Regulating Sovereign Wealth Funds to Avoid Investment Protectionism

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ABSTRACT

Chinese and Emirati purchases of US companies have collapsed because of suspicions that their Sovereign Wealth Fund (SWF) status is a disguise for political ambitions. SWFs have grown in size and number, drawing the attention of many government officials because of their non-transparent nature and expansionary investment policies. Their government-controlled status and non-transparent nature have raised fears among governments of political rather than economic investment motivations. SWFs may use their economic influence to obtain critical information, transfer jobs abroad, or compromise the operation of strategically important companies. Such concerns have led to proposals for national measures to regulate investments of foreign SWFs with a view to controlling their economic and security impact. This article questions whether the existence of SWFs justifies the adoption a particular set of national or international foreign investment regulations. It offers an assessment of competing models from the viewpoint of theory, costs, and implementation. It also examines the alternative model of international self-regulation.

KEYWORDS: sovereign wealth funds; finance law; protectionism; investment regulation; self-regulation; transparency

1. INTRODUCTION

In the last decade Sovereign Wealth Funds (SWFs) have grown in size and number, drawing the attention of many government officials because of their non-transparent nature and expansionary investment policies. SWFs have been a valuable source of foreign investment for the global economy, demonstrating a generally passive investment stance and maintaining a long-term investment outlook. Nevertheless, their government-controlled status and non-transparent nature have raised fears among governments of political rather than economic investment motivations.

Concerns highlight the risk that SWFs use their economic influence to obtain critical information, transfer jobs abroad, or compromise the operation of strategically important companies. Such concerns have led to proposals for national measures to regulate investments of foreign SWFs with a view to controlling their economic and
security impact. This article questions whether the existence of SWFs justifies the adoption of a particular set of national or international foreign investment regulations. This involves an analysis of the rationale for regulating SWFs, and the scrutiny of existing theoretical proposals.

National legal instruments applying to SWFs implemented in a number of jurisdictions are mentioned1 without extensive analysis. Additionally, various forms of regulation established at the international level (principally the Generally Accepted Principles and Practices) will be examined as an alternative to more theoretical academic proposals.

The question of foreign investment regulation necessitates discussion of the effects of protectionism. Economic protectionism is prevalent in the ownership of domestic corporate assets and the screening of foreign investments. While being easy to achieve consensus among governments and commentators against the adoption of investment protectionist measures, determining whether there is a clear rationale for regulating SWFs is more controversial. If it is accepted that SWFs pose risks (and thus costs) to national security and systemic stability, then a rationale for regulation is easier to establish. If those threats are fictitious (and hence the regulatory costs unjustified), a very limited form of regulation aiming to address protectionist pressures and maintain consumer/corporate market confidence could suffice.

In establishing a rationale for regulation, a central topic is the role of transparency. While many authors believe that the main object of legislation should be to tackle the opacity of SWFs (either as an intermediate aim, or as a problem in itself), others deem opacity not to be the problem so tackling it would be futile. The position in this article is that, while transparency and accountability are sound principles in themselves, SWFs should not be subject to additional regulation simply because of their government owned status, when this is not warranted by solid macroeconomic justifications. Essentially, transparency in financial markets should go hand-in-hand with competitive neutrality.

One of three categories of SWFs regulatory proposals advocate restricting SWFs’ operations either by imposing investment caps, or removing entire sectors from their investment ambit. A second group supports imposing softer restrictions upon SWFs to incentivize them. The third proposes imposing mandatory reporting requirements. An alternative view encourages a ‘self-regulation’ option where SWFs themselves find solutions at the international level. An analysis of all those models from viewpoint of theory, implementation, and costs reveals that none of the above proposals deals satisfactorily with the rising influence of SWFs.

The analysis in this article evolves around the objectives of economic efficiency (understood as the efficient allocation of capital and the level playing field competition between financial actors), financial stability, and national security. It is argued herein that most measures proposed as national legislation are overly protectionist and go far beyond what is necessary to respond to potential concerns associated with SWFs, while seriously risking damaging their positive effects. Alternatively, it is submitted that the option of international instruments resulting from self-regulation is

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1 See nn 13–14.
better placed to address the potential negative impact of SWFs while preserving the benefits.

This article first offers a brief trajectory of SWFs, describing their main characteristics and investment patterns. Secondly, it examines the issue of regulating SWFs, initially, by setting out the reasons for the avoidance of protectionism, then by applying the rationale for regulating the wider financial sector to SWFs. This continues by examining the role of transparency in the debate about SWFs, and the impact of various international regulations. The third section discusses the main categories of theoretical regulatory proposals, namely those of investment restrictions, incentive-type regulation, and command-and-control regulation. It offers an assessment of the above models from the viewpoint of theory, costs, and implementation. The final section examines the alternative model of international self-regulation.

(a) SWFs trajectory

Key characteristics of SWFs

No consensus has been reached on the exact meaning of the term ‘SWFs’, first evoked by Rozanov. Most definitions suggest these are state-owned investment funds (not operating companies) that make long-term domestic and international investments in search of commercial returns. Rozanov lists the major SWFs and estimates the size of each. The author subsequently claims that the most important step in designing a fund is defining its liability profile. Accordingly, he classifies SWFs into five categories: stabilization/buffer funds, endowment funds, pension reserve funds, development funds, and government holding funds. The International Monetary Fund (IMF) has defined them as ‘special investment funds created or owned by governments to hold foreign assets for long-term purposes’.

The list of SWFs includes China Investment Corporation, Qatar Investment Authority, Abu Dhabi Investment Authority, Temasek (Singapore), and Government Pension Fund – Global (Norway). The largest SWFs are currently established in Asia, although Latin America and Africa are expected to increase their share of similar funds in the future. Overall, SWFs are estimated to possess collectively over $6 trillion of assets under management.

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

therefore, face the challenge of transforming the present-day revenue streams from the sale of the resources or other export successes into sustainable income.\footnote{Steffen Kern, ‘Sovereign Wealth Funds – State Investments on the Rise’ Deutsche Bank Research, 10 September 2007, 4 <www.dbresearch.de/PROD/DBR_INTERNET_DE-PROD/PROD000000000215270.pdf> accessed 6 November 2014.}

SWFs tend to be particularly opaque institutions. Although the matter is touched upon further below,\footnote{See discussion on the place and role of transparency in SWFs regulation.} at this stage it suffices to say that, as opposed to the majority of large market investors (such as commercial banks, pension, and mutual funds), most SWFs do not issue public reports on their size and holdings, management personnel, and management structures.\footnote{For a list ranking a fund’s transparency from 1 to 10, see the SWF Institute that uses the Linaburg Maduell Transparency Index, applying criteria such as the publication of audited annual reports, the application of ethical standards, and the fund’s investment policies. SWF Institute (n 6).} Additionally, SWFs rarely reveal their business plans or future intentions or the extent to which governments intervene in SWFs’ decisions.\footnote{See, for example, Law No 47 of 1972 in Kuwait ‘Prohibiting and providing penalties for the disclosure of information’ on the KIA, see: Kuwait Investment Authority, ‘Transparency and Disclosure of Information’ (2008) <www.kia.gov.kw/En/About_KIA/Transparency/Pages/default.aspx> accessed 4 November 2013.} This element has given rise to suspicions in the past that SWFs may hide their home countries’ political agendas behind their investment policies. As a result, it has been claimed, for example, that SWFs may use their financial influence to extract sensitive information or ship jobs abroad, or even use their financial leverage to obtain political concessions from their recipient\footnote{‘Recipient’ or ‘host’ countries are supposed to describe the countries/economies receiving their investments, as opposed to ‘home’ economies, meaning the countries managing the funds.} countries.\footnote{Indicatively see, Lawrence Summers, ‘Funds That Shake Capitalist Logic’ Financial Times (London, 29 July 2007) <www.ft.com/cms/s/bbf8f0b8-3dcc-11dc-866a-00007796fd2a.html> accessed 1 November 2014; Steven Weisman, ‘Concern about “Sovereign Wealth Funds” Spreads to Washington’ The New York Times (New York, 20 August 2007) <www.nytimes.com/2007/08/20/business/worldbusiness/20iht-wealth.4.7186699.html> accessed 26 December 2013; Joshua Aizenman and Reuven Glick, ‘[SWFs]: Stumbling Blocks or Stepping Stones to Financial Globalization?’ Federal Reserve Bank of San Francisco Economic Letter Number 2007–38, 2–3 <http://www.frbsf.org/economic-research/publications/economic-letter/2007/december/sovereign-wealth-funds-financial-globalization/el2007-38.pdf> accessed 20 December 2014.} These fears have been exacerbated when the investments target national infrastructure deemed to be of national importance,\footnote{In France, investments in a number of sectors require special governmental approval (art R153-2 of the Financial and Monetary Code).} or when they originate from countries perceived as a geopolitical rival to the host country.\footnote{In the USA, the criteria for the administrative approval of the particular investments include (i) the acquiring country’s adherence to non-proliferation regimes and (ii) the relationship of the acquiring country with the USA, specifically on its record on cooperating in/with counterterrorism efforts (50 USCA app para 2170(f)(9)(A)-(C) codifying the Foreign Investment and National Security Act 2007).}

The above concerns have led in the past to a number of notorious cases of governmental opposition to foreign buyout attempts. In July 2005, China National Offshore Oil Corporation (CNOOC) bid $18.5 billion to buy a US oil major, Unocal Oil Company. The move gave rise to intense scepticism based on the disadvantage American energy firms would suffer in competing with a State-owned enterprise (SOE), the lack of reciprocity in the Chinese market as well as the status of
As regards the investment behaviour of SWFs, although it cannot be claimed that sovereign investors act uniformly, for the great majority of them, various noticeable common patterns can be identified. First, SWFs tend to be relatively risk averse. This usually means investing in low-risk holdings, such as US government bonds, buying small stakes in a wide range of companies and using low leverage. It is claimed, in particular, that SWFs often engage in a simple form of ‘trend chasing’, while they are also more likely to invest at home when domestic equity prices are higher, and invest abroad when foreign prices are higher.

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

Stabilization funds also seek higher allocations of lower-risk equities and bonds. This is to be expected considering that, during times of worldwide economic slumps,
low-risk securities are the only ones that hold their value. The same also applies to funds that aim at generating long-term savings (savings funds). KIA, for example, was long known to run a very low-risk portfolio due to the fact that it was responsible for Kuwait’s ‘Fund for Future Generations’. Moreover, SWFs, as opposed to other investment vehicles, are not leveraged. Overall, it is supported that their level of risk-taking resembles that of private equity firms.

