sup>50</sup> This internal structure almost assures that its investment decisions will be far more politicised than the management of China's formal reserves by the central bank. Conflict of interests may arise when the government supposed to be a regulator for public interest, becomes an investor. At the current stage, it seems unrealistic for CIC to ensure that political criteria do not influence the investment decision. With the Chinese government typically owning significant stakes, it is hardly possible to separate SWFs with strategic motives from those SWFs with purely investment motives.<sup>51</sup> The disguising of political intervention through SWFs investments may negatively impact the integrity of the global financial market.

*(c) The Strategic Investment*

It is worth examining the unique model characterised through an investment strategy that is economically driven but targeted to China's political objectives.<sup>52</sup> Given the multipurpose entity of the CIC with political and commercial objectives combined, there are legitimate concerns that SWF investment may be motivated by non-economic considerations, deviating

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<sup>48</sup> LC Backer, 'Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law' (2008) 82 (5) *Tulane Law Review* 1801, 1868 at 1866

<sup>49</sup> Company Law 2006 Article 3

<sup>50</sup> 'China's Trillion-Dollar Kitty is Ready' *Asia Times* (2 October 2007)

<sup>51</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 *Stanford Law Review* 1365

<sup>52</sup> X Ping and C Chao, 'Sovereign Wealth Funds, Macroeconomic Policy Alignment and Financial Stability' (21 November 2008) <<http://ssrn.com/abstract=1420614>> accessed 10 February 2010

from conventional wealth maximisation.<sup>53</sup> SWFs may be subject to the arbitrary influence of the Chinese government despite its own statement that:

“[C] IC will deal with its SWFs investment independently by persisting in the principle of separating government functions from company management.”<sup>54</sup>

The above claim that ‘the mission for the CIC is purely investment-return driven’<sup>55</sup> may not readily root out the likely political impact on potential transactions, resulting in certain unease against host countries’ national security. Inescapably, the acquisition of skills, brands and technology will be taken into consideration, although China claimed that the CIC’s investment will not aim at obtaining advanced technology.<sup>56</sup>

However, Cohen argued over two decades ago that “high finance can no longer be kept separate from high politics,”<sup>57</sup> which hypothetically renders it impossible to explicitly distinguish the boundaries of the economical and political transaction structures. Realistically, it seems almost impossible for CIC to operate immune from potential political interference without the imposition of some form of international mandatory rules. China’s SWF emergency serves as the best annotation to Cohen’s observation, which suggests the way in which political objectives for economic activity can be harmoniously mixed with profit maximization to deepen a new form of investing that is neither entirely private nor wholly public. The line between political and financial power is becoming increasingly blurred,<sup>58</sup>

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<sup>53</sup> J Aizenman and R Glick, ‘Sovereign Wealth Funds: Stylized Facts about Their Determinants and Governance’ *NBER Working Paper 14562* (Cambridge MA: National Bureau of Economic Research, 2008) 23

<sup>54</sup> ‘China Should Beware a Backlash’ *Financial Times* (24 July 2007)

<sup>55</sup> J Dean and A Batson, ‘Beijing to Take Passive Investment Approach’ *Wall Street Journal* (10 September 2007)

<sup>56</sup> K Bradsher, ‘\$200 Billion to Invest, But in China’ *The New York Times* (29 November 2007)

<sup>57</sup> B J Cohen, *In Whose Interest? : International Banking and American Foreign Policy* (New Haven , London, Yale University Press, 1986)

<sup>58</sup> Y Funabashi, ‘Keeping up with Asia: America and the New Balance of Power’ (2008) 87 *Foreign Affairs* 110; LC Becker, ‘Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Global Governance through Private Global Investment’ (2009) 40 *Georgetown Journal of International Law* 101, 217 (Becker challenged conventional boundaries between ‘private’ investment and ‘public’ responsibility for global financial stability.)

and implications for global financial markets remains unascertainable. Even if Chinese SWFs' operations are driven by a variety of factors, including political considerations in addition to their commercial motives, they would be evaluated on their own merits and could potentially be viewed as 'legitimate' and 'trustworthy', were their operating to be in accordance with the best governance standards. Undoubtedly, the CIS does attempt to achieve both commercial and political aims, *de facto* in compliance with a motto prevailing in China's socialist market economy, that finance and markets are now high politics. It is worth considering the consequence of whether such an approach would be bound to threaten host countries' national security.

## **2. National Security**

The rise of SWFs raises legitimate concerns in recipient countries about protecting national security,<sup>59</sup> which rationale ostensibly justifies certain restrictions of access to sensitive areas. The recent emergency of a Chinese SWF with initial capital of \$200 billion has posed delicate economic and security concerns. Of greater concern are the perceived threats to national security<sup>60</sup> and strategic industries through leveraging the SWFs to gain sensitive technologies and scarce resources or even increasing unjustified international influence. Meanwhile, it is of vital significance for the host state to define clearly perimeters of "national security" to underpin legitimacy for the deployment.

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<sup>59</sup> C Ervin, 'Sovereign Wealth Funds: Should sovereign wealth funds be treated differently than other investors?' *OECD Observer* (May-June 2008)

<sup>60</sup> Ilene Knable Gotts and Leon Greenfield, 'Does the U.S. Foster national Champions? Foreign Acquisitions and National Security' (2007) 10 (3) *Global Competition Review* 2

The SWFs may aim to obtain expertise and technology while gaining foothold for the new market share. Fears are raised of a foreign entity's potential to influence the action of the target, especially perceived as vital to national security. Summers raised a similar concern:

“The logic of the capitalist system depends on shareholders causing companies to act so as to maximise the value of their shares. It is far from obvious that this will over time be the only motivation of government as shareholders. They may want to see their national companies compete effectively, or to extract to technology or to achieve influence.”<sup>61</sup>

The general scepticism converges into to a hot debate as to the role of the Chinese government, as SWFs' predominant owner. A hearing was held to examine the nature of Chinese SWFs and whether Chinese investments should be treated differently so as to protect the US' national security.<sup>62</sup> Such endeavours aim to ensure that SWFs are transparent and seek economic, rather than political gains. International standards may help to mitigate national security concerns from SWFs. An international regulatory regime is highly demanded to guard against the uncertainties of a governance vacuum in global finance, which is to be discussed in the Part C. 2 below.

### **3. Transparency: Are SWF's objectives clearly communicated?**

Transparency is the core of accountability,<sup>63</sup> which facilitates the maintenance of SWFs openness in furtherance of alleviating the risk of political influences. Greater information disclosure can help alleviate recipient countries' suspicion and build trust between SWFs owners and recipient countries. SWFs would clearly inspire more confidence in host

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<sup>61</sup> L Summers, 'Sovereign Funds Shake the Logic of Capitalism' *Financial Times* (30 July 2007)

<sup>62</sup> U.S.-China Economic and Security Review Commission, 'Hearing on China's Views of Sovereignty and Methods of Access Control' (27 February 2008) <<http://www.uscc.gov/hearings/2008hearings/hr080227.php>> accessed 12 March 2010

<sup>63</sup> Edwin M. Truman, 'A Scoreboard for Sovereign Wealth Funds' in the "Conference on China's Exchange Rate Policy" (Peterson Institute, Washington, DC, 19 October 2007) <<http://www.iie.com/publications/papers/truman1007swf.pdf>> accessed 19 March 2010

countries if they were more transparent and had stronger corporate governance, which is why the fact that the Chinese government owns these SWFs assets raises a controversy that the investment decision is guided by political, rather than economic considerations.<sup>64</sup> Despite the reassurances provided by the CIC, it seems unconvincing due to the lack of a clear investment strategy that is free from political influences and the degree to which China will make the CIC transparent is uncertain.<sup>65</sup>

At the current stage, there is an international standard for disclosure of reserve holdings, to which China does not adhere. The opacity of SWFs has been a key focus of western critics, who fear politically-driven investment decisions by largely autocratic states.<sup>66</sup> Controversies seem to arise from conflicting perception of state capitalism and market capitalism.<sup>67</sup> Such a tension can be contributed to the lack of transparency of objectives,<sup>68</sup> which may mask market abuses and further raise the cost of capital.<sup>69</sup> For instance, CIC's articles of association have not been made public, so the mandated objectives, structure and constitution are still unknown.<sup>70</sup> The problem is exacerbated because an SWF's motives for investing cannot be accurately observed.<sup>71</sup> Concerns have been expressed about their multiplicity of objectives, making it difficult to assess the SWFs' activities and their impact on global capital

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<sup>64</sup> J Politi, 'Sovereign Funds Face U.S. Threat' *Financial Times* (14 February 2008)

<sup>65</sup> There is insufficient information on how the CIC's earnings are employed, decisions not made exclusively by managers no systematic information published on the location of CIC investments, no annual report released to date, no audit released to date, no policy on the use of leverage publicly released and no policy on the use of derivatives publicly released.

