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**Depoliticization and Regulation of
Sovereign Wealth Funds:
A Chinese Perspective**

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Abstract

China's Sovereign Wealth Fund ("SWF"), the China Investment Corporation (the "CIC"), has experienced severe losses in international markets during current crisis, although the CIC, along with other SWFs mainly from emerging countries, has been controversially perceived as a threat or an destabilizer in different way by Western minds. The CIC's experience so far reveals important lessons. The regulation of SWFs at home rather than host should play a more important role in their development and should be afforded top priority for their lack of expertise and experience in international investment. Meanwhile, from a pragmatic point of view, financial return in the long run should be the fundamental goal of SWFs rather than any other non-commercial considerations.

This paper proposes a three-step functional approach from Chinese perspective to regulate SWFs. First, home countries should erect effective and transparent firewalls between their role as shareholders and their role as watchdogs of state-owned capital-exporting. The Santiago Principles can be utilized as a benchmark for that purpose. Second, host countries should abandon all biased laws and regulations regarding SWFs and treat them as private institutional investors. Finally, there should be an effect to clarify and redefine international investment regimes, which should include governmental investments. Under that broad definition, issues and concerns on the part of the home countries and host countries, then should addressed at bilateral, multilateral or global investment forums. Consequently, there will be no need to create national/international regulatory agencies or to formulate biased regulations after the depoliticization of SWFs.

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I. INTRODUCTION

This article explores why and how to depoliticize the Sovereign Wealth Funds (SWFs)¹ from perspective of China Investment Corporation (CIC) in process of formation and its investment during last two years.

SWFs issue is not new but another name of the old story about foreign exchange reserve management, which has gained new prominence since fall of 2007.² Such public attention is the result of three factors. First, the level of the reserve has increased dramatically over the last decade to record high. Second, more central banks of both developing and developed countries prefer diversifying their reserve management and investing the foreign exchange into financial markets to obtain higher return than just purchasing U.S. Treasury bonds.³ And the third is large size, high growth rate, and lack of transparency of SWFs' operation.⁴ The concerns raised include the possibility that SWFs could be used to further political purposes and target strategic acquisitions,⁵ the risk of equity price bubbles due to the sheer size of their investments,⁶ the risk of an increase in volatility of financial markets,⁷ the possibility that SWFs might have a detrimental effect on corporate governance for their political motives or lack of

¹ The first documented use of the term is attributed to Andrew Rozanov. See Andrew Rozanov, Who Holds the Wealth of Nations, *Central Banking Journal*, Vol. 15, no. 4, 2005. There is no universally accepted definition of SWF. IMF, "Selected Definitions of SWFs", *Sovereign Wealth Funds – A Work Agenda*, Feb 29, 2008, Annex II, at 37. Here uses this term as the investment vehicle owned by governments and formed out of reserves for investments in debt and equity markets of other countries.

² e.g., Lawrence Summers, *Sovereign Wealth Funds Shake the Logic of Capitalism*, *Financial Times*, July 30, 2007; Steven R. Weisman, *Concern about Sovereign Wealth Funds Spreads to Washington*, *International Herald Tribune*, August 20, 2007; Jeffrey Garten, *We Need Rules for Sovereign Funds*, *Financial Times*, August 8, 2007; Edwin M. Truman, *Sovereign Wealth Funds: The Need for Greater Transparency and Accountability*, *Peterson Institute for International Economics*, No. PB07-6, August, 2007; Bertrand Benoit, *Germany Drafts Plans for Own CFIUS Deal Watchdog*, *Financial Times*, September 27 2007; Larry Elliott, *Chancellor Backs G7 Move to Get Tough on Sovereign Wealth Funds*, *The Guardian*, October 20, 2007; Gerard Lyons, *State Capitalism: The Rise of Sovereign Wealth Funds*, *Standard Chartered Bank*, October 15, 2007.

³ Lawrence Summers, *Opportunities in an Era of Large and Growing Official Wealth*, in *Sovereign Wealth Management* edited by Jennifer Johnson-Calari and Malan Rietveld, *Central Banking Publications*, at 28.

⁴ Current market estimates of SWFs' assets range from \$1.9 to 3.2 trillion. IMF, "Sovereign Wealth Funds", *Global Financial Stability Report*, Annex 1.2 of chapter 1, September 2007; Jen, *Sovereign Wealth Funds and Official FX Reserves*, *Morgan Stanley Research Global*, September 14, 2006; Kern, *Sovereign Wealth Funds - State Investments on the Rise*, *Deutsche Bank research*, September 10, 2007. The SWFs' assets are believed to reach up to 12 trillion \$ by 2015. For underlying assumptions et detailed calculations. Stephen Jen, "How big could sovereign wealth funds be by 2015?" *Morgan Stanley Research Global*, May 3, 2007.