Secondly, SWFs tend to be passive investors, in the sense that they avoid interfering in the management of the companies in which they invest. Most SWFs, even the largest ones, have outsourced the management of their assets and often vote by proxy. This may happen because, although public sector investment managers have significant experience in fixed-income markets, they often have limited capacity for investment in other asset classes, such as equities. Thus, the SWFs rely on external fund managers to implement their strategic asset allocation in areas where their capacity is limited. This method is said to be very effective in heading off potential political backlash and concerns over their motives. ADIA has reportedly long outsourced the management of 70 to 80 per cent of its assets to foreign money managers, while KIA outsources at least 50 per cent. In addition, many SWFs—particularly the bigger ones—avoid taking active management roles. China’s CIC has a stated policy to take no seats or only non-voting seats on the boards of its purchases. Another characteristic example, in this respect, constitutes the decision of China Investment Corporation who, following its investment of nearly 10 per cent in Blackstone in 2007, opted to forego the corresponding stake’s voting rights.

22 Since 2007, however, it was believed to have increased investments in risky assets such as equities, alternatives (e.g. hedge funds) and its general exposure to emerging markets, while reducing its US fixed-income portfolio, Setser and Ziemba (n 80) 23.
25 IMF (n 21) 9.
26 At the same time, ‘winning business from [SWFs] requires more work than for typical institutional clients. Training and educating the fund’s staff often is expected to come with managing the assets. The funds also expect more disclosure about the money manager’s own business’, Jay Cooper, ‘Sovereign Wealth Fund Hires No Cinch’ Pensions and Investments (London, 17 March 2008) <www.pionline.com/apps/pbcs.dll/article?AID=/20080317/PRINTSUB/529010448&AssignSessionID=173359561655636> accessed 1 November 2014. Nevertheless, a modest tendency in favour of in-house asset management can be discerned. According to the IMF, ADIA has now established an in-house capacity and operates as highly professional investment managers and relies less on external managers than in its past, IMF (n 21) 8.
27 However, it is stressed by critics that even if CIC’s international investments are genuinely based on commercial considerations alone, critics posit that China’s use of some portion of SWF assets for politically driven domestic investments undermines the country’s claim that the CIC is a passive global investor, Brune Nancy Brune, ‘SWFs: Passive Investors or National Security threat?’ in Al Mehaiza Myrna (ed), The Impact of the Growth of Sovereign Wealth Funds (Arab Financial Forum 2009) 73.
Thirdly, SWFs are typically long-term investors and instances of assets sales are rare.\textsuperscript{29} It was also seen above that their long-term investment outlook constitutes, according to the IMF, one of their defining characteristics.\textsuperscript{30} One of the most prominent examples of such investment behaviour include KIA’s 7.1 per cent stake in Daimler AG—making KIA one of the single largest shareholders of the German car manufacturer—that dates back to an investment made in 1969.\textsuperscript{31} A survey by Norton Rose LLP on SWFs and the global private equity landscape shows that, 71 per cent of SWF respondents said they regarded themselves as being longer-term investors than private equity firms.\textsuperscript{32} This is almost exactly the same percentage as all non-SWF respondents when they were asked directly if they thought SWF investments were longer-term than traditional private equity investments. When asked to explain their answer to this question, typical views included observations that SWFs had longer ‘time horizons’ and that they were not engaged in ‘active management’.\textsuperscript{33}

The above evidence, starting with the SWFs’ overall passive investment stance, makes it harder to argue about sovereign investments’ impact on national security. Any such impact would logically necessitate an active participation in general meetings and the use of voting power in favour of decisions which would harm local economies, such as moving jobs, expertise or classified information abroad. Similarly, it would necessitate a tendency from SWFs to appoint members in corporate boards to increase their influence and bargaining power. Such is usually the behaviour observed in institutional investors,\textsuperscript{34} a class of investors that SWFs are often compared to because of their size.\textsuperscript{35} No such evidence exists for SWFs. On the contrary, SWFs have a strong tendency to remain low profile and their only iconic investments are limited to companies that have no impact on national security (such as football teams or fashion retailers).

Next, SWFs’ long-term investment outlook serves to silence concerns about their impact on financial stability, as it is also confirmed by a number of studies and reports.\textsuperscript{36}

\textsuperscript{29} Moore and Choi (n 23).
\textsuperscript{30} See n 4.
\textsuperscript{32} Moore and Choi (n 23).
\textsuperscript{33} ibid.
\textsuperscript{34} As Davies noted in 2003, ‘shareholder activism on the part of institutions is now a bigger part of the corporate scene than it was, say, 20 years ago, and it is an activity which is crucially underpinned by the rights of shareholders at general meetings’. Paul Davies, Gower and Davies: Principles of Modern Company Law 6th ed, (Sweet and Maxwell 2003) 338; Richard Parnham, ‘German Lawyers Learn the Art of Shareholder Activism’ (2001) Euro Law 8; Bo Gong, ‘The Role of Institutional Shareholder Activism in Corporate Governance: a Comparative Analysis of China and the United Kingdom’ (2012) Comp Law, 172–74; Ryan Bolger, ‘Canada Signals “Sea Change” in Global Shareholder Activism’ (2012) 30(16) IFL Rev 12.
\textsuperscript{36} Such was the conclusion of an IMF empirical study on the subject. The impact is further analyzed on different sectors (financial and non-financial), actions (buy and sell), market types (developed and emerging markets), countries, and level of corporate governance (high and low); Tao Sun and Heiko Hesse, ‘SWFs and Financial Stability—An Event Study Analysis’ IMF Working Paper Monetary and Capital Markets
In the past, SWFs have been frequently compared to hedge funds due to their similar opacity and secrecy, a comparison which extended to their impact on host economies. SWFs, however, in practice bear little resemblance to hedge funds: as not only are they long-term investors, but they are also largely unleveraged. This finding, in combination with the fact that SWFs provided valuable financial liquidity during the financial crisis and came to the rescue of a number of high-profile financial institutions, makes it safe to conclude that SWFs do not present any particular considerations from a financial stability point of view. Although SWFs may still have to be subjected to wider prudential regulation, there is nothing particular or special about SWFs compared to other financial actors which should warrant the adoption of additional prudential regulations.

And yet, despite all available evidence, national security still often becomes a guise for protectionism and populism against SWFs. In an illustrative attempt to paraphrase Johnson, we may say that ‘national security’, nowadays, ‘is the last refuge of the scoundrel’.

(b) A rationale for regulation

Avoidance of investment protectionism

‘Protection’ in the economic sense is defined as:

The imposition of tariffs, quotas, or other non-tariff barriers to restrict the inflow of imports.

The concept of protectionism has existed in various forms throughout history. More recently, numerous protectionist measures emerged in the aftermath of the Global Financial Crisis (GFC). In particular, the World Bank reported that 17 G20 countries had implemented 47 measures whose effect was to restrict trade at the expense of other countries. Others resorted to sector-specific bailout programmes to support crisis-hit industries. Programmes that distort resource allocation and

37 Such as by a former Director at the SEC, Thomsen who said, SWFs, like hedge funds, are relatively opaque and they have, by virtue of their substantial assets, substantial power in financial markets, Linda Chatman Thomsen, ‘Testimony Before the U.S.-China Economic and Security Review Commission’ (2008) SEC <www.sec.gov/news/testimony/2008/ts020708lct.htm> accessed 1 November 2014.
38 The IMF estimated that only a few months other the financial crisis erupted (by February 2008), SWFs invested over US $35 billion into large banks, IMF (n 21) 10.
41 See further: Ha-Joon Chang, ‘Regulation of Foreign Investment in Historical Perspective’ (2004) 16 EJDR 687.
43 Wolf-Georg Ringe and Ulf Bernitz, ‘Company Law and Economic Protectionism – An Introduction’ in Ulf Bernitz and Wolf-Georg Ringe (eds), Company law and Economic Protectionism: New Challenges to European Integration (OUP 2010) 2 ff; One example being Germany’s national car scrappage scheme, labelled an ‘environmental bonus’. 
prove disadvantageous for other sectors and competitors in other countries effectively amount to trade barriers.\textsuperscript{44}

Protectionism may be motivated by political, or short-term economic considerations;\textsuperscript{45} however, it often comes at a significant economic cost to national welfare. One cost is the deadweight loss caused by restrictions to free trade, borne by consumers and society.\textsuperscript{46} It is estimated that trade restrictions raise the cost of imported goods in the USA by 20 per cent on average, and raise the price of comparable domestically produced goods by 10 per cent to 14 per cent because of reduced price competition.\textsuperscript{47}

Political opposition to cross-border M&A can equally impose monetary costs on the economic value of domestic firms. Examining the case of Congress’s opposition to CNOOC’s proposal to acquire Unocal in the USA,\textsuperscript{48} Won and Wang noted the significant setback in the share prices of both firms in the wake of anti-CNOOC events.\textsuperscript{49} These two portfolios lost a total of nearly $59 billion in their market values, which exceeded Kuwait’s 2005 GDP.\textsuperscript{50} Takeover protectionism can, therefore, similar to trade protectionism, compromise social welfare and an economy’s growth prospects.

Investment protectionism may also have detrimental effects on national welfare. A comparative analysis of the US economy between two periods can serve to prove this point. Between November 1982 and December 2007, substantial overseas capital was available in the USA and the economy was in recession only 4.6 per cent of the time.\textsuperscript{51} Conversely between 1945 and 1982, foreign capital was generally unavailable, and the economy was in recession 22.4 per cent of that time.\textsuperscript{52} More recently, the GFC showed FDI as not only a useful stabilizing force post-crisis, but also as possibly contributing to the recovery of the economy.\textsuperscript{53}

It thus becomes easy to understand the available choices of policy-making in terms of a trade-off between market openness on one hand, and prudential regulation and the protection of national security on the other. Formulating the proper regulatory response requires striking a fine balance between the need for foreign capital and the danger of foreign governments interfering in certain sectors of the national economy. It is difficult, in this sense, to predict when a regulatory response may go too far and become (or be perceived as being) overly protectionist. An

\textsuperscript{44} ibid.
\textsuperscript{45} Such as the preservation of employment, Patrick Messerlin, \textit{Measuring the Costs of Protection in Europe – European Commercial Policy in the 2000s} (Institute for International Economics 2001) 41.
\textsuperscript{46} See Milton Friedman and Rose Friedman, \textit{Free to Choose} (Harcourt 1980) 41.
\textsuperscript{48} See n 15.
\textsuperscript{50} ibid 448.
\textsuperscript{52} ibid.
example of the downside of protectionism was when the largest Chinese SWFs suspended investments in Europe before the financial crisis, as a reaction to the scepticism faced by the CIC in their operations in Europe. Similarly wary of protectionism, Nair argued that India should not create an SWF with the aim of investing India’s surplus in energy abroad, on the assumption that SWFs generally face protectionism and political backlash throughout the world. In short, Nair believes an SWF for India is more likely to bring problems rather than benefits. Similar claims have been made by the UAE’s Central Bank Governor. Finding where the red line lies for each potential (benign) investor is not an easy task either.