<sup>66</sup> Robin Wigglesworth, 'IMF Guidelines Spur Steps towards Transparency' *Financial Times* (18 March 2010)

<sup>67</sup> PS Goodman and L Story, 'Overseas Investors Buying U.S. Holdings at Record Pace' *New York Times* (20 January 2008)

<sup>68</sup> The SWF Institute located in California of the USA has developed a Linaburg–Maduell transparency index to evaluate the transparency of global SWFs. Among the global top SWFs, the transparency score of CIC is the lowest.

<sup>69</sup> K Scannell, 'Cox Cites Concerns over Sovereign Funds' *Wall Street Journal* (25 October 2007)

<sup>70</sup> C Chance, 'China's Sovereign Wealth Fund Takes Shape' *Asian Investor* (22 February 2008)

<sup>71</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 (5) *Stanford Law Review* 1345, 1369 at 1364

markets.<sup>72</sup> Another concern is that China may use these investments to advance their own national interests.<sup>73</sup> The lack of transparent and verifiable decision-making process, governance and investment strategy has triggered considerable concerns among China's major targeting host countries.<sup>74</sup>

The inherent failure to disclose is likely to produce and perpetuate inherent market instability and hide systemic risks, and even lead to investment restrictions. While SWFs have little incentive to disrupt markets, the lack of transparency will create competitive difficulties for other market participants, which could trigger disruptions in financial markets.<sup>75</sup> Gilson and Milhaupt suspect that the Chinese government, acting through SWFs with direct ownership of operating companies, seeks to level the playing field.<sup>76</sup> EC President Jose Manuel Barroso raised a similar concern:

“We cannot allow non-European funds to be run in an opaque manner or used as an implement of geopolitical strategy...By contrast, Norway's SWF is often perceived as the gold standard of sovereign wealth funds...”<sup>77</sup>

Notably, a wave of protectionist sentiment might be fuelled by the untransparent SWFs-related investments, which may further lead to the erection of new barriers to cross-border capital flows.

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<sup>72</sup> CE Schumer, ‘Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?’ Hearing before a Joint Economic Committee, 110<sup>th</sup> Congress (3 February 2008)

<sup>73</sup> International Financial Service London (IFSL) Research Sovereign Wealth Funds (April 2008) <[www.ifsl.org.uk/upload/CBS\\_Sovereign\\_Wealth\\_Funds\\_2008.pdf](http://www.ifsl.org.uk/upload/CBS_Sovereign_Wealth_Funds_2008.pdf)> accessed 18 July 2010

<sup>74</sup> E Bayh, ‘Time for Sovereign Wealth Fund Rules’ *Wall Street Journal* (13 February 2008); HR Clinton, ‘The Invasion of the Sovereign-Wealth Funds’ *The Economist* (17 January 2008)

<sup>75</sup> R Beck and M Fidora, ‘The Impact of Sovereign Wealth Funds on Global Financial Markets’ (2008) 43 (6) *Review of European Economic Policy* 349-358

<sup>76</sup> RJ Gilson and CJ Milhaupt, ‘Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism’ (2008) 60 *Stanford Law Review* 1346

<sup>77</sup> Rory Watson, ‘Europe Looks to Set Ground Rules for Sovereign Wealth Funds’ *Business Times* (27 February 2008)

Transparency reduces the likelihood of future governance problems. The appropriate level of transparency would provide a disciplinary effect on the management of SWFs, promote accountability and reduce incentives for government intervention.

“Great information disclosure in area such as purpose, investment objectives, institutional arrangements and financial information... can reduce uncertainty and build trust in recipient countries.”<sup>78</sup>

SWFs would have to be forced to comply with extremely strict rules on accounting and disclosure. However, the rising power enjoys a high degree of freedom to customise their political and economic policies rather than fully adopting Western norms. It remains reasonably challenging as to whether it is appropriate to judge SWFs based on levels of transparency and whether it would be reasonable to demand full transparency.<sup>79</sup> In this sense, it remains doubtful as to whether China’s SWF could operate with a high degree of transparency utilising an investment strategy based on commercial principles.

The biggest concern seems to be not the potential for political shenanigans but uncertainties about how SWFs-related issues might affect the financial markets,<sup>80</sup> such as how to alleviate a wave of protectionist sentiment in the host countries. Since China’s SWFs are intimately tied to political interests, there is ambiguity over their performance objectives and they thus face more strict regulations and even rejection from certain host countries. A global regulatory approach to SWFs with a premium on transparency, predictability and accountability should be put as a high priority to govern investments in relation to SWFs.<sup>81</sup>

The potential multilateral approach may provide a dramatic reappraisal of how to reduce systemic economic risk, including serving to safeguard potential protectionism.

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<sup>78</sup> Y Otaiba, ‘Our Sovereign Wealth Plans’ *Wall Street Journal* (19 March 2008)

<sup>79</sup> Christopher Cox, Chairman, Securities and Exchange Commission, ‘The Rise of Sovereign Business’ (Gauer Distinguished Lecture in Law & Policy at the American Enterprise Institute Legal Centre for the Public Interest, 5 December 2007) <[www.sec.gov/news/speech/2007/spch120507cc.htm](http://www.sec.gov/news/speech/2007/spch120507cc.htm)> accessed 29 March 2010

<sup>80</sup> A Closer Look at Sovereign Wealth Funds: Secretive, Powerful, Unregulated and Huge (11 January 2008) Knowledge at Wharton <<http://www.whartonsp.com/articles/article.aspx?p=1156965>> accessed 8 March 2010

<sup>81</sup> PT Larsen, ‘Call for SWFs to Agree Code of Conduct’ *Financial Times* (23 January 2008)

## **C Global Regulatory Regime: A Top priority on the Agenda?**

China's SWFs soaring investment in global financial markets has been increasingly reigniting protectionist fears, which have exerted a significant impact on these funds' investment ability. Historic changes in the global economic and financial landscape require corresponding shifts in the global regulation. Such a tension has fostered calls for greater monitoring and regulation of recipient countries' behaviour as well as those of SWFs at a multinational level. As mentioned above, SWFs' investment decision-making should be based on commercial grounds, rather than to advance geopolitical purposes. In the interests of the stability and openness of the international financial system, IMF and OECD have been working on initiatives, of which the GAPP and OECD Guidelines aim to forestall any movement towards an undesirably protectionist trend. They are specifically designed to establish 'trust' between SWFs and recipient countries, advancing a governance framework for the best practice. The former developed a code of conduct for SWFs with the focus on transparency to allay host countries' scepticism; while the latter worked out guidelines for recipient countries to ensure predictable investment framework so as to formalise the risk assessment criteria in reviewing security processes. The next part analyses whether internationally agreed principles could reinforce a balance between restricting SWFs and maintaining an open capital movement environment, through making SWFs more transparent and accountable to participants in financial markets.