⁵ Lawrence Summers and Steven R. Weisman, *supra* n2.

⁶ Satoshi Kambayashi, *The World's Most Expensive Club*, *The Economist*, May 24, 2007.

⁷ Krishna Guha, *Warning over Sovereign Wealth Funds*, *Financial Times*, June 22, 2007.

sophistication⁸ and, finally, the risk of the emergence of a new form of financial protectionism as reaction to SWFs.⁹

Thus, SWFs have been driven under the spotlight and depicted mainly in a negative tone as “barbarians in the gate”¹⁰ or political monsters or presumed offenders until proven innocent; in a word, the funds are politicized. For example, a February 2008 poll showed that Americans are overwhelmingly opposed to SWF investments.¹¹ Also, many politicians began to respond to this public distrust through hearings, statements and regulations hostile to sovereign investments. Some countries indeed made and implement adverse economic policies. Given the climate, the issue was then put on agenda of Group Eight, IMF, and OECD and the voluntary code Santiago principles were made last October. And some commentators pointed out the worst scenario that SWFs, combined with so-called authoritarian governments will finally emerge as a viable challenger like Trojan horses to the liberal democratic path taken by the advanced industrialized states.¹² Among them, opposition was particularly pronounced to investments by SWFs headquartered in the Middle East or East Asia. But, today, SWFs are no longer seen as something to be dreaded and their investments not always make headline anymore.

CIC has never been an exception in that way even before its formal incorporation. Its sudden peril may well be related to China’s increasing economy (or geopolitical) power, although China’s reserve manager as well as regulator, i.e., State Administration for Foreign Exchange (SAFE) have invested the reserve in financial markets through its secretive subsidiary about a decade ago. Since the deal with Blackstone at May 2007, any

⁸ Steven R. Weisman, *supra* n2.

⁹ Michael R. Sesit, Sovereign Wealth Funds are Starting to Dominate Global Finance, *International Herald Tribune*, June 18, 2007 and David J. Lynch, U.S.: Secretive Global Funds May Hurt Treasuries Market, *USA Today*, June 21, 2007.

¹⁰ Monitor Group, *Weathering the Storm: Sovereign Wealth Funds in the Global Economic Crisis of 2008*, at 6.

¹¹ According to Public Strategies Inc, “A majority of American voters think investment by foreign governments in U.S. companies harms U.S. national security interests, and nearly half believe such investments harm the American economy, according to a new survey of the attitudes of U.S. voters toward sovereign-wealth funds.” Public Strategies Inc, *Survey Reveals Voters Wary of Foreign Government Investment*, available at http://www.pstrategies.com/PR_20080221_PSI_SWF_Poll.php.

¹² Daniel W. Drezner, *White Whale or Red Herring? - Assessing Sovereign Wealth Funds*, *Glasshouse Forum*, 2008.

investment of CIC has been faced the danger of over-interpretation and is believed as a likely elaborated move to reach the geopolitical strategy.

This article borrows the definition of accountability from Grant and Keohane¹³ to analyze the reason for depoliticization of SWFs and solutions for the main concerns mentioned. Part II proposes a dual-layer accountability mechanism to define depoliticization. Part III presents the background and incorporation of CIC and its legal framework and flaws. Part IV focuses on the market mechanism between CIC and financial markets by reviewing its investment policies and practice. Part V concludes with a simple three-step approach to depoliticize CIC.

II. DEPOLITICIZATION AND ACCOUNTABILITY

The term “depoliticization” may be used in many ways and is fraught with ambiguity. Here use the term to refer to the process of replacing political accountability mechanism with legal and market one for SWFs’ operation and regulation. I propose that two types of separate accountability mechanisms are allocated among three actors: the funds, home states as sponsors as well as the final controllers of the funds, and the investors both at home and abroad. Highly linked with mechanisms affecting the efficiency and effectiveness of SWFs’ operation are the legal regime between home state and the funds, and the market regime between the funds and investors. The legal accountability refers to the requirement that agents abide by formal rules and be prepared to justify their actions in those terms, in courts or quasi-judicial arenas.¹⁴ And the market accountability suggests that market competition provide its rewards and sanctions by the aggregation of individual investor or consumer choices.