In this context, it is understandable why, as long as SWF investments are not examined from a public-policy perspective, concerns about them will persist, resulting in mounting pressure on national governments to adopt protectionist measures. Indeed, protectionist attitudes, obvious until the financial crisis, were seen as the direct result of the opaque nature and difficulty of determining the investment motives of SWFs.

Under this light, there should be no difficulty in establishing that the protection of the public from national or economic threats is more valuable than the efficiency gains that derive from market openness. Under this reasoning, national security is taken as of utmost importance and necessarily is hierarchically above financial

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54 Jiwei, CIC Chairman, characteristically said, ‘officials in Europe told me they wanted me to state clearly that we wouldn’t take stakes of more than 10%, or ask for voting rights . . . so I said fine, if Europe doesn’t want me, I won’t go. So I want to thank these financial protectionists, because as a result, we didn’t invest a single cent in Europe’, Jason Dean, ‘China Wealth Fund to Boost Investments’ The Wall Street Journal (New York, 20 April 2012) <http://online.wsj.com/article/SB124006120569931959.html> accessed 1 November 2014.

55 As observed Stephen Schwartzman, founder and head of the private equity firm Blackstone. ‘But since the spotlight has been put on them, they have pulled back dramatically. They don’t want to be members of a club that doesn’t want them as members. They’ve pretty much withdrawn’; Benjamin Cohen, ‘Sovereign Wealth Funds and National Security: The Great Tradeoff’ (2009) 85 Intl Aff 718.

56 Nair, a senior fellow at the Wharton Financial Institutions Center, supports this view on the basis that India should diversify its excess reserves in energy, a sector tightly protected by governments from foreign investments, Vinay Nair, ‘Should India Set up a Sovereign Wealth Fund? It’s a Bad Idea’ Knowledge@Wharton (27 March 2008) <http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4272> accessed 9 November 2013.

57 ibid.


stability considerations and economic efficiency. Financial stability is also rated as more important than economic efficiency, which can be pursued only once the fundamental goods of national security and financial stability are reasonably safeguarded. As Kern notes, there should be ‘no place for naivety – security interests should be defended’. The question then becomes: are those interests under threat, and, even then, is regulation necessary to achieve these aims?

Rationale for regulatory intervention

Having established the broad principles that must shape the regulatory response to SWFs, the next step is to establish a rationale for regulating SWFs. History has been dominated by the clash between economists who consider market forces to be largely sufficient to regulate the behaviour of market participants, and those who see regulation as an alternative to the failure of market forces to produce a socially optimal outcome. Regulation itself does not come without costs, nor is it panacea to every inefficient market outcome. It is essential, therefore, for the establishment of a regulatory rationale, to expose the elements that make regulation necessary.

The adoption of financial regulation is a process that is, to a large extent, reactionary to financial crises. According to Brunnermeier and others:

when everyone is calling for more regulation, for example, as now, in a post-crisis setting, it is not needed at all, since bank managers are timid and risk averse. When regulation is needed no one wants it, because asset prices are rising, there is a boom, everyone is optimistic and regulation just gets in the way.

Conversely, in the case of regulating SWFs, regulation is more popular when the economy is performing well, when company managers and governments can afford to be more selective about the origin of foreign investments and the reserves of SWFs grow at a faster pace. During downturns, foreign investments become crucial for the economy, and few governments discuss regulation. Indeed the financial crisis and the need for external capital has effected a shift in the attitudes of Western

62 Kern (n 7) 15.
governments towards SWFs. As to the time when regulation is more needed, there is no definitive distinction between times of growth and times of crisis, since the perceived risks of SWFs exist independently of the state of the recipient economy. Screening SWF investments during an economic downturn, however, could come at extremely high economic cost. Therefore, during recessions the immediate national interest dictates that SWFs remain unregulated regardless of possible future national security risks.

Thus, the objectives of wider financial regulation might be, for example, to sustain systemic stability, to maintain the soundness and safety of financial firms, or to protect consumers. The economic nature of those objectives implies that regulation ultimately aims to improve national welfare. However, it was seen above that regulating economic activity, such as trade or FDI, can harm national welfare as a matter of trade-off between them. The explanation for this apparent contradiction is that regulating trade or FDI (and thus giving rise to protectionism) can impede healthy economic activity and thus be welfare reducing. Regulating the financial sector, however, might address problematic activity, protect society from recessions and maintain national welfare. By extension, it is understood that trade and FDI can increase total welfare (defined as the surplus consumers and producers benefit from while conducting an economic activity) in the long-term, whereas an unregulated financial sector can increase total welfare only in the short-term. In the longer term, the financial sector, if left unregulated, will succumb to the boom-and-bust cycle, threaten financial stability, and produce losses for society as a whole.

Thus, the objectives of regulating the wider financial sector are mainly economic, namely the maintenance of financial stability and the protection of individual firms and minority shareholders.

The question then is, should standards of prudential regulation apply equally to public, as much as to private entities? Or maybe different considerations warrant a distinct approach for public entities engaged in economic activity? As SWFs are a relatively new phenomenon and have, so far, never given rise to financial stability concerns, the example of public (state run) pension funds may be of use here. Detailed regulations for pension funds exist in most countries. Pension plans, first, may give rise to information asymmetries and thus justify regulatory intervention to protect consumers, for example, by enforcing and overseeing disclosure. The investments and risk undertaken by pension funds may also create externalities and threaten financial stability and/or the stable outflow of pension payments. Further intervention may, thus, be justified to impose financial reserves and place limits on risky assets. One such example is the EU’s European Insurance and Occupational Pensions Authority (EIOPA) among whose core responsibilities is to support the stability of

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69 Formerly concerned governments, when the recession struck, set aside their concerns over national security and actively sought investments by SWFs, see n 66.

70 See n 39 onwards.

the financial system along with the protection of pension beneficiaries.\textsuperscript{72} Public pension funds are generally subject to prudential regulations to the same extent as private ones, and quite rightly. For instance, regulations in Canadian and European public and private funds require the use of liability discount rates that are based on high-quality interest rates.\textsuperscript{73} By contrast, in the USA the same only applies to corporate pension funds. Public ones, instead, may link the liability discount rates to the (assumed and thus arguably subjective) expected rate of return on their assets.\textsuperscript{74} According to a 2014 study by the Universities of Yale and Maastricht, US public pension funds made use of this laxity to accumulate substantial risky assets (amounting to 75 per cent of their portfolio). A major worry by the authors is that the increased risk-taking of US public plans could lead to substantial future costs to taxpayers or public entities, if their risky investments fail to meet the expected rates of return. They conclude that there is no reason why public pension funds should be regulated differently to private ones.\textsuperscript{75} This example is illustrative of the logical assumption that, as far as economic considerations are concerned, market imperfections (information asymmetries, agency problems, transaction costs, public goods, negative externalities, and imperfect competition) can equally arise from the behaviour of, or affect, public entities as much as private ones. This is also a fundamental premise of the principle of competitive neutrality, namely that ‘no business entity is advantaged (or disadvantaged) solely because of its ownership’.\textsuperscript{76}

Llewellyn identifies seven components of the economic rationale for regulation and supervision in banking and financial services.\textsuperscript{77} These are discussed below and their applicability to the case of SWFs considered (Figure 1). For this purpose, the main risks caused by SWFs are considered, examining their applicability to the various components of the rationale for the regulation of banking and financial services.

The first component is the potential systemic problems associated with externalities (a particular form of market failure). This point is intended to address the systemic risks caused by the behaviour of financial institutions. Systemic risks that flow from externalities usually describe the economically rational behaviour of a financial firm, which, if adopted by all firms, will cause the banking system to collapse.\textsuperscript{78} This threat is generally considered to be inherent in the financial sector because of the links between the firms operating in it and does not apply to other sectors, such as manufacturing.\textsuperscript{79} In the case of SWFs, such a threat is present only to the extent that SWFs investments might contribute to the creation of asset bubbles or where they collectively withdraw their investments thus causing market crashes. The available

\begin{itemize}
\item \textsuperscript{74} ibid.
\item \textsuperscript{75} ibid 31.
\item \textsuperscript{76} Antonio Capobianco and Hans Christiansen, ‘Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options’ OECD Corporate Governance Working Papers, No 1/2011, 3.
\item \textsuperscript{78} Brunnermeier and others (n 66) 13–23.
\item \textsuperscript{79} ibid.
\end{itemize}
evidence, however, defeats the likelihood of such a scenario. As it is stated, SWFs as a rule tend to execute long-term investments\textsuperscript{80} while instances of asset sales are rare.\textsuperscript{81} In any event, there is no credible reason why SWFs should not require separate consideration from other investment vehicles in the general context of financial regulation. However, a number of authors deem such a threat to be real.\textsuperscript{82}

The second component of the rationale for regulation is the correction of other market imperfections and failures. This means that there are inherent costs in the market, such as information problems, conflicts of interest, and agency problems that are not taken into account by the relevant actors while determining the price for their...


transactions. In light of the opacity of SWFs and the information asymmetries created thereby, this rationale appears to be more topical. It has been argued that SWFs raise questions as to their behaviour as shareholders and the risk of political interference. The existence of such a threat, however, is not supported by the experience with SWFs until now. In fact, despite the existence of SWFs for decades, not a single substantiated example of political interference has been recorded, indicating that fear scenarios involving SWFs exist merely in the realm of the hypothetical.