### **1. GAPP/Santiago Principles**

In order to facilitate the development of a best practice code of conduct to govern SWFs, the IMF coordinated the creation of the International Working Group (IWG) on SWFs in May

2008. The IWG, in which China participated, <sup>82</sup> recently published twenty-four voluntary principles known as the ‘Generally Accepted Principles and Practices’ (GAPP) for SWFs or ‘Santiago Principles’.<sup>83</sup> It is agreed that an internationally agreed standard to guide SWFs’ management would alleviate tensions between the SWFs owners and recipient countries. IWG describes the purpose of the GAPP as being to

“[I]dentify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability and arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis.”<sup>84</sup>

The principles appear to adjust SWFs’ investment policy based on economic and financial grounds,<sup>85</sup> which reinforce and ensure politics are immunised from SWF investment decisions. The GAPP attempts to ensure reasonable standards of transparency and independence from political and non-economic motivations.

“SWFs-related investment decisions should aim to maximise risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds”<sup>86</sup>

The SWF should also publicly disclose its governance framework and objectives as well as the methods that maintain its independence.<sup>87</sup> If properly achieved, the independence requirement would be conducive to mitigating the risk that the SWF makes investment decisions on perceived geopolitical goals. The criteria will look at the corporate governance practices of SWFs and whether these entities will operate on a “non-commercial” basis. The goals aspire to align SWF internal governance with Western expectations, which are

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<sup>82</sup> ‘IMF Urges Action on Sovereign Wealth’ *Financial Times* 24 January 2008; China’s participation, at least, reflects its willingness to work with the IMF and other member states to seek a transnational-level solution to address concerns about the SWFs investments.

<sup>83</sup> Articles 1-5 cover legal framework and objectives; Articles 6-17 provide governance structure and the remaining is about investment and risk management issues.

<sup>84</sup> IWG, ‘Sovereign Wealth Funds: Generally Accepted Principles and Practices -Santiago Principles (October 2008) 4

<sup>85</sup> Santiago Principles Article 19

<sup>86</sup> Santiago Principles Art 19; IWG, ‘Sovereign Wealth Funds: Generally Accepted Principles and Practices-Santiago Principles’ (October 2008) 4 <<http://www.iwg-swf.org/pubs/gapplist.htm>> accessed 13 March 2010

<sup>87</sup> Santiago Principles Art 16

equipped with a set of screening criteria that can be used by regulators to judge foreign SWFs' investment.

The internationally agreed voluntary codes of conduct are seen as the most effective and proportionate way to address concerns over possible risks that the cross-border operations of some SWFs which could interfere with the normal functioning of market economies.<sup>88</sup> The GAPP represents an attempt at the transnational level to produce voluntary regulation, serving as a benchmark for SWF-related investment behaviour, and represents a remarkable step of successful multilateral collaboration. While the initiatives are voluntary their implementation subject to home country laws – their makeup suggests that governance is an important component in overcoming legitimacy. Indeed, these principles seek to align SWFs' principles and practices with Western normative expectations. The international initiatives are conducive to helping China build its own institutional capacity as well as to help shape the emergence governance structure of multi-polar global finance. The initiatives offer the most promising way to increase the accountability of SWFs' activities. At least, the participants can distinguish themselves as positive players in the playing field by signing on to the best practises.<sup>89</sup>

Ideally, CIC would be motivated exclusively by long-term growth and a higher return on invested capital rather than geopolitical concerns. A bottom-line should be maintained that the SWFs should never be used to exercise a political leverage and further destabilise the international financial market. The responsible investment could be achieved by SWFs'

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<sup>88</sup> 'Commission Outlines Position on Sovereign Wealth Funds and Financial Stability' (2008) *EU Focus* 229, 2-3

<sup>89</sup> Benjamin J Cohen, 'Sovereign Wealth Funds and National Security: The Great Tradeoff' (2009) 85 (4) *International Affairs* 713, 731 at 724

effective adoption of the GAPP, which could be an important stepping stone for SWFs' integration into the global financial systems. It would bar the SWFs from a range of politically motivated investment activities.<sup>90</sup> Echoing IWG's efforts, the OECD set forth its own Guidelines for recipient countries, seeking to ensure stable financial markets and avoid any protectionist policies targeting SWFs.

## 2. OECD Guidelines

SWFs should operate on a good faith basis, and invest on the basis of economic and financial risk and return-related considerations.<sup>91</sup> The use of SWFs for political purposes rather than commercial purposes, or to obtain sensitive technology, might serve as a legitimate basis for protectionism. On the other hand, the ambiguous assessment criteria raise the degree of unpredictability for SWFs investments in part because the host countries may politicise the process. With an aim to foster an open-investment environment, the OECD has sought its own version of a set of benchmark rules,<sup>92</sup> to ensure that host countries do not disguise protectionism as measures taken to safeguard national security.

As analysed above in Part B-2, national security was recognised as a legitimate limitation on the open trade principles. The OECD has established a principles-based framework for implementing national security limitations on open investing. Care must be taken to ensure that such measures address genuine security concerns and avert protectionism, which may impose high costs on national economies and delay recovery. To prevent protectionist use of

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<sup>90</sup> WL Watts, 'World a Better Place' Thanks to Sovereign Funds' *Market Watch* (24 January 2008)

<sup>91</sup> Santiago Principles Article 19: "The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds."

<sup>92</sup> A Gurria, 'Sovereign Wealth Funds and Policies' (OECD, 2008)

<<http://www.oecd.org/dataoecd/34/9/40408735.pdf>> Accessed 10 February 2010

national security measures and to increase their effectiveness, the OECD Guidelines recommend steps which governments should take to make their national security measures: least-discriminatory, transparent and predictable, proportionate to the objective pursued, and accountable in their application.<sup>93</sup>

Equally important, the separation of sovereign objectives from private equivalent objectives would involve the creation of another standard—something like a reasonable operating company investment policies standard.<sup>94</sup> The OECD Guidelines aim at a level-playing field in markets where SWFS and private sector companies compete in order to avoid market distortions, which can apply to both entities on an equivalent basis.<sup>95</sup> These regulations in the form of soft law principles demonstrate to the critics that SWFs can be responsible participants in the international financial system. The possibility that a state might seek to use its investments for political leverage is very slim, if the state is looking to invest its surplus capital in the most commercially advantageous way.<sup>96</sup> In a more practicable way, it is expected that recipient countries make regulatory objectives and criteria evaluation processes as transparent and predictable as possible by codifying their laws and making them easily accessible to the public. Given most countries have established regulatory mechanisms to screen out potentially threatening SWFs investments, the international soft initiatives associated with the hard laws may constitute a more powerful framework for the alignment

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<sup>93</sup> *Guidelines for Recipient Country Investment Policies Relating to National Security* (25 May 2009) <<http://www.oecd.org/dataoecd/11/35/43384486.pdf>> accessed 14 March 2010; *Chair's Summary of the OECD Council at Ministerial Level OECD Observer* (Paris, June 2008) 4, 5

<sup>94</sup> *OECD Guidance on Sovereign Wealth Funds* <[http://www.oecd.org/document/19/0,3343,en\\_2649\\_34887\\_41807059\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/19/0,3343,en_2649_34887_41807059_1_1_1_1,00.html)> accessed 9 February 2010

<sup>95</sup> LC Backer, 'Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience' (2009) 19 (1) *Transnational Law & Contemporary Problems* 101, 294 at 230

<sup>96</sup> P Mandelson, 'Sovereign Wealth and Politics' *Wall Street Journal* (6 June 2008)

with the best practice code. They are highly expected to catalyse an open investment environment and avoid protectionism with respect to host countries.