Then, all the concerns and controversies about SWFs are centered on how to allocate the mechanisms or how to draw a boundary between state and market. From this

¹³ Accountability is a protean concept. Here the term is used in its basic meaning, i.e., accountability implies that some actors have the right to hold other actors to a set of standards, to judge whether they have fulfilled their responsibilities in light of these standards, and to impose sanctions if they determine that these responsibilities have not been met. See Ruth W. Grant, Robert O. Keohane, *Accountability and Abuses of Power in World Politics*, *American Political Science Review* 99 (1): 29-43. Also Jerry L. Mashaw, *Accountability and Institutional Design: Some Thoughts on the Grammar of Governance*, in Dowdle, M.W. (ed.) *Public Accountability: Designs, Dilemmas and Experiences*. Cambridge: Cambridge University Press, at155-156.

¹⁴ *Ibid*, Ruth W. Grant and Robert O. Keohane, at 36.

angle, the red-hot debate around SWFs is just an alternative version of the traditional proposition on the role of government and its relationship with market.

The legal accountability mechanism stresses the role of enforceable and explicit rules which are preset and rule-based rather than the discretionary and sometimes unpredictable or arbitrary power held by political elites. As a result of the growing formalization of social relations, this kind of accountability is of increasing importance to public institutions in most western countries.¹⁵ The salient features of legal accountability are its integrity, predictability and explicitness, ensuring transactional security.

However, these merits cost flexibility and efficiency in decision-making process. Hence, there is a tradeoff to be reached. In the context of emergence and expansion of SWFs, legal accountability is linked closely with their motivation and transparency. Some countries have detailed rules encompassing the varying scope from the fund's capital resource to investment portfolio; some others only rely on decisions of a few political elites, such as China and Mid-East countries. Given the westerners' prevailing understanding of law and democracy, it is not unusual that the latter is usually viewed as being politically motivated entities without necessary checks and balances. Further, the opaqueness in decision-making will intensify the concerns about its non-commercial objectives and potential harm to recipient countries' national interests or "strategic sectors". In this way, the rule-based structure will be considerably helpful to present the black box of political decision-making under the sunshine, set a high barrier to any political interference and address those concerns resulting from imperfect and asymmetric information. However, it seems not easy to have an effective institution in managing SWFs for the national variations in legal traditions and mentalities on one hand, and the adaptability to reflect market changes on the other hand.

At the second layer, the market accountability displays its importance to both the funds and investors during investment decision-making. Here the term is utilized to emphasize information disclosure, competition and caveat emptor principle, etc. To a certain extent, one could roughly equate it with market discipline. While how to realize the collaboration and cooperation between private actors in different countries is not an

¹⁵ Mark Bovens, *Analysing and Assessing Public Accountability: A Conceptual Framework*, European Governance Papers (EUROGOV) No. C-06-01. Available at <http://www.connex-network.org/eurogov/pdf/egp-connex-C-06-01.pdf>.

easy task, the investments of SWFs which are believed as governmental investors¹⁶ or a sign of state capitalism¹⁷ are changing the landscape of global finance. However, it is noteworthy that when involving in commercial activities as an exception to sovereign immunities, the state agencies or their subsidiaries will not enjoy sovereign status in transactions and possible dispute resolution in accordance with relevant prescriptions and practices. Once SWFs invested in another country, their home countries impliedly acknowledge that the funds will be considered as ordinary commercial entities without any privilege. Simply put, the funds must comply with commercial principles and discharge the responsibilities such as ethnic and environmental requirements of host countries like any other actors. However, SWFs nowadays confront the same problem as that of hedge funds and private equities one or two years ago: because of their systematic significance in the market, they have been pressured to become more transparent and adopt a higher moral standard than their smaller equivalents.

III. CIC'S INCORPORATION AND LEGAL FRAMEWORK

A. Background and Facts

On September 29, 2007, CIC was officially set up to enhance the long-term risk adjusted return. Chinese government decides to incorporate a professional investment agency for several reasons. First, in September 2007, China's reserve hit unprecedented level of \$1.4 trillion.¹⁸ It's believed that this amount is much more than necessary reserve scale estimated in any measure.¹⁹ The empirical research shows that over the long horizon, the return on reserves invested according to standard central banks approaches in local terms is close to zero or even negative.²⁰ Second, other costs are growingly unacceptable associated with holding excessive reserves including sterilization costs, opportunity costs,

¹⁶ Ernesto Zedillo, Governments as Global Investors, Forbes, May 19, 2008.

¹⁷ Gerard Lyons, supra n2.

¹⁸ To June 2009, the reserve has hit \$2.1 trillion. SAFE, Monthly Foreign Exchange Reserves, available at http://www.safe.gov.cn/model_safe_en/tjsj_en/tjsj_list_en.jsp?ID=3030300000000000&id=4.