Quite to the contrary, it is believed that the unique scrutiny that SWFs attract and the suspicion surrounding them, cause them to act ‘hypercautiously’.

The third rationale identified by Llewellyn is the need for monitoring of financial firms and the economies of scale that exist in this activity. The idea behind this point is that all firms observe the rules laid down by market regulators, whether they concern financial stability, national security or investor protection and, as such, monitoring is a fundamental principle of any form of regulation and it applies to financial firms and SWFs alike.

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

The fifth component is the potential for gridlock. This term describes the situation where all firms know how they should behave towards customers but, nevertheless, adopt hazardous strategies to secure short-term advantages since detecting such hazardous behaviour is only possible in the long-term. SWFs, assisted by their opacity, could engage in such behaviour and hide political agendas behind their investments or use their financial influence to obtain political advantages (use of political leverage). However, as argued above, SWFs’ passive investment attitude and their general desire to remain low-profile leads one to conclude that this threat is limited.

The sixth rationale for regulation is the risk of moral hazard. It is associated with governments’ preferences to create safety net arrangements, including lender of last resort, deposit insurance, and compensation schemes. This element has no relevance to SWFs.

Llewellyn states consumer demand for regulation as the final component of the rationale. This aims at creating a degree of assurance among consumers, as well as encouraging lower transactions costs (for example, cost savings in investigating financial firms’ positions). This applies to SWFs if the recipient companies and countries are considered to be the consumers. A graphic representation of this analysis is provided in Figure 1.

83 Llewellyn (n 77) 21.
84 See n 12.
85 Truman (n 89) 4.
87 Llewellyn (n 77) 27.
As seen from the discussion above, the majority of rationales used to justify the regulation of the wider banking and financial sector could also apply to SWFs. However, the underlying premises of these rationales are disputed by various commentators. For example, various experts in the field contest the risks SWFs pose to systemic stability (Llewellyn’s first component) or political interference (part of the second ‘market imperfections’ component). When such risks are unsubstantial, then the rationale for regulating SWFs folds.

Thus, the question is whether the above-mentioned market imperfections necessarily warrant the adoption of regulation or whether the market response to market imperfections can be cost-effectively replaced or improved by government. Indeed, Mezzacapo argues that although markets do not necessarily provide first-best incentives to behave as efficiently as possible, (sometimes) they could provide strong incentives. Thus, Mezzacapo argues, when searching for an appropriate market response to market imperfections, it is crucial to determine the incentives of the various market participants. As stated above, the market imperfections created by SWFs (and the subsequent costs) are rooted in SWFs’ lack of transparency. Therefore, a clear incentive is created for SWFs themselves to build trust, but also more particularly, to devise rules, institutions, and behaviours, minimizing the costs flowing from the opacity of SWFs. Simultaneously, recipient governments and companies welcoming FDI have a clear incentive to maintain an open economy, while ensuring the protection of vital national and economic interests.

‘Transparency’ at the centre stage of the discussion

Increasing SWFs’ transparency is often considered the solution to most concerns regarding SWFs. Thus, the question of whether it is transparency that must be targeted by regulatory proposals has been elevated to centre stage in the discussion. It must be pointed out in this respect that various US and EU regulations provide for a considerable and comprehensive mandatory disclosure regime when a major stake in a listed company is acquired. However, as discussed above, such requirements have so far not produced an effective disclosure regime for SWFs.

88 An IMF study examined financial stability issues that arise from the increased presence of SWFs in global financial markets. It concluded that there is ‘no significant destabilizing effect from SWFs on equity markets, which is consistent with anecdotal evidence’, Sun and Hesse (n 36) 4.


91 ibid.

92 In the USA, statute requires disclosure of important information by anyone seeking to acquire over 5% of a company’s securities by direct purchase or tender offer, Securities Exchange Act 1934, Pub L 73-291, 48 Stat 881, 15 USC 78a and the following; When a major holding in a listed company is acquired or disposed, see arts 85–97 of Council Directive 2001/34/EC of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities.

93 See n 9 onwards.
Opinions diverge as to the role of transparency in the debate about regulating SWFs. Some authors view transparency as a means to achieve other results, while others argue in favour of transparency as an objective in itself.

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

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

Truman adopts a more principled approach towards transparency, stating ‘transparency [in SWFs] promotes horizontal accountability among the interested parties and stakeholders (domestic and international) as well as vertical accountability within the policy process’. ‘Accountability’, he adds, ‘involves the citizens of the home country, the citizens of the host country (who may distrust the motives of the foreign government), and the international financial community in general, including other participants in global financial markets’. Although Truman does not make his position as to the place and role of transparency in the discussion entirely clear, his stance comes close to arguing that there is a case for transparency per se.

Gilson and Milhaupt argue otherwise that increasing transparency is unnecessary, that the fundamental problem lies in the state-owned nature of SWFs, and in the fact that sovereigns have ‘different interests from private investors’. Therefore, ‘lack of transparency is not in itself the problem, and as a result transparency cannot be itself the solution’.

This article’s position is that while transparency and accountability of financial firms are sound governance principles, financial actors should be allowed to derogate from applying them fully if this is necessary for their operation. Transparency and accountability could become powerful tools in the hands of regulators tasked with

94 Mezzacapo (n 90) 28.
96 Mezzacapo (n 90) 45.
97 Truman (n 89).
98 ibid 8.
100 According to Gilson and Milhaupt, international investments are always political and the very existence of sovereign investors (quoting Truman) ‘calls into question our most basic assumptions about the . . . functioning of our economies and the international financial system’, ibid 3.
maintaining financial stability and eradicating market imperfections. In the case of SWFs, such funds should be actively encouraged to increase transparency, as this can alleviate potential concerns of recipient countries and create a more open environment for SWFs. Conversely, as things currently stand, SWFs should not be obliged to implement higher transparency standards than those required for their competitors (which is usually taken as the standard required for the maintenance of financial stability). This is where the principle of competitive neutrality (‘no business entity is advantaged or disadvantaged solely because of its ownership’)\(^\text{101}\) becomes relevant again. In fact, a certain degree of opacity is necessary for SWFs in order for them to maintain their effectiveness and competitiveness vis-à-vis other investment vehicles, such as hedge funds. Therefore, as long as no particular considerations apply to SWFs, then their mere government-owned status should not be enough to ground theoretical and unclear concerns about national security and political interference. At the same time, if a level playing field is established in the regulation of all financial actors, SWFs would not be permitted to resist calls for transparency on the basis that they are being unfairly discriminated against.\(^\text{102}\) Such examples are the requirement in the USA of disclosure of important information by anyone seeking to acquire more than 5 per cent of a company’s securities by direct purchase or tender offer,\(^\text{103}\) or the EU transparency rules when major holding in a listed company is acquired or disposed\(^\text{104}\) which apply regardless of the public or private nature of the investor.

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

Having analyzed the theoretical framework of the rationale for regulating SWFs, the article now moves on to examine regulatory structures that have been proposed in the past in the context of SWFs.

(c) Potential regulatory frameworks

In recent years, and since SWFs have attracted a level of attention, various regulatory models for SWFs have been proposed. A categorization of the models most commonly offered in the relevant literature follows.

In the first category are models that favour limitation of SWFs’ operations. For example, one suggestion proposes a ceiling on the amount of shares SWFs can acquire in domestic companies, or that it be conditional (on state approval) for share ownership to exceed a certain percentage. A second type of model favours ‘incentive-type’ regulations. Supporters propose imposing charges on SWFs (such as additional taxes or restricting voting rights) until they rectify the costs they impose on target countries, or until they transfer their assets to private actors. The third kind of regulatory proposal suggests imposing reporting requirements on SWFs. Finally, another

101 See n 75.
103 See n 91.
104 ibid.
regulatory model, discussed below, advocates allowing SWFs to regulate their behaviour by themselves (‘self-regulation’).

**Limiting SWFs’ acquisitions and protecting strategic industries**

The first model suggests imposing ceilings on the share quantities SWFs can acquire and/or protecting certain industries from their investment ambit. This regulatory model originally concerned formerly state-owned enterprises, in which Britain’s Government purported to continue to exercise control over future ownership and activities, through the possession of a ‘golden share’. This enabled the state to control the percentage of shares held in a company by foreign investors, or ensure its approval was required for the execution of business activities, such as mergers and asset sales.

Garten proposed a similar scheme, noting many governments contemplated adopting measures to protect their industries from SWFs, but failed to ‘admit that dealing with SWFs may require departures from the conventional liberal orthodoxy concerning global trade and investment flows’, which Garten believed necessary. He suggested SWFs should not own more than 20 per cent of any company in the USA or the EU without the host government’s permission. Garten suggested a requirement of reciprocity, where the ability of a country to buy foreign assets was conditional on it granting similar access to foreign (Western) funds. In his view, the underlying premise is that SWFs are essentially political entities and should be treated as such.

Investment caps soon became a popular idea among European countries. Das highlighted that the ‘knee-jerk reaction’ of analysts and policy-makers in the recipient economies is to limit the stakes that SWFs can have in [a] certain category of industries... Under such a model, the regulatory authorities of the host country can determine both the accessible and the stake limits of the industries. Such a model applies in India, where the Foreign Exchange Management Act 1999 enables ‘Press Notes’ to be issued and establish the foreign investment policy applicable to each sector. The Press Notes determine which sectors require the prior approval of the Foreign Investment Promotion Board before foreigners may directly invest in them and which do not require approval. Additionally, the Press Notes establish the maximum percentage of a company that can be owned by a foreign investor based on the sector in which that company operates.

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

Incentive-type regulation is softer than the regulation-type discussed above. It is designed to offer incentives to SWFs operating in various countries which encourage...
them either to rectify the various costs they impose on the system or to transfer the exercise of voting rights attached to company shares to third parties. While superficially appealing, analysis reveals that the underlying purpose of such proposals is to incentivize SWFs to suspend investment activities altogether.