### **3. Implementation**

The principles and Guidelines are characterised by lack of any legal binding force due to the voluntary nature of the code,<sup>97</sup> which affects the effectiveness of compliance with soft initiatives. The initiatives could be rendered meaningless without an effective enforcement mechanism. Thus, there remain significant challenges on how these principles can be effectively enforced. They must be ratified by the competent authority in each signatory. The implementation of each principle of the GAPP principles underpinning SWFs' operation is subject to applicable domestic laws. To underline and integrate the soft initiatives into participants' home judicial and enforcement systems, the institutional construction would play an indispensable role, such as an organ to independently verify and another to oversee compliance with the GAPP. Regardless of seeking to maximize economic and political objectives, SWFs will also be subject to those host state national regulatory regimes.<sup>98</sup> Most receiving countries have enacted relevant provisions against those untransparent SWFs investments. Given the unpredictability of the national security and eminent protectionism, it would streamline a healthy global financial market with the SWFs investment operating under a sophisticated legal framework. The next part examines the current legal regimes adopted, with U.S. legal parameters particularly highlighted since most SWFs move to its capital markets.

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<sup>97</sup> Nicholas Pettifer, 'IMF Persists with Pointless Sovereign Wealth "Code"' International Financial Law Review (4 September 2008)

<sup>98</sup> Santiago Principles Article 15

## **D The SWFs-Oriented Legal Framework**

SWFs are conceived as maximising their country's long-term strategic objectives rather than as profit-maximising actors,<sup>99</sup> despite the lack of a clear dividing line between each.<sup>100</sup> Actually, SWFs are still in the process of building their international legitimacy. SWFs would be used illegitimately to advance political, as opposed to commercial, agendas. This competitive advantage is particularly concerned as SWFs increasingly are involved in cross-border M&As, while standing in the same shoes as a private investor. Any SWF perceived to be illegitimate in a jurisdiction will eventually see its access to that jurisdiction constrained.<sup>101</sup> The EU and the U.S. are concerned with their emerging geopolitical rival, about its increased size and aggressiveness of SWFs. The strict control triggers significant regulatory scrutiny over those strategically sensitive investments. The SWFs are subject to those host state national legal regimes that affect in equal measure all economic organs and the markets in which they operate.<sup>102</sup>

### **1. Legal Frameworks in the EU**

The European Commission (EC) acknowledges that SWFs have so far behaved as reliable investors, without distorting the functioning in the internal market. However, it stressed the

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<sup>99</sup> DW Dezner, 'Sovereign Wealth Funds and the (In)security of Global Finance' (2008) 62 *Journal of International Affairs* 115, 117

<sup>100</sup> Joel Slawotsky, 'Sovereign Wealth Funds as emerging Financial Superpowers: How U.S. Regulators Should Respond' (2009) 40 (4) *Georgetown Journal of International Law* 1239: the fundamental difference between SWFs and other investors is the potential for investment decisions to be based on non-financial factors, due to their status as government-owned entities.

<sup>101</sup> RW Tucker and DC Hendrickson, 'The Sources of American Legitimacy' (2004) 83 (6) *Foreign Affairs* 18, 32

<sup>102</sup> LC Backer, 'Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience' (2009) 19 (1) *Transnational Law & Contemporary Problems* 101, 294 at 129

necessity to obtain greater insight into SWFs' governance and greater transparency on their investment management.<sup>103</sup> Without a multilateral regulatory framework, the European Union (EU) has traditionally dealt with SWFs in a protectionist manner by allowing Member States to retain 'golden shares',<sup>104</sup> setting caps on aggregate shareholding in strategic industries or subjecting any proposed foreign investment to a rigorous approval and reviewing process on the ground of 'national security'.<sup>105</sup> The ultimate objective is to maintain its own economic security by protecting national champion companies and industries.

To sustain a clear, predictable and reliable legal environment, the EC explicitly holds that any authorisation system for foreign investment needs to comply with the principles of proportionality and transparency. And any condition or restriction on foreign investment cannot be based on purely economic grounds.<sup>106</sup> Such a stance is in perfectly adherence to the principles of transparency and proportionality enshrined in a recently-issued recommendation.<sup>107</sup> The EC Treaty has strengthened free movement of capital on a legal footing:

"All restrictions on the movement of capital between member states, and between member states and third countries shall be prohibited."<sup>108</sup>

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<sup>103</sup> European Commission, Communication from the Commission to the European Parliament, the European Economic and Social Committee and the Committee of the Regions: *A Common European Approach to Sovereign Wealth Funds* (27 February 2008) 4-5

<sup>104</sup> As a control-right equity share to outvote all other shares under certain specific circumstances, golden shares provide a national government with a veto power as regards important decisions such as takeovers. Golden shares could prevent an outright takeover of strategic holdings and politically sensitive companies. Nevertheless,

<sup>105</sup> 'Germany Plans for Own CFIUS Deal Watchdog' *Financial Times* (27 September 2007)

<sup>106</sup> C-503/99, *Commission v Belgium* [2002] ECR I-4809

<sup>107</sup> Commission of the European Communities, Communication From the Commission to the European Parliament, the Council, the European Economic and Social Committee, and the Committee of the Regions, *A Common European Approach to Sovereign Wealth Funds*, COM (27 February 2008) 115 final 9

<sup>108</sup> EC Treaty Article 56

The general adoption of the GAPP in the EU may mitigate protectionism so as to maintain the free flow of cross-border investments. The comprehensive regime of national legislations, Community principles of free movement of capital as interpreted by the ECJ and political sensitivities can create a more complex process for both recipient countries and the SWFs investors.<sup>109</sup>

## **2. U.S. Legal Parameters**

The American approach differs from those of its European counterparts. The U.S. usually adopts defined criteria narrowly focused on national security rather than broader economic or national interests. Americans rely on legislation that would implement increased scrutiny and review of SWFs that might affect national security. It is prohibited for foreign acquirers to obtain ownership of controlling stakes in certain sensitive sectors, such as airlines and nuclear energy.<sup>110</sup> These transactions could encounter a review by the Committee on Foreign in the United States (CFIUS) review or even political opposition. Chinese SWFs had to weigh the higher bid against the risk that CFIUS would reject the transaction. This has been well reflected by the adverse political reaction to efforts by China National Offshore Oil Corporation (CNOOC)'s acquisition of the U.S. oil firm Unocal in 2005.<sup>111</sup> The Congressional opposition resulted in the withdrawal of CNOOC's \$18.5 billion bid for Unocal, largely because the deal was portrayed as being politically driven for China's strategic energy interests. Finally, it was the threat associated with CFIUS' review and its political fallout that forced CNOOC to

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<sup>109</sup> Ilene Knable Gotts and Paul A. von Hehn, 'Sovereign Wealth Fund Investments-Risk of New Wave of Protectionism in the EU and the U.S.' LexisNexis® Expert Commentary (May 2008)

<sup>110</sup> 49 U.S.C.A. §40102

<sup>111</sup> Michael Petrusic, 'Recent Development, Oil and the National Security: CNOOC's Failed Bid to Purchase Unocal' (2006) 84 North Carolina Law Review 1373, 1387

abandon the acquisition.<sup>112</sup> As a result, the revision in US law was fuelled by controversies surrounding the proposed takeover. CFIUS has been conferred a power to determine whether a transaction is a foreign government-controlled investment.<sup>113</sup> The CFIUS investigates the transaction that would result in foreign control of “critical infrastructure” which could impair national security.