The first incentive-type regulation is the one restricting the voting rights of shares held by SWFs, a historic protectionist measure against foreign corporate control. In the USA in 1791, legislative provisions were made in the charter for the country’s first quasi-central bank, the first Bank of the United States, to avoid foreign domination. Under the charter, only resident shareholders could vote and only American citizens could become directors. This provision prevented foreign control of the Bank, even though 70 per cent of its shares by 1811 were foreign owned.111

Gilson and Milhaupt developed this idea in relation to SWFs. The authors’ ‘minimalist approach’ was to remove the voting rights of equities of US firms acquired by foreign government controlled entities, until the equity is transferred to private hands.112 Their rationale is that, in principle, the interests of sovereign and private investors clash and they accept Keynes’s maxim that ‘international cash flows are always political’.113 The authors call this state directed capitalism ‘mercantilism’. By removing voting rights, sovereigns will refrain from exercising influence over management and those who have purely financial motives will continue to invest.114 This mechanism mirrors the ‘break through’ rule provided by the EU Takeover Directive.115

Gilson and Milhaupt accept that their model may lead to unsuccessful results if applied in an under-inclusive or an over-inclusive manner. In the first case (under-inclusion), the model will lack effectiveness if it is not applied to other manipulative transactions, such as requiring strategic concessions before an SWF injects more capital into a portfolio company (problem of reciprocity); or if it does not cover state investment entities other than SWFs which may also be used to advance political goals, such as government-controlled companies.116 The authors believe that these problems can be managed under existing disclosure rules in developed countries or via other measures dealing with the phenomenon of state capitalism in general.117

In the second case (over-inclusion), the measure may apply to foreign public entities other than SWFs, such as state pension funds, and could risk being imposed by foreign governments on US state pension funds, such as the CalPERS. Gilson and Milhaupt argue that suspending the voting rights of US state pension fund foreign equity investments should not hurt the funds’ performance for the same reason that vote suspension should not deter US equity investments by foreign SWFs who do not have a strategic motive.118 Conversely, this negates the positive impact that

111 Chang (n 41) 3.
112 Gilson and Milhaupt (n 99) 10.
113 ibid 1.
114 ibid.
115 The ‘break through’ rule provides that shareholder voting restrictions provided by corporate charter, contracts or different shareholders’ agreements do not apply where the offeror has gained 75% of the target company’s shares.
116 Gilson and Milhaupt (n 99) 26–28.
117 ibid 28.
118 ibid 30.
shareholder activism by US state pension funds has had on corporate governance standards in other countries. The authors accept this cost, but believe it is not a large one, mainly because the role played by US state pension funds in the effort to improve corporate governance standards has not been central.119

Another proposal falling in the category of ‘incentive regulation’ is the one offered by Fleischer in 2009.120 Fleischer based his discussion on the US tax regime that currently treats SWFs as sovereigns for tax purposes.121 Sovereign status in this context can be a significant benefit. As long as the SWF does not engage in commercial activity other than ‘portfolio investments’ (defined as the acquisition of non-controlling stakes), the funds can avoid both US income taxes and withholding taxes on their US investments.122 Private-foreign investors, conversely, are generally taxed lightly on their portfolio investments in the USA, but do face significant taxes on some types of income, such as dividends from US corporations and certain real estate investments.123 Fleisher, citing Qantas Airways v US,124 argues that such generosity is not required under international law, as ‘the international doctrine of sovereign immunity as such imposes no restrictions’ on the USA’s right to tax SWFs.125

Calculating when an exemption should be warranted would be complex since SWFs have varying degrees of independence from government influence.126 In the USA, an entity which is at least 50 per cent owned by a foreign government loses the tax exemption,127 as does one where the foreign government128 has sufficient interest for effective control.129 The US policy ensures SWFs remain as minority shareholders and draws the line at having foreign governments control US companies without paying tax.

In other cases it may be futile to attempt to link an SWF action to its respective government. Even if this hurdle is overcome, most governments now adopt a more restrictive approach towards sovereign immunity, which immunizes foreign states from suits in connection with sovereign acts, but does not equally cover commercial acts.130 This exception from immunity applies both with regard to immunity from jurisdiction as well as immunity from execution.131 States adopting this approach

119 ibid.
121 US Tax Code, s 892.
123 Fleischer (n 120) 463–5.
124 Qantas Airways, Ltd v United States, 62 F 3d 385, 388–90 (Fed Cir 1995).
125 Fleischer (n 120) 459.
126 SWFs can have varying degrees of independence from government influence. In certain cases it would, indeed, be futile to attempt to link an SWF action to its respective government.
128 Defined as the integral parts of a government or any body that constitutes a governing authority.
include the USA\textsuperscript{132} and the UK\textsuperscript{133}, the primary recipients of SWF investments. The jurisdictional immunities of the state were addressed again in February 2012 in the case of \textit{Germany v Italy (Greece intervening)}\textsuperscript{134} before the International Court of Justice. The Court noted that it was not called upon in these proceedings to consider the question of how international law treats the issue of state immunity for non-sovereign activities, especially private and commercial activities (\textit{acta jure gestionis}) to which, under many laws, immunity does not apply. As Truman, rightly, notes:

\begin{quote}
governments are understandably concerned about not compromising their room to manoeuvre in managing their international investments \ldots however, once a government seeks to operate outside its national borders, then it no longer is “sovereign” in most respects.\textsuperscript{135}
\end{quote}

Indeed, in most jurisdictions, sovereign immunity does not apply to foreign governments’ commercial activities.\textsuperscript{136} This point becomes relevant when considering the applicability of the ‘act of state doctrine’ to the behaviour of SWFs. The act of state doctrine holds that ‘every sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgement on the acts of the government of another done within its own territory’.\textsuperscript{137} This doctrine is used to protect a national government from the scrutiny of acts performed within its own borders by foreign courts.\textsuperscript{138} For acts performed by a government outside its national borders, the act of state doctrine cannot be evoked.

Fleischer develops a theory of taxing sovereign wealth as a complementary instrument to other regulations. He performs a cost–benefit analysis (CBA) of the operation of SWFs and concludes that the negative externalities outweigh the positive ones.\textsuperscript{139} In his view, because the potential for negative harm is severe, the potential

132 Letter from Tate, Acting Legal Adviser, US Department of State, to Acting US Attorney Perlman, 19 May 1952, reprinted in 26 Department of State Bulletin 984–85; Under the restrictive theory, foreign states were accorded immunity for their governmental acts, but not for their private or commercial acts.
133 s 14(2), (3) State Immunity Act 1978.
135 Truman (n 89).
137 Underhill \textit{v} Hernandez, 168 US 250 (1897). In this case, Underhill instituted an action in a New York Court to recover damages for his detention in Venezuela by Hernandez’s new revolutionary government. Finding for the defendant, the court determined that Hernandez had acted in his official capacity as a military commander so his actions were those of the Venezuelan government. Therefore, based on the act of state doctrine, the Court refused to hear Underhill’s claim against the government.
139 He argues SWFs: threaten American foreign policy interests; support the inefficient allocation of resources; increase managerial slack (for example, when China acquired a non-voting stake in Blackstone); may have a contagion effect as a result of their lack of transparency; encroach on the autonomy of the American enterprise (in exchange for foreign investments), and support autocratic regimes, see (n 120) 485 ff.
for positive benefit modest, and the capital supplied by SWFs so easily replaced by private investors, there is a *prima facie* case for a Pigouvian tax. Fleischer argues that setting the right tax rate depends on what policymakers believe is the hurdle rate of SWF investors, which means in practice, whether they should be taxed more or less than private investors.

Following representations made to the US Joint Committee on Taxation, Funk argues the US tax exemption in reality is unlikely to impact on the structure of an investment by an SWF, given the usual nature of such investments. The notion that SWFs’ investments are not significantly affected by possible tax exemptions may minimize the economic (if not political) case for a Pigouvian tax.

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

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

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

Keller suggests an ‘indirect’ supervisory and regulatory framework adapted to address the specific concerns about SWF investments may be based ‘on the mandatory requirement for a SWF to conduct investments over a certain threshold (or investments of certain kinds) through third-party professional asset managers’, or

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140 Although he states that ‘neither the brightest promises nor the greatest perils of [SWFs] have yet been realized’, see (n 120) 494.

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


143 Fleischer (n 120) 469; 472–3.

144 Staff of Joint Committee on Taxation, 110th Cong, Economic and US Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States 21–22 (Comm Print 2008).


146 For examples of such regulations, see for instance, in the US context, the Employee Retirement Income Security Act 1974 (Pub L No 93-406, codified in part at 29 USC s 1002 and the following) applying to pension funds; the Investment Advisers Act 1940 (15 USC s 80b-6) for institutional advisors; See also, Sandra Blome and others, *Pension Fund Regulation and Risk Management: Results from an ALM Optimisation Exercise* OECD, Working Papers on Insurance and Private Pensions No (2007) 8.
alternatively ‘to disclose its shareholder voting records when the ownership percentage in a company exceeds a given threshold’.147

A more detailed model is proposed by Mezzacapo, who suggests following a two-layer approach of ‘self-regulation within a statutory framework’,148 similar to the one widely adopted in Europe for stock exchange regulation. In this respect, she recalls the provisions introduced in 2005 in the Italian Financial Consolidated Act149 in order to increase transparency, and thus market discipline, in relationships between Italian listed companies and foreign companies having their registered office in a country whose legal system does not ensure transparency.150 The same provisions also apply to Italian companies with financial instruments widely distributed among the public and affiliated with or controlled by such foreign companies.

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

In order to prevent jurisdiction shopping by SWFs, where state investors would select as targets the jurisdictions that are more favourable to them, reporting requirements could be implemented on a global basis. A number of international organizations could be considered to host such an enterprise, although it is argued by Mattoo and Subramanian that the WTO would be the ‘natural’ place to strike a bargain between countries with SWFs which want secure and liberal access for their capital, and capital-importing countries that have concerns about the objectives and operations of SWFs.151 According to the authors, such a bargain would necessarily involve greater transparency by SWFs and channelling investment through independent asset managers, in return for access for SWF investors to Western markets. The model for the transparency requirement could be the disclosure requirements of the OECD’s principles of corporate governance.152

**Self-regulation**

Since the beginning of the debate on SWFs, the idea of self-regulation has not received wide support in the literature. Most commentators seemed unaccepting that, left to themselves, SWFs would produce a reliable regulatory framework to address

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148 Mezzacapo (n 90) 45.
149 Legislative Decree n 58 of 24 February 1998.
150 Meaning transparency as to their establishment, assets and liabilities, and operations.
the perceived costs raised by the activity of SWFs. The model of self-regulation was, nevertheless, the one opted for by the IMF during the International Working Group which culminated in the ‘Generally Accepted Principles and Practices’ (GAPP) (discussed in more detail below). Even now, GAPP (or ‘Santiago Principles’) offer possibly the most effective route towards reducing the costs due to SWFs and silencing their critics, and together, reducing protectionist pressures.

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

(d) Analysis

The basic problem identified in the above-mentioned proposals is that they appear to be overshooting the mark. Nearly all of these proposals are based on the misguided premise that regulation is necessary to preserve national security and other interests, while the available evidence on SWFs shows that such intervention is unnecessary. Additionally, each of those proposals is likely to impose extra burdens upon SWFs which might incite them to seek investment opportunities elsewhere, where they will not face protectionism. Thus, such models can result in being more economically injurious than beneficial.

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

Theory

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

This first objection could form a preliminary basis for rejecting most of the above models. In practice, any measure that aims at screening FDI on national security or any other grounds (even those justified) involves some degree of protectionism. However, the above models appear to go beyond what is necessary to guarantee specific national interests. As explained above, most of the concerns about SWFs, which prompted the above regulatory models, are

153 Although, it may still serve a useful purpose in satisfying critics and general consumer demand for a risk-free economic environment. See above, the fourth component of Llewellyn’s rationale, ‘consumer confidence’.

154 See above the case of Chinese funds, n 54.

155 Figure 2.

156 Mattoo and Subramanian (n 151) 16.
either theoretical, exaggerated, or completely unfounded and thus do not need addressing with hard-line legislative measures. In fact, the available evidence on SWFs shows that they do not pose realistic national security threats. Moreover, it has been advocated in this article that nothing in the structure, size, or behavior of SWFs poses particular financial stability risks, that is, different to those posed by other market actors, such as hedge funds and private equity firms. In other words, while acknowledging that SWFs could have an impact on financial stability and, thus, should be subjected to the same standards of prudential regulation as other actors, there is nothing specific about SWFs that should warrant special regulations. If anything, the behavior of SWFs, (given their risk aversion, passive behaviour and long-term outlooks) as well as their injections of liquidity during the crisis,\textsuperscript{157} show they are a factor of stability in international financial markets.

Garten’s model (setting investment caps) has been met with fierce opposition in The Economist. In its criticism, The Economist described Garten’s view as ‘outrageous’ and said that he fails to explain ‘how any of this would serve the interests of the countries in which SWFs might want to put their money’.\textsuperscript{158} It was, moreover, argued that there are better ways of managing risk. If, for example, the government of North Korea was in a position to lay its hands on vital defence-related technology by buying British Aerospace, say, that would, indeed, be a worrisome development. But the danger could be prevented ‘by making any such takeover subject to a national-security veto’, as would be the case in the USA.\textsuperscript{159} Following this article, and during the financial crisis, Garten himself retreated from his position, stating that he had ‘misjudged the context of global capital flows in the last half of this decade’ and that ‘we should be careful not to discriminate against SWFs, especially as compared with other investors such as private equity, hedge funds and corporations’.\textsuperscript{160}

This usual mistrust towards SWFs also appears in Gilson and Milhaupt’s model. They, however, do not consider their proposal ‘protectionist’, believing a protectionist measure to be one designed to protect domestic companies’ commercial interests. Whereas their proposal ‘would not lower investment values for foreign investors on account of their nationality or sovereign affiliation \textit{per se}.’\textsuperscript{161} They believe that the absolute value of the investments (and thus their attractiveness) will remain unaffected by their proposal. However, it cannot be guaranteed that the economic value of a non-voting share will remain the same \textit{vis-à-vis} sovereign investors,\textsuperscript{162} or that the overall value of a share will not decrease (even very modestly) if demand by SWFs drops. In any event, Gilson and Milhaupt’s argument appears to be an attempt to stretch the analysis of their model to bypass the ‘protectionism’ label. It is difficult to

\begin{itemize}
  \item \textsuperscript{157} See n 38.
  \item \textsuperscript{158} Economist staff, ‘Fear of Foreigners’ Economist (London, 14 August 2007) \texttt{<www.economist.com/node/9641906> accessed 26 December 2013.}
  \item \textsuperscript{159} ibid.
  \item \textsuperscript{161} Gilson and Milhaupt (n 99) 11.
  \item \textsuperscript{162} Principle No 21 of GAPP states that ‘SWFs View Shareholder Ownership Rights as a Fundamental Element of Their Equity Investments’ Value’, see International Working Group on Sovereign Wealth Funds, ‘Sovereign Wealth Funds - Generally Accepted Principles and Practices’ (October 2008) \texttt{<www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> accessed 20 January 2014.}
\end{itemize}
see how removing an important privilege from a specific type of foreign investor can escape the characterization of ‘protectionism’. In addition, their proposal appears to discriminate against sovereign investors by removing a fundamental proprietary right (the voting right attached to each share) for a weak justification, which is to protect ‘market-based capitalism against mercantilist regimes’. Their justification, therefore, appears to be based primarily on the ideological premise that state capitalism is inherently problematic.

A similar inclination to that of Gilson and Milhaupt’s is also evident in Fleischer’s proposal (a fact which reinforces the reasons for including these two models in the same category). Fleisher argues that ‘a tax on sovereign wealth could help encourage a broader policy of supporting private investment over state-controlled investment’. In this respect, it should be said that while taxing and removing voting rights from SWFs appears to ‘incentivise’ them to operate differently, in reality what both theories suggest is to maintain the restrictions for as long as SWFs hold domestic securities or to tax them simply for their presence in the domestic market. There is little SWFs can do to remove those restrictions or avoid taxation, other than abandon the market altogether.

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

Implementation

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

The implementation of the first category of proposals, namely, restricting the investments of SWFs, is prevented by the problem as to how to identify an investor or a fund that should be subjected to such restrictions. This is a controversial and multifaceted issue. Furthermore, some host country corporations and pension funds may be as averse to such limitations on the SWFs as the SWFs themselves.

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

Since some of those models support restriction of FDI, in particular sectors, a serious obstacle in their implementation would be identifying those ‘strategic sectors’ that warrant special protection. It would be very difficult to adopt in the EU context a uniform framework establishing which industries are ‘strategic’ and which are not. In carrying out such an enterprise, each Member State would be bound by its own interests and beliefs and by its own special circumstances, making it difficult to identify those sectors or sub-sectors of a strategic value to every Member State. The fact that France included ‘casinos’ in its 2005 list of strategic industries as being ‘directly or indirectly linked to matters of national security’, is only demonstrative of the difficulties awaiting the EU regulator faced with the task of formulating an EU-wide list. In its capital movement case law, the CJEU has given directions as to what activity constitutes a strategic interest (which would, in any event, exclude sectors as obviously not strategic as ‘casinos’) but they still remain very broad and, more importantly, they do not give sufficient direction as to what specific parts of a sector are strategic. As a result, the Court may view Telecoms a ‘strategic’ industry, although the Commission might not classify an entire national telecoms industry as strategic, rather only specific parts.

A similar, if not more difficult, task would involve identifying those funds that should be subject to reporting requirements. First, a number of high-profile SWFs

169 Commission v Belgium para 49.
171 See for instance, Commission v Spain para 66; Commission v Belgium para 43; C-367/98 Commission v Portugal para 47.
172 Commission v Spain para 71.
would refuse to be characterized as such.\textsuperscript{173} Thus, each country would be faced with the task of unilaterally picking the specific funds that must disclose more information without driving those funds’ investments away to other countries.

To ensure a level playing field among all countries concerned, a global list of SWFs could be agreed multilaterally, possibly within the context of the WTO, as suggested by Mattoo and Subramanian.\textsuperscript{174} This would prevent both the reduction of FDI in countries that implement stricter reporting requirements, and prevent the exploitation by SWFs of poorer underdeveloped countries in urgent need of foreign capital that are unable to screen FDI, let alone impose reporting requirements.\textsuperscript{175} However, it is unclear how an international institution could force a member to subject its state-owned funds to reporting requirements, or even force it to recognize that it possesses such a fund in the first place.\textsuperscript{176} The failed outcome of the negotiations for a Multilateral Investment Agreement (MIA) in 1998\textsuperscript{177} under the auspices of the World Bank and the OECD, and the failure of the WTO to include investment issues in its mandate in 1994 are sufficiently paradigmatic of the difficulties of such an endeavour.\textsuperscript{178}

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

Finally, Fleischer’s taxing model appears less difficult to implement, but it is doubtful whether tax policy can identify the appropriate tax to compensate for risks to national security. Tax authorities are hardly the appropriate bodies to protect national security and set foreign policy. In other words, how is a tax official supposed to calculate and impose a tax to compensate for the cost of ‘threatening American national interests’ or ‘supporting autocratic regimes’?\textsuperscript{179}

Costs

The final part of the analysis discusses the potential costs of each system. Here, the consequences between various policy options deriving from the Great Tradeoff (as described by Cohen)\textsuperscript{180} between market openness and national security, become


\textsuperscript{174} Mattoo and Subramanian (n 151).

\textsuperscript{175} The WTO’s dispute resolution mechanism would ensure that countries with SWFs respect the established rules, Agreement Establishing the WTO, 15 April 1994, 33 ILM 1144, <www.wto.org/english/docs_e/legal_e/04-wto.pdf> accessed 1 November 2014, establishing the WTO’s structure and relations among its members.

\textsuperscript{176} For example, Saudi Arabia has never publically admitted to managing such a fund.

\textsuperscript{177} MIA purported to develop multilateral rules that would ensure intra-state investment was governed in a more systematic and uniform way. This enterprise halted because of insurmountable disagreements, including the ‘exception culturelle’ maintained by France and Canada in support of French culture, Jean-Rodolphe Fiechter, ‘The French Strategic Investment Fund: A Creative Approach to Complement SWF Regulation or Mere Protectionism?’ (2010) 3 J Appl Econ 59, 67.

\textsuperscript{178} ibid.

\textsuperscript{179} Fleischer (n 120) 451.

\textsuperscript{180} Cohen (n 55).
more obvious. The costs associated with each system may differ greatly, but they also depend on the special circumstances of each country. For example, during the Dubai Ports case, the argument was used that such a deal might facilitate the smuggling of terrorists into the USA from the Middle East. Concerns about terrorism, however, are not identical for all countries that receive SWF investments. This fact must be considered when assessing the costs and benefits of a model, when applied in different countries. If the USA is a far more popular destination for foreign capital than other recipient countries, it may be more willing to sacrifice a small part of this in order to maintain national security safeguards. In contrast, FDI in Greece, Portugal, Spain, and Ireland might have a higher value during the debt crises currently facing these countries, and thus the cost of hindering foreign capital might be higher for them than for Switzerland or Estonia. For this reason, the costs (or benefits) of each regulatory model are determined by circumstances which are better assessed on a case-study basis.