*(a) Is there a safe-harbour under the CFIUS’ review?*

With China’s excess foreign exchange reserves deployed in equities and M&As for higher return, SWFs have attempted to assure recipient countries that their motives are purely commercial. China has so far steered away from deals that might trigger political backlash, indicating that it has no intention of investing in sensitive sectors pursuing the controlling stake. Given that acquisition in sensitive and strategic industries may raise national security concerns, Chinese SWFs are primarily focused on acquiring minority equity stakes. For instance, Chinese SWFs have been acquiring less than 10% of a company’s outstanding capital in order to avoid triggering CFIUS’ review.<sup>114</sup> Chinese SWFs have remained largely passive investors and have declined to take up board seats even when offered to them in return for sizable investments.<sup>115</sup>

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<sup>112</sup> EL Andrews, ‘China’s Oil Setback: The Politics, Shouted Down’ *New York Times* (3 August 2005)

<sup>113</sup> 50 App. U.S.C.A. §2170 (f) (8); GS Georgiev, ‘The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security’ (2008) 25 (1) *Yale Journal on Regulation* 125, 134

<sup>114</sup> 31 C.F.R. §800.302(b) (2008)

<sup>115</sup> Monitor Group, *Sovereign Wealth Fund Investment Behaviour: Analysis of Sovereign Wealth Fund Transactions during Q3 2008* (Monitor Group 2009); Katharina Pistor, ‘Sovereign Wealth Funds, Banks and Governments in the Global Crisis: Towards a New Governance of Global Finance?’ (2009) 10 *European Business Organisation Law Review* 333, 352 at 343

Since transactions with a foreign entity holding 10% or less of the voting interest and holding that interest solely for passive investment are probably not to be scrutinised, the SWFs intentionally structure their transactions so that they do not acquire board rights or control in the portfolio firm, with the structures designed to avoid adverse regulatory consequences.<sup>116</sup> CIC bought a \$3 billion non-voting stake in Blackstone Group, a leading U.S. provider of global asset management and financial advisory services, on 20 May 2007, which did not need the US government approval as the stake is less than 10%. Since Blackstone shares have dropped about 64%, leaving CIC with a loss of about \$1.9 billion. On 19 December 2007, the CIC invested \$5 Billion to purchase a 9.9% non-voting stake of Morgan Stanley.<sup>117</sup> Both passive investment strategies took advantage of the so called ‘safe harbour’ exemption available under the regulations for a foreign investment of 10% or less of the voting securities of a US company, and thus avoided triggering a lengthy CFIUS review. In reality, such conservative approach may still possibly stir protectionism,<sup>118</sup> due largely to CFIUS’s test dependant on the “functional abilities” of an acquirer to exercise control.<sup>119</sup>

Holding a small minority of shares or not taking a board seat does not provide a guarantee that there will be no influence or control. In this sense, merely structuring an investment under the 10% ownership threshold will not necessarily provide an automatic safe-harbour for transaction parties. Whether CFIUS determines that a proposed transaction is legitimate largely depends on implications for national security. The Treasury Department clarified that even a foreign investment below 10% will not be immune from CFIUS review if they exhibit control or “take any action inconsistent with acquiring or holding its interest solely for the

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<sup>116</sup> Paul Rose, ‘Sovereign Wealth Funds: Active or Passive Investors?’ (2008) 118 Yale Law Journal Pocket Part 104 <<http://thepocketpart.org/2008/11/24/rose.html>> accessed 3 March 2010

<sup>117</sup> Andrew Edwards and Jed Horowitz, Morgan Stanley Swings to Loss Amid Mortgage-Related Woes’ *Wall Street Journal* (19 December 2007)

<sup>118</sup> J Wilman, ‘Big Spenders Stir Protectionism’ *Financial Times* (29 July 2007)

<sup>119</sup> 31 C.F.R. §800.702

purpose of investment.”<sup>120</sup> CFIUS is obliged to examine whether a foreign government-controlled transaction has an effect on the national security of the U.S.<sup>121</sup> In particular, CFIUS takes into account the potential effect on ‘critical infrastructure’<sup>122</sup> and ‘critical technologies’ sensitive to the national defence.<sup>123</sup> In the absence of clear definition of the concept of ‘national security’, CFIUS is conferred with wide discretion, leaving uncertainty and unpredictability to foreign SWFs-related investments. There seems to be no *de minimis* investment threshold that falls outside of CFIUS' jurisdiction.

In addition, the U.S. Securities Exchange Act 1934 requires investors attempting to acquire more than 5% of shares in listed companies to report to the exchange where the securities are traded.<sup>124</sup> SWFs will be obliged to disclose where they acquire a 5% or more equity stake in a public company,<sup>125</sup> or potentially controlling stake in any U.S. company.<sup>126</sup> These requirements, to a certain extent, make up for the asymmetry of access information between SWFs owners and other private investors. In view of the unpredictability for the transaction parties, a controversy arises as to whether the Foreign Investment & Security Act of 2007 (FISIA) can strike a balance between the economic benefits of foreign investment in the United States and national security concerns about technology and critical infrastructure.

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<sup>120</sup> *Proposed Treasury Regulations Provide That Small Investments in U.S. Firms May Be Subject to CFIUS Review* (21 April 2008) <[www.wlrk.com/docs/proposedFISIAregulations.pdf](http://www.wlrk.com/docs/proposedFISIAregulations.pdf)> accessed 12 March 2010

<sup>121</sup> 50 U.S.C. app§2170 (b) (1) (B) and (b) (2)

<sup>122</sup> 50 U.S.C. app§2170 (f) (6)

<sup>123</sup> 50 U.S.C. app§2170 (f) (7)

<sup>124</sup> 15 U.S.C. app§ 78 m (d); E Greene and B Yeager, ‘Sovereign Wealth Funds-A Measured Assessment’ (2008) 3 *Capital Market Law Journal* 264

<sup>125</sup> Securities Exchange Act 1934 §13 (d); The Williams Act §13, 15 U.S.C. §78m(d) (2006); Exchange Act Rules, 17 C.F.R. §240.13d-1 (2007)

<sup>126</sup> Exchange Act Rule 13a-1 I, 17 C.F.R. §240.13a-1I (2008)

*(b) Foreign Investment and National Security Act of 2007 (FINSAs 2007)*

As a result of the CNOOC and Dubai Ports cases, Congress passed the FINSAs 2007,<sup>127</sup> so as to tighten CFIUS's review over acquisitions of U.S. business by foreign government-related entities. The FINSAs confers the power to weigh the effect of the proposed transaction in terms of the national security.<sup>128</sup> The investigation may be triggered when investments involve the critical infrastructure, telecommunications, and energy assets. The FINSAs, *prima facie*, provides increasing restrictions through the expansion of the concept of 'national security'.<sup>129</sup>

Although the FINSAs2007 may not materially increase the regulatory burdens on potential foreign acquirers, the passage itself highlights the U.S. government's commitment to continuing close scrutiny of foreign investment in critical industries. More significantly, the FINSAs has put the review process of the Dubai Ports-like deals on a legal footing,<sup>130</sup> where integrity of the regulatory system had been severely compromised.

"SWF investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly, the geopolitical goals of the controlling government . . . Greater information disclosure by SWFs . . . strong governance structures, internal controls, and operational and risk management systems . . . SWFs and the private sector should compete fairly . . . SWFs should respect host-country rules . . ."<sup>131</sup>

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<sup>127</sup> Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246

<sup>128</sup> Foreign Investment and National Security Act 2007 s2

<sup>129</sup> Michael F. Martin, 'China's Sovereign Wealth Fund' (Order Code RL34337, CRS Report for Congress, 22 January 2008)

<sup>130</sup> In 2005, Congressional resistance thwarted China National Offshore Oil Corporation (CNOOC)'s attempted acquisition of Unocal; in 2006, the UAE-owned DP World's acquisition of six port facilities in the U.S. was blocked. Both tenders were withdrawn eventually.

<sup>131</sup> Ashby Monk, 'Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy, and Governance' (2009) 14 (4) *New Political Economy* 451, 468; Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi (20 March 2008)

<<http://www.ustreas.gov/press/releases/hp881.htm>> accessed 9 February 2010

The broadened investigatory authority of CFIUS conferred by FINSA 2007 may precipitate protectionism.<sup>132</sup> With an original intention to protect legitimate national security while encouraging foreign investment, the criteria governing review processes are quite vague, leaving much to the discretion of CFIUS.<sup>133</sup> Further, there is no bright line, such as based on a particular ownership percentage, for the “control”, but reliance is on a foreign acquirer’s functional ability to exercise control. Little guidance is offered regarding how national security is weighed and evaluated.<sup>134</sup> Subtly, it might be designed to combat circumvention through a structured transaction mala fide, were it be adopted with a bright line. However, it is always unpredictable to ascertain what constitutes threats to national security. There might be a rationale to doubt whether the host state uses national security as a pretext for arbitrary acts of protectionism, with a regulatory asymmetry taken into account.

## **E Paradoxical Hypothesis**

It is noteworthy to look into the insights of implications resulting from China’s outbound expansion through its SWFs. Only on a proportionate basis would policy makers be able to treat SWFs objectively, so as to maintain a proper level of social cost for the cross-border free movement of capitals. Otherwise, too excessive scrutiny of SWFs investment may fuel nationalism, and further hamper the free flow of foreign capital. A warning is given in this part that the potential consequence of protectionism should be avoided.

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<sup>132</sup> 50 U.S.C.A. app §2170 (a)(6)

<sup>133</sup> Benjamin J Cohen, ‘Sovereign Wealth Funds and National Security: The Great Tradeoff’ (2009) 85 (4) *International Affairs* 713, 731 at 723

<sup>134</sup> Benjamin J Cohen, ‘Sovereign Wealth Funds and National Security: The Great Tradeoff’ (2009) 85 (4) *International Affairs* 713, 731 at 729

## 1. Chinese SWFs' Endeavours: Building International Legitimacy?

Indubitably, SWFs are owned and managed by the Chinese government to achieve a mixture of economic, financial and political objectives. The SWFs' impact on global financial stability would be positive if sound governance standards were met,<sup>135</sup> meanwhile dissipating recipient countries' concerns. Given the absence of a well-established governance regime for SWFs investment, China should expect to be held to the highest standards of accountability in managing those SWFs. It would be in the interests of China to devise means to allay some of these concerns principally by introducing greater transparency into the operations of the SWFs. A key step that Chinese authorities might take to alleviate such fears is the upgrading of corporate governance standards in order to entrench the commercial orientation of these SWFs and strengthen governance mechanisms to raise decent credibility.<sup>136</sup>

Policing conflicts of interest among participants has always been corporate governance's forte.<sup>137</sup> A god model, like Norway's SWFs, has already integrated into global financial markets and widely perceived as legitimate and trustworthy.<sup>138</sup> The reform of corporate governance in alignment with global best practice is consistent with the long term efficiency of global capital markets and the interests of large institutional investors themselves.<sup>139</sup> China's views on governmental accountability and transparency have not always meshed

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<sup>135</sup> S Mezzacapo, 'The So-Called "Sovereign Wealth Funds": Regulatory Issues, Financial Stability and Prudential Supervision' (2009) *European Economy* 378

<sup>136</sup> OECD Investment News, '*China's Outward FDI Faces Challenges as it Continues to Expand*' (June 2009, Issue 10) <<http://www.oecd.org/dataoecd/53/24/43143597.pdf>> accessed 8 February 2010

<sup>137</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 (5) *Stanford Law Review* 1345

<sup>138</sup> The Norwegian SWF is widely acknowledged to offer a model of good governance and accountability due to its transparency, ethical investing and avoidance of strategic stakes. F Wu and A Seah, 'To Counter Negative Perception and Opposition, CIC Needs to Enhance its Transparency' *China Business Review* (July-August 2008)

<sup>139</sup> JN Gordon, 'The International Relations Wedge in the Corporate Governance Debate' in JN Gordon and M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge, CUP 2004) 161-209

with those of the West.<sup>140</sup> Its SWFs' focus on resources has raised suspicions of politically motivated investing,<sup>141</sup> thereby triggering protectionism among host countries and undermining China's ability to invest in Western jurisdictions

Monk observed that trust may serve as an important stepping stone for SWFs' integration into the global financial system, and SWFs can achieve legitimacy in Western jurisdictions by aligning their governance practices with their target jurisdictions' legitimate expectations for these practices.<sup>142</sup> With Chinese enterprises possessing increasingly considerable business shares, a coordinated, multilateral effort to enhance disclosure requirements would benefit all parties. Even the firms themselves would gain from a more open and trusting atmosphere in host countries,<sup>143</sup> despite the fact that Chinese SWFs are not currently capable of immunising investment decisions from political interference. At least, providing transparency of ownership and legal structure and disclosure of the investment strategies could help to alleviate any concerns that the SWFs are to be set up for political ends. And more significantly, Chinese SWFs could be evaluated on their own merits, which would go closer to being viewed as 'legitimate' and 'trustworthy'. Given the general lack of experienced professionals, misaligned incentive structure and less sensitivity to market stimuli, it does take time to develop and make up for the deficiency expeditiously in the long run.<sup>144</sup>

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<sup>140</sup> Daniel J. Ikenson, 'Nothing to Fear but Fear-Mongers Themselves: A Look at the Sovereign Wealth Fund Debate' (14 March 2008) <[http://www.cato.org/pub\\_display.php?pub\\_id=10655](http://www.cato.org/pub_display.php?pub_id=10655)> accessed 29 March 2010

<sup>141</sup> R Carew and T Wright, 'CIC Bets Big on Resources' *Wall Street Journal* (24 September 2009); G Chen, 'Chinese Sovereign Fund Turning to Natural Resources' *New York Times* (19 February 2009)

<sup>142</sup> A Monk, 'Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy and Governance' (2009) 14 (4) *New Political Economy* 451, 468

<sup>143</sup> U.S.–China Economic and Security Review Commission, 'Chinese Outward Investment: Better Information Required-Testimony Hearing on "US Debt to China: Implications and Repercussions"' (25 February 2010)

<sup>144</sup> J Gapper, 'Learn to Love State-Owned Invaders' *Financial Times* (27 July 2007)

Arguably, regardless of perceived legitimate concerns about implications of SWFs' governmental ownership, host countries' scepticism of China's pursuit of political rather than economic objectives appears largely in the realm of the hypothetical.<sup>145</sup> There is no evidence that China's SWFs have sought to lever their position to pursue geopolitical motives. They have intended to avoid being targets under CFIUS and FINSA, through purchasing non-voting share stock and rather conservative investments, i.e. less than 10% stake in target entities. There would be little rationale to impose additional burdens over SWFs. Nevertheless, trillions of SWFs in official hands at sharp variance with a market-based global economy plausibly generate national sentiments in host countries.

## **2. Are SWFs' risks overestimated?**

Chinese SWFs' investment behaviour has appeared to be largely conservative and benign in its objectives, giving grounds for cautious optimism.<sup>146</sup> There is little evidence of any ulterior political motives in practice and they do not appear to be active in ways that threaten the economic or national security of host countries where they invest.<sup>147</sup> The west has dozens of years' experience dealing with the delicate challenge of promoting and regulating foreign investment. CFIUS is capable of reviewing SWF investment for national security concerns. CFIUS, together with a whole host of anti-trust, banking, securities and other regulations, provides a secure safety net to assure that SWFs are likely to act pursuant to commercial interests.