Any national authority contemplating establishing a regulatory framework for SWFs should do so on the basis of a CBA. A regulator that does not use a CBA to formulate new policy or to check on the impact of specific measures runs the risk of delivering an output that may reflect the given objectives but may lead to unintended inefficiency, since not all relevant factors will be considered. One of the most important elements of the CBA is the description of the difference between the world as it would be if a proposed option were adopted and the situation if it were not adopted. A CBA, therefore, focuses on the incremental impact of the proposed options (including the ‘do nothing option’). According to Alfon and Andrews, the cost of no action in the wider financial sector could be large: a complete market failure, while the indirect costs (negative market impact) are those that are least obvious from a cash perspective. On the subject of regulation of SWFs, the no action option will hardly result in a complete market breakdown or a threat to national security. Conversely, the indirect costs that may arise from strict regulation of FDI warrant more attention and analysis.

At the present time there are sufficient indications of the trade-off that ensues if governments give way to protectionist calls and adopt legislation restricting SWFs. Bloomberg and Schumer have cited the example of the US Sarbanes–Oxley Act 2002—shortly after its passing, there were signs of investment shifts towards Europe and Asia. While discussing protectionism (see above), it was stated that Chinese funds have proved that they are prepared to seek investment opportunities elsewhere

181 Levin (n 17).
185 ibid.
186 ibid 18.
187 ‘Over the first ten months of 2006, [USA] exchanges attracted barely one third of the share of IPOs measured by market value that they captured back in 2001, while European exchanges increased market share by 30 percent and Asian exchanges doubled their share’, Michael Bloomberg and Charles
if faced with a protectionist backlash, even before the adoption of concrete legislation. Such behaviour was in line with previous statements by Chinese officials that they will avoid investing in countries that use national security as an excuse for protectionism. Moreover, as already explained, the protectionist outlook of many Western countries in the energy sector may be hindering India from creating an SWF, thus further reducing global liquidity. Such a fund would aim to direct its investments in the Western energy sector to complement India’s lack of natural resources, but would certainly raise suspicions and eventually face the resistance of Western governments. Even when investments are not met with resistance by national administrations, the highly heterogeneous standards of foreign investment regulations set up by different governments can still inflict considerable compliance costs on SWFs and hence affect the efficient flow of capital.

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

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

Gilson and Milhaupt, who suggest removing the voting rights of state investors, themselves admit the risk of over-inclusion, namely the expectation that governments whose SWFs and pension funds have their voting rights suspended will impose similar suspensions on the equity holdings of comparable US government
entities.\(^\text{193}\) As they admit, this side-effect might cause the positive impact that shareholder activism by US state pension funds, for example, CalPERS, has had on corporate governance standards in other countries, to be lost.\(^\text{194}\) However, Gilson and Milhaupt appear prepared, albeit tacitly, to accept a larger loss than they openly admit, since the positive effect of activist SWFs investing in domestic equity will also be lost. Sovereign shareholders, in their few instances of activism have on many occasions benefited companies by raising takeover premiums and opposing hostile takeovers.\(^\text{195}\) Finally, an additional type of cost incurred by this model is the reduction in value of the shares in question. As SWFs would abstain from purchasing such stock, and would arguably favour stocks from other countries or investments in government bonds or real estate, the subsequent drop in demand for shares would also be reflected in their price. Although this reduction could be small (even minuscule), no company management would choose to incur it simply to prevent sovereign shareholders from voting in company meetings.

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

\begin{table}[h]
\centering
\begin{tabular}{|l|l|l|l|}
\hline
Regulatory Model & Theoretical Objections & Implementation & Costs \\
\hline
\textbf{Investment Caps} & Discriminatory/Protectionist & Contravening EU law/Difficulty of adopting a common position & Reduced foreign investment \\
(Garten/Davies) & & & \\
\hline
\textbf{Incentives Regulation} & Discriminatory/Protectionist & Contravening EU law/Difficulty of value judgments & Reduced foreign investment/Loss of equity value/Reduced shareholder activism \\
(Gilson & Milhaupt/ Fleischer) & & & \\
\hline
\textbf{Command and Control} & Discriminatory/Protectionist & Public or confidential disclosure? & Reduced foreign investment \\
(Truman/ Garten/Mezzacapo) & & & \\
\hline
\textbf{Self Regulation} & No objection & Doubts as to effectiveness & No objection \\
(IMF/SWFs) & & & \\
\hline
\end{tabular}
\end{table}

\(^{193}\) Gilson and Milhaupt (n 99) 29.
\(^{194}\) Ibid 30.
\(^{195}\) For example, Norway’s Government Pension Fund’s opposition to MidAmerican’s bid for Constellation in late 2008, where the Fund had a 4.8% stake. Norway’s SWF considered the price insufficient and has brought MidAmerican to court.
opaque SWFs pay a ‘Pigouvian’ tax\textsuperscript{196} to the recipient countries, to compensate for the costs they impose on them (however large or small) and at the same time be incentivized to become more transparent.\textsuperscript{197} It can be argued that the tax incentive proposal is a good way to incorporate the cost, if any, in the decision-making of SWFs and thus appears to be the most effective way to regulate ‘market imperfections’.\textsuperscript{198} Although Fleischer’s proposition, surely, also creates the risk of turning investors away and hardly escapes criticism as to the obstacles to its implementation, from the point of view of costs it is, at least in theory, the best of the models discussed so far.

**Self-regulation**

The above analysis indicates that most types of hard regulatory interventions to regulate SWFs have serious setbacks as much from a theoretical perspective, as from the point of view of implementation and costs. The present section discusses the alternative model of supranational self-regulation favoured by the IMF. A proposal prioritizing international over national action is founded upon the belief that a set of commonly accepted shared values is of chief importance for the effectiveness and legitimacy of such a governance structure. Binding sovereign investors together, with the additional involvement of an international institution, is a more effective way of enhancing the legitimacy of regulatory intervention than unilateral action.\textsuperscript{199}

Compared to the national regulatory options discussed above, supranational responses to SWFs present a number of advantages. First, supranational bodies are perhaps more immune to short-term political considerations such as a possible momentary suspicion towards foreign investments.\textsuperscript{200} As a result, measures adopted by such an entity can offer greater objectivity, focus on longer-term benefits and resist frequent changes in the law. Secondly, the objectivity of a supranational effort, removed from national political considerations, could also appeal more easily to SWFs and include them in the rule-making process, thus equating this process to that of self-regulation.\textsuperscript{201} Thirdly, supranational responses are harmonized. The heterogeneity of various national investment review standards could impose undue costs of compliance on SWFs and hence affect the efficient flow of capital.\textsuperscript{202}

\textsuperscript{196} See n 140.
\textsuperscript{197} If the negative externalities generated by outweigh the positive externalities, this may warrant a higher tax on SWFs. If the opposite applies, this may warrant subsidizing SWFs, ibid 29.
\textsuperscript{198} As argued by Llewellyn on the rationale for regulation, ‘focusing on the accountancy cost of regulation (which can be measured) overstates the true cost of regulation because it does not incorporate the true value of the consumer benefit if the effects of market imperfections are alleviated’, Llewellyn (n 77) 21.
\textsuperscript{199} Additionally, for the importance of shared values in the modern global financial regulatory architecture, see, Emilios Avgouleas, *Governance of Global Financial Markets* (CUP 2013) 435–39.
\textsuperscript{200} Such calls are sometimes reflected in the unjustified negative press that foreign investors receive.
\textsuperscript{201} Self-regulation describes an array of regulatory instruments that rely upon consensus and co-operation as a means through which behaviour is regulated, Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation – Text and Materials* (CUP 2009) 92.
\textsuperscript{202} Mattoo and Subramanian (n 151) 16.
This regulatory framework is typically implemented through the means of a Code of Conduct (CoC). A CoC is defined by the International Federation of Accountants as a set of:

| principles, values, standards, or rules of behavior that guide the decisions, procedures and systems of an organization in a way that (a) contributes to the welfare of its key stakeholders, and (b) respects the rights of all constituents affected by its operations. |

CoCs, as policy tools, are usually entered into on a voluntary basis, meaning that the negotiating members were not compelled to participate by a central decision maker. Rather, a central body provided its members with an opportunity to negotiate and agree on a set of rules. This method of setting international standards is common, given that the drafting of command-based tools is, in most cases, unrealistic beyond the national level. Attempting to establish mandatory rules at the international level would necessarily encounter the problems identified above.

**CoCs and SWFs**

The effort to establish an international regulatory framework for SWFs was primarily led by the OECD, which opened the way for the IMF to elaborate on the issue even further. The OECD Investment Committee began by publishing a report to the G7 countries on SWFs and recipient country policies. This document highlighted the beneficial impact of SWFs on the global economy and recognized the legitimacy of national security concerns although it stated that these cannot be a cover for protectionist policies. The OECD suggested that security-related investment safeguards should be made as open as possible and that investors and home countries can ease concerns through greater transparency. The OECD policy initiatives continued with a declaration on SWFs and Recipient Country Policies in 2008, and with a publication collecting the main OECD policy instruments that apply to SWFs and

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204 Morgan and Yeung argue that the absence of democratic rule-making institutions that can legitimately establish and enforce legally binding commands across and within nation states constitute the main hurdle in utilizing command-based techniques at the supranational level, Morgan and Yeung (n 201) 313.

205 See n 152 onwards.


207 ibid 4.

208 ibid 6.

recipient countries. These two policy documents largely restated the conclusions of the April Report to the G7 countries.

Arguably, the most important step in the process of the supranational regulation of SWFs came in October 2008, when the International Working Group (IWG) of SWFs published GAPP. This was the result of a long process of reflection led by the IMF and the G7 over the impact of SWFs on financial stability and the potentially political character of their investments. The purpose of GAPP was to promote those accepted principles and practices that establish appropriate governance and accountability standards regarding the investment practices of SWFs. A distinctive feature of GAPP, as opposed to the policy tools of the OECD, is that they were drafted with the participation of some of the world’s largest SWFs, thus amounting to a self-regulatory initiative.