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<sup>145</sup> Edwin M. Truman, 'Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications' Testimony before the Committee on Banking, Housing, and Urban Affairs United States Senate (14 November 2007)

<sup>146</sup> Benjamin J Cohen, 'Sovereign Wealth Funds and National Security: The Great Tradeoff' (2009) 85 (4) *International Affairs* 713, 731 at 719

<sup>147</sup> Robert M. Kimmitt, 'Public Footprints in Private markets: Sovereign Wealth Funds and the World Economy' (2008) 87 (1) *Foreign Affairs* 124; William Miracky, Davis Dyer and others, 'Assessing the Risks: The Behaviour of Sovereign Wealth Funds in the Global Economy' (Monitor Group Cambridge 2008) 4

*(a) The Functionality of Capital Markets' Self-Adjustment*

There is no solid evidence that Chinese SWFs have actively sought to lever their investment strategies for geopolitical purposes, nor has it been justified that SWFs investment strategies differ in substance from those of traditional private actors. After all, most established capital markets themselves have their own adjustment functioning role. The SWFs operate pursuant to sophisticated capital markets rules wherever they invest, and interact with other participating members by virtue of the sovereign ownership. SWFs' influential potential upon global financial markets or a corporate behaviour largely depends on their size of stake respectively. Compared with private institutional investors, SWFs represent a relatively small fraction of the overall capital markets. Beck and Fidora from European Central Bank observed that "in comparison, the combined value of global SWFs may reach up to 3% of global financial assets."<sup>148</sup> Any possible SWFs-generated risks would be offset by other private institutional portfolios' adjustments. It is highly improbable that SWFs-related decision-making will erode the governance standards and use its financial leverage to compromise stability of global capital markets. Likewise, the same rule applies within a specific firm behaviour, which may be the most realistic criticism about SWFs' collateral investment. SWFs usually make conservative investments and take a minor stake in an individual company, and the likelihood seems slight for the minority shareholder to divert the firm's share value-maximization for its geopolitical motives. This is in stark contrast to China's corporate structure in terms of China's unique social and legal settings, where political and economical elements are always intertwined within Chinese SWFs decision-

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<sup>148</sup> Roland Beck and Michael Fidora 'The Impact of Sovereign Wealth Funds on Global Financial Markets' (2008) 43 (6) *Intereconomics: Review of European Economic Policy* 349, 358; 'Asset Backed Insecurity' *The Economist* (19 January 2008): "Total SWF assets make up only 2% of the world's \$165 trillion in traded securities."

making process. In China, the assessment of a board's performance largely depends on whether their decisions are highly in line with the political niche, which ultimately determines their future promotion and other eco-political interests. However in a Western company, it is almost impossible for the board of the firm to breach their fiduciary duties to cater for SWFs' intangible strategies. Any perceived deviation from profit-seeking orientation would be thwarted by the majority's backlash. As Romano observed, "SWFs would certainly not be the first shareholders to make investment decisions based on objectives other than profit maximization."<sup>149</sup>

*(b) Are current laws and regulations adequate to govern SWFs management?*

Ostensibly, SWFs might act to advance those collateral geopolitical strategies, rather than to simply maximise their investment returns. With comprehensive voluntary regulation and laws in place, the ability for SWFs to distort the capital market is substantially mitigated. It is a well-established principle of international law that sovereign immunity does not extend to a state's commercial activities in another jurisdiction.<sup>150</sup> Plainly, the SWFs-related investments are not to be immunised from the jurisdiction of host countries' courts where they are conducted commercially.<sup>151</sup> SWFs are generally subject to mandatory disclosure and governance rules.<sup>152</sup> Specially, any potential foreign control in certain sensitive industries is subject to various statutory regimes. Arguably, fears about SWFs threatening national

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<sup>149</sup> Roberta Romano, 'Public Pension Fund Activism in Corporate Governance' in Baums, R. Buxbaum and K. Hopt, (eds.) *Institutional Investors and Corporate Governance* (Walter de Gruyter & Co., 1994) 105

<sup>150</sup> Ernest K Bankas, *The State Immunity Controversy in International Law: Private Suits against Sovereign States in Domestic Courts* (Springer, Berlin, New York 2005) 69-77; Larry Cata Backer, 'Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law' (2008) 82 (5) *Tulane Law Review* 1801, 1868 at 1867

<sup>151</sup> 28 USC §1605 (a): "[a] foreign state shall not be immune from the jurisdiction of courts of the U.S. or of the State in any case...in which the action is based upon a commercial activity carried on in the U.S. by the foreign State."; Victor Fleischer, 'A Theory of Taxing Sovereign Wealth' (2009) 84 (2) *New York University Law Review* 440, 513

<sup>152</sup> Evan Bayh, 'Time for Sovereign Wealth Rules' *Wall Street Journal* (13 February 2008)

security are overly simplistic and largely unfounded. Apparently, the laws and soft initiatives are already well-suited to identify and discipline those perceived threats posed by those SWFs with ulterior purposes. Epstein and Rose observed: “the risks that SWFs may act strategically in the future is significantly mitigated by existing safeguards, such as securities laws, antitrust laws and corporate law.”<sup>153</sup> There is little rationale for additional regulations of SWFs *vis-à-vis* hedge funds and other private equity instruments.<sup>154</sup> Otherwise, SWFs might be put in a disadvantaged position. Apart from legitimate security concerns, it is also worth examining what genuine and eminent risks are ahead in the present economic downturn. Such exploration of the insights and implications of protectionism may help recipient states to strike a right balance between building an open investment environment, while ensuring that SWF would not compromise the integrity of their financial markets.

### **3. Is protectionism the genuine risk?**

The perceived threats might be overestimated and it remains an imminent issue in terms of the risk of financial protectionism and political backlash. Disproportionate restriction over SWFs may lead to a wave of financial protectionism that would cause damage to the international financial market. The issue is whether the value of protection obtained outweighs the forgone benefits of investments prevented in a more restrictive global financial market. It should be emphasised that the multilateral objective is greater disclosure, not greater restrictions. If not addressed properly, the national sentiments and tension could

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<sup>153</sup> Richard A. Epstein and Amanda M. Rose, ‘The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow’ (2009) 76 *The University of Chicago Law Review* 111, 134; Senate Committee on Banking, Housing and Urban Affairs, ‘Turmoil in the U.S. credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments’ (Testimony of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System, 110<sup>th</sup> Congress, 2<sup>nd</sup> Session 24 April 2008)

<sup>154</sup> Richard A. Epstein and Amanda M. Rose, ‘The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow’ (2009) 76 *The University of Chicago Law Review* 111, 134 at 123

provoke a wave of protectionism.<sup>155</sup> Regulatory measures in violation of the OECD Guidelines could disrupt the efficiency of global capital flows, and further severely damage global economic growth.