GAPP consists of 24 practices and principles, focusing on three key areas. These are intended to be implemented by SWFs and include: (i) legal framework, objectives, and coordination with macroeconomic policies; (ii) institutional framework and governance structure; and (iii) investment and risk management framework where SWF managers were encouraged to disclose more information. GAPP left it to each individual SWF to assess their implementation, and disclose their assessment to the public.

The object of SWFs should not be to project state power. Instead, according to Principle 19 it is to ‘maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds’. If investment decisions do not comply with this goal, then the goal of the fund’s investment policy ought to be disclosed. It is suggested by Backer that such deviation from the suggested model might open that fund to special regulation. SWF management ‘should be consistent with what is generally accepted as sound asset management principles’ (Principle 19(2)).

GAPP reaffirmed the distinction between private and public funds. While the objective of the private funds lies in the maximization of their owners’ wealth, public ones may have a wider array of objectives, such as macroeconomic ones. This view of GAPP suggests, however, that the attainment of macroeconomic objectives is limited to economic ones and does not extend to political goals. Moreover, a number of principles encouraged the separation between the entity and the sovereign. This is supported through the establishment of clear objectives for the fund, the division of roles and responsibilities, and provisions on independence and the maximization of

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211 OECD (n 206).
212 Although the October publication included older OECD instruments on international investments that were also of relevance to SWFs.
213 IWG, ‘GAPP’ (n 162).
214 As Norton says, the issues considered included the relation of SWFs to: (i) financial stability and currency exchange rate impact; (ii) possible geo-political issues; and (iii) risk management issues, including matters of transparency, accountability, and governance, Joseph Norton, "The "Santiago principles" for SWFs: a Case Study on International Financial Standard-setting Processes" (2010) 13 J Intl Econ L 645.
risk-adjusted financial returns. This may be accomplished at a functional level, for example, through a legal specification of roles and responsibilities.

GAPP’s main aim is, therefore, to make the sovereign entity act like a private one. This insistence on the ‘private actor’ is not unknown as it is widely used in the EU law of state aid, where an action by the state is compared to that of a private actor under similar circumstances, to determine whether it is compatible with the common market.

However, while directing SWFs to adopt the conduct of a private investor, GAPP does not require the funds to hire external managers. Instead, it is the fund’s investment policy that should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.

Implementation of GAPP
CoCs still present a significant weakness in terms of the absence of any formal enforcement mechanism. No SWF is under any obligation to implement or observe any of these principles, not even those funds that took part in the preparatory work of the IWG. Although under national self-regulatory models the law may intervene in a facilitative capacity by enforcing mutual agreements, such enforcement cannot be easily implemented at the supranational level where compliance is usually reliant upon the parties’ willingness to observe the agreed rules. The absence of an appropriate enforcement mechanism thus risks rendering those commitments ineffective.

This concern, although a valid one, should not be overstated. Enforcement, just like standard-setting, differs significantly depending on whether it is made at the national or supranational level. At the supranational level, both the drafting of command-based tools and the enforcement of the agreed rules are, in most cases, unrealistic or at least unworkable. International commitments, even when drafted as binding rules, are left to Member States to implement domestically.

If it is accepted that SWFs belong in a ‘community of shared fate’, they can incentivize members to supervise potential non-compliance and use persuasion and negotiation to ensure that compliance. An effective implementation of the agreed rules can also have symbolic value as it may allow individual SWFs to invoke it in order to advertise their ‘business ethos’ to the rest of the financial world. Such

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216 See, in particular, Principles 1, 6, 8, 15, 19, 20, and 21.
218 The test aims to discover whether an undertaking has received a benefit that it would not have received in ‘the normal course of events in the private market’, Case C-256/97 DMT [1999] ECR I-3913, opinion of AG Jacobs at para 31.
219 Sub-principle 18.
220 Morgan and Yeung (n 201) 95.
221 ibid 313.
222 For example, the failure of one participant may have catastrophic effects on the entire community and thereby threaten the well-being of each individual participant, so as to encourage the emergence of consensual mechanisms of regulation, ibid 316.
223 ibid 328.
‘business ethos’ is not merely limited to its reputational value. It is observed that, following the financial crisis, SWFs have demonstrated an increased appetite for joint ventures and foreign investment activities in cooperation with local funds.224 One such example is the China Africa Development Fund, a Chinese investment fund focusing on stimulating and facilitating Chinese investments in Africa.225 A good reputation, in this sense, becomes essential for SWFs to continue to project the image of benign investors and convince local funds to cooperate.

For the time being, the available evidence on compliance with GAPP shows mixed results: while overall compliance is still lacking, many encouraging signs can already be observed. According to the Behrendt Report on the progress in the implementation of GAPP by SWFs, compliance with GAPP 18 months after their publication remained low (Figure 2).226

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This, however, does not constitute in any way a reason to abandon the entire effort. The progress recorded in the Behrendt Report took place within a short period from the conclusion of GAPP. It is natural to expect institutional change to be slow, especially when it happens on a voluntary basis and it takes place in countries with varying traditions of governance and administration. If anything, the results of the Behrendt Report constitute an additional reason to formalize the task of reporting the compliance progress of SWFs by entrusting it to the International Forum of Sovereign Wealth Funds (IFSWF). This institution is best placed to carry out this task as it is charged with the organization of SWF meetings and can thus cover the additional monitoring costs through the contributions of SWFs and the IMF. It is, thus, supported that the option of self-regulation at the international level avoids the majority of the problems identified in the hard-law national regulatory proposals discussed above. It is proportional to the issues relevant to SWFs and preserves the investment-friendly environment that is necessary in a global post-crisis recovery scenario such as the current one. Therefore, it offers a better theoretical framework upon which to base the regulation of SWFs.

Organization of a self-regulating SWF body. The purpose of this analysis is to provide a rationale for regulating SWFs rather than a full regulatory framework. However, some brief discussion and thoughts on the form of this self-regulatory body is warranted, to be of benefit to the conclusion.

The current annual meetings of the IFSWF are by invitation only and, aside from press briefings, there is no detailed account of their meetings. The lack of transparency is displayed openly with a members-only log-in to their website required to view any detailed accounts. Only 8 of 21 members of the body disclose detailed information on their investment policies, and some but not all members are legally required by their jurisdictions to disclose information or accounts of their investment activities, with one member admitting they have no intention of publishing an annual report or financial statements. Increased transparency would indeed be beneficial for the markets and provide assurances for host governments; indeed Norway has argued that its rigorous transparency requirements have explained risks that have been beneficial to its investments including during the 2008 financial crisis.
A sensible means of organizing a self-regulating SWF body would be to assign responsibility for such organization to a secretariat. The secretariat would arrange an annual forum, which would be for SWFs to exchange ideas and discuss their progress in implementing GAPP. International bodies, such as the IMF, the EU, the Arab League, the African Union, and representatives from NAFTA could participate only as observers or to contribute with ideas. Ideally, membership should be open to all state-owned investment funds regardless of their investment objectives, thus drawing as much participation as possible (including pension funds, development banks, and similar organizations).

The IMF would be a suitable and convenient platform to be used as secretariat. Otherwise, it may be possible for the WTO to play an administrative role such as a secretariat, since as the article has highlighted, it would be impracticable for the WTO to undertake a regulatory role. The advantage of the WTO is that it provides equal participation among members, as opposed to the IMF or the World Bank which may be viewed as Western-controlled bodies (since by political agreement they are always headed by Westerners and the voting power of their Western members carry more weight).  

The IFWSFs could play a gate-keeping role in excluding and isolating certain funds, such as the Libyan SWFs if necessary. However, they should specifically not be empowered to impose additional disciplinary measures since this would defeat the voluntary nature of the scheme. Furthermore, it would be impracticable, create divisions among SWFs, and consequently risk damaging the project as a whole.

It is important to note that GAPP is not a set of ideals that SWFs will struggle to reach, ‘but an inventory of best practices that already exist’. This means that GAPP does not require SWFs to adopt any practice that is not already being followed by at least one other SWF. This fact makes it difficult for SWFs to argue that the CoC’s standards of accountability and transparency are a costly burden. It is equally important that GAPP is constructed in a broad way so as to provide SWFs with sufficient flexibility in their manner of implementation as long as the spirit of the code is complied with. In short, it can be expected that since SWFs have signed up to GAPP, they should observe ‘a process of competitive emulation’ among them.

2. CONCLUSION
This article has demonstrated that regulatory responses to SWFs need to take into account the reality and the actual characteristics of sovereign investors. Otherwise, they run the risk of becoming overtly protectionist and imposing unwanted costs on the global financial system. It is true that where SWFs are involved there is no


237 ibid.
consensus on how they should be dealt with from a regulatory perspective. Nevertheless, a close examination of SWFs’ investment behaviour, and a sober analysis of the real benefits and potential costs they bring to international financial markets, lead to the conclusion that the nightmare scenarios about financial instability and national security predicted by many are not realistic. In other words, it is unrealistic to claim that the trade-off to market openness (‘the do nothing option’) is a compromise of national security or financial stability. At the same time, a trade-off can be said to exist in the option of adopting hard regulation, which is a loss of efficiencies.

At the same time, a trade-off can be said to exist in the option of adopting hard regulation. This could erase efficiency benefits, and consequently would mean the actual negative costs of SWFs are not significant enough to justify hard regulatory intervention. Nevertheless, a limited form of regulation may be warranted simply to ease protectionist pressures and maintain consumer (and corporate) confidence in the market for SWF investments. While other risks, such as the undue political leverage of countries managing huge SWFs, may be real, they cannot be tackled by a simple regulatory instrument. Increasing transparency might have a positive impact, but SWFs should be allowed to remain opaque to the extent that their immediate competitors are allowed to.

Taking all of the above into account, neither the ‘restriction’ of SWFs, the ‘incentives’, or the ‘command and control’ regulatory models can offer a satisfactory regulatory response to the rising phenomenon of SWFs. These models are either excessively protectionist and discriminatory (and are not justified by the real facts regarding SWFs) or they are too costly and unworkable.

Alternatively, a supranational regulatory framework that would involve the participation of such funds, such as GAPP, appears to eliminate many of the direct costs identified. As a result, it creates a more investment-friendly global environment and assures the continued operation of those benign investors.