*(a) Protectionism*

The global financial crisis has provided fertile ground for protectionist against SWFs-related investments. Although SWFs' investment strategies and performance don't appear to have differed markedly from those of private funds,<sup>156</sup> it seems unrealistic to root out scepticism about SWFs' motives and consequences. Having reserve-rich countries become owners of financial assets in the West could inflame nationalistic sentiments and pressures for protectionism under the guise of safeguarding national security. It is reasonably doubted whether the current attitude toward SWFs has been directed in a disproportionate way, given they are already subject to supervision and regulation at international, EU and national levels. Thus, it is imperative to intensify the significance of ensuring a well-functioning financial market on the basis of open and non-discriminatory rules. The West has strengthened scrutiny over SWFs-related investments, through imposing special restrictions on SWFs. Due to CIC's weakness in governance, unsurprisingly, it tends to be a target of criticism and is subject to restrictions from developed host countries. The perception of strategic behaviour by Chinese SWFs will inevitably result in a protectionism backlash, and has sparked a wave of protectionism sentiment in the more market-oriented jurisdictions.<sup>157</sup> The steps will foster

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<sup>155</sup> Daniel W, Drezner, 'Sovereign Wealth Funds and the (In)Security of Global Finance' (2008) 62 (1) *Journal of International Affairs* 120; Gawdat Bahgat, 'Sovereign Wealth Funds: Dangers and Opportunities' (2008) 84 (6) *International Affairs* 1189, 1204

<sup>156</sup> Stefan Schonberg, 'Sovereign Wealth Alarm: Will the big sovereign wealth fund surge lead to European protectionism?' *The International Economy* (2008) 58

<sup>157</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 *Stanford Law Review* 1369

a disintegration of the global economy and once again raise the barriers to cross-border capital flows. As a result, erecting arbitrary barriers would lead to protectionism and would be counterproductive.<sup>158</sup>

Over-estimation of SWFs' risks may lead to protectionist legislation. Milhaupt and Gilson argued that the equity of a U.S. firm acquired by a foreign government controlled entity would lose its voting rights, but would regain them when transferred to non-state ownership.<sup>159</sup> Theoretically, the hypothesis attempts to make Chinese government entities lose direct influence over management through voting, so as to realise that the expected returns to the SWFs-related investor remain identical to those of other shareholders. O'Brien challenged the proposal that "...limiting voting rights to demonstrate passivity could lead to the expansion of even more opaque investment mechanisms."<sup>160</sup> The suspension of voting rights may *prime facie* violate the principle of good governance and potential responsible engagement by shareholders. As a fundamental ownership right, the right to vote is rooted in any mature corporate governance mechanism, which is also integral to the vitality and attractiveness of any established capital markets.<sup>161</sup> The exercise of ownership rights has also been enumerated in both OECD Principles of Corporate Governance<sup>162</sup> and those of GAPP<sup>163</sup>. The temporary suspension of the voting rights seems undoable in the context of China's

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<sup>158</sup> Bob Davies, 'US Pushes Sovereign Funds to Open to Outside Scrutiny' *Wall Street Journal* (26 February 2008)

<sup>159</sup> RJ Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 *Stanford Law Review* 1345, 1368

<sup>160</sup> Justin O'Brien, 'Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds' (2008) 42 *International Lawyer* 1231, 1257 at 1241-42

<sup>161</sup> Amy Keller, 'Sovereign Wealth Funds: Trustworthy Investors or Vehicles of Strategic Ambition? An Assessment of the Benefits, Risks and Possible Regulation of Sovereign Wealth Funds' (2009) 7 *The Georgetown Journal of Law & Public Policy* 333, 372 at 369

<sup>162</sup> *OECD Principles of Corporate Governance* Article 1

<sup>163</sup> *Santiago Principles* Article 21

SWFs.<sup>164</sup> As Truman observed, “if passive investment were defined as nonvoting shares, the unintended collateral consequences would be significant”.<sup>165</sup>

*(b) Unintended Consequences*

Protectionism would prevent the effective restructuring of global financial institution, not only impeding further integration of China into the world economy, but causing a negative chain reaction in eroding potential international cooperation in other arenas. It is very likely to trigger retaliation by China’s imposing restrictions and further risking counterparties’ prospects in the world’s fastest-growing economy. The EU and the U.S. may confront a dilemma when adopting stringent protectionist regulation, as many recipient countries remain in desperate need of foreign investments. As CIC’s Chairman Jiwei Lou cautioned:

“If an economy will use national security as a criterion for entry of sovereign wealth funds, we will be reluctant to tap the market because you are not sure what will happen.”<sup>166</sup>

The tit-for-tat war would be bound to damage Western multinationals with a considerable stake relying on their affiliate operation in China.

To say the least, if protectionist barriers were erected, SWFs would likely invest elsewhere, leaving the protectionist country without the much-needed capital that flows from these international sources.<sup>167</sup> As Rose argued,

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<sup>164</sup> RJ Gilson and CJ Milhaupt, ‘Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism’ (2008) 60 *Stanford Law Review* 1345, 1346; Gilson and Milhaupt argued that the political issue of how to ensure that “market-based capitalist regimes are protected against incursion by new mercantilist regimes “can be resolved by “a simple corporate governance fix” whereby “the equity of a US firm acquired by a foreign government controlled entity would lose its voting rights, but would regain them when transferred to non-state ownership.”

<sup>165</sup> Edwin M. Truman, ‘Do Sovereign Wealth Funds Pose a Risk to the United States?’ (Remarks at the American Enterprise Institute, Washington, DC, 25 February 2008)

<sup>166</sup> ‘China Investment Corp Warns Western Governments against Protectionism’ *AFX News Limited* (10 December 2007)

“Imposing passivity on SWFs might merely push SWFs to invest in other jurisdictions with lax regulatory standards or political impotence to protect themselves against opportunistic SWF activities.”<sup>168</sup>

China would inevitably see its SWFs expand to a more diverse portfolio in pursuit of positive returns.<sup>169</sup> In particular, the globally depressed assets offered an ideal opportunity for China to buy into tremendously-needed natural resources. As Cooke observed, with the Crisis deepened, China has focused on rescuing domestic economies, like addressing infrastructural projects,<sup>170</sup> rather than on investing internationally, further decreasing investment in the West by SWFs.<sup>171</sup> It is imperative that benefits of economic openness should not be undermined by protectionism. There is definite reason to confine a regulatory response proportionately in the case of genuine national security concerns raised by SWFs transactions.

## Conclusion

The enormous increase in foreign exchange holdings by China owes to its long string of favourable balance-of-trade results. The SWFs-related investment has become a major focus of international economic and financial policy. The current global crisis gives China ample leverage in shaping the future economic landscape. China has clearly been taking advantage of the current geopolitical and economic environment. Meantime, China has gained access to highly-demanded expertise in financial management. The principal concern rests on whether

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<sup>167</sup> David H. McCormick, ‘Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?’ *Hearing before the J. Economic Committee 110<sup>th</sup> Congress* (International Affairs, U.S. Department of Treasury, 2008)

<sup>168</sup> Paul Rose, ‘Sovereigns as Shareholders’ (2008) 87 *North Carolina Law Review* 83, 94

<sup>169</sup> Daniel H. Rosen, ‘How Much Can China Really Diversify Its Reserves?’ *Wall Street Journal* (17 March 2010)

<sup>170</sup> Gawdat Bahgat, ‘Foreign Wealth Funds: An Assessment’ (2010) 1 (2) *Global Policy* 162, 171 at 164

<sup>171</sup> Jennifer Cooke, ‘Finding the Right Balance for Sovereign Wealth Fund Regulation: Open Investment vs. National Security’ (2009) 2 *Columbia Business Law Review* 728, 783 at 733

the investment is driven by political objectives instead of commercial ones, with a potential to disrupt financial markets. The operation of the government-owned investment vehicle of SWFs is at variance with the traditional market-oriented framework, where private sectors are the major players. In view of SWFs owned by the Chinese government, a growing fear has been sparked on that their potential use not only aims at attractive returns, but also pursues geopolitical objectives, such as control of strategic natural resources or the extraction of sensitive technologies. This represents a potential threat to the national security of host countries.

However, there is no solid evidence that Chinese SWFs are using their ownership stakes in a way that threatens recipient countries' national security and the concerns are mainly hypothetical. Although there is no specific national or multi-lateral regulation of SWFs-related portfolio investments, the existing regulatory regimes in place sufficiently screen out potentially threatening investments of SWFs. A most significant necessity appears to strike a proportionate balance between sustaining the openness of capital markets and efficiently minimising implications of SWFs political arenas. A well-framed corporate governance regime should underpin Chinese SWFs to gain trust and legitimacy in the global financial markets, and is likely to achieve the ultimate goal of being the maintenance of global capital flow efficiency, while addressing the legitimate political and economic systemic issues.