¹⁹ According to recent literature, several basic benchmarks for emerging market economies are suggested: reserves equal to short-time external debt (1.0), reserves equal to roughly 5-20 percent of M2 (0.05-0.22), and reserves equal to three or four months of imports (3.00). China's ratios are 11.58, 0.22, and 15.72, respectively. See Wijnholds, J. Onno De Beaufort and Arend Kapteyn, Reserve Adequacy in Emerging Market Economies, IMF Working Paper No. 01/143, 2001; Russell Green and Tom Torgerson, Are High Foreign Exchange Reserves in Emerging Markets a Blessing or a Burden? Office of International Affairs Occasional Paper No. 6, U.S. Department of the Treasury, March 2007.

²⁰ Lawrence Summers, supra n3, at 21.

and balance sheet risks. Third, rapid reserve accumulation may create a false sense of security and reduce the incentive to tackle difficult reforms such as currency policy.²¹ What's worse, since over 2/3 of the reserve is invested in low-yield U.S. Treasury bonds,²² the concentration in portfolio left China vulnerable to losses led by either strengthening of the Yuan or rise in American interest rates.

On the other hand, the compulsory settlement of foreign exchange system made this situation more unsustainable than ever.²³ All the citizen and firms should preserve any foreign currency within a limited number and must sell all the excessive part to People's Bank of China (PBOC).²⁴ PBOC is the last and largest buyer of foreign exchange at the cost of issuance of the same amount of fundamental currency. Unfortunately, it is not riskless to purchase high-graded treasury or other institutional bonds. The latest example is the bond issued by Fannie Mae and Freddie Mac which hit record lows.²⁵

These factors make diversifying reserve management necessary, reasonable and desirable for China. Actually, as early as 1997, SAFE set up a commercial entity, China SAFE Investment Co.,²⁶ in Hong Kong secretly and begun investing stock and equities. Yet, even so far, little information about its operation has been made available and the spotlight has never been shined on it as much as CIC.

²¹ Madhusudan Mohanty, Foreign Exchange Reserve Accumulation in Emerging Markets: What are the Domestic Implication? BIS Quarterly Review, September 2006. And some researchers point out that from 2005 to 2007, the total amount of hot money entering to China is as much as over \$820 billion, accounting for a half of the reserves. See Zhangming, The Scale and Channels of Hot Money Entering into China: From 2005 to 2007, Research Center for International Finance of China Social Science Academy, Working Paper No. 0811.

²² SAFE, China's International Investment Position, available at http://www.safe.gov.cn/model_safe_en/tjsj_en/tjsj_detail_en.jsp?ID=30307000000000000.1&id=4 (last visited on August 20, 2008).

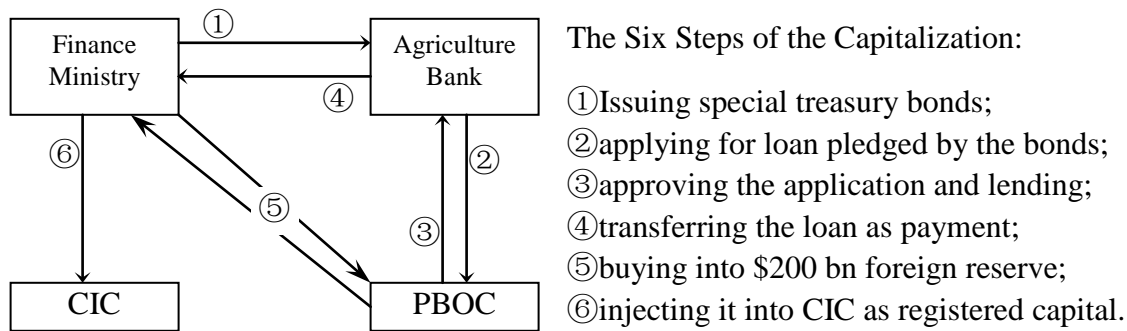
²³ In August 2008, SAFE has revised the basic rule governing the management of foreign exchange, i.e. Regulations of the People's Republic of China on Foreign Exchange Administration, including lifting the compulsory settlement for the first time in 11 years. The new regulations allow qualified entity deposit foreign exchange aboard etc. The changes are designed to cope with rapid growth in the country's foreign reserves and increasingly heavy cross-border capital flows. Xinhua News Agency, China Revises Foreign Exchange Rules, available at http://www.chinadaily.com.cn/bizchina/2008-08/07/content_6913287.htm, (last visited on August 20, 2008).

²⁴ The basic regulation is Regulations on the Foreign Exchange System of the People's Republic of China made by State Council.

²⁵ Krishna Guha, Chris Giles and Saskia Scholtes, US takes control of Fannie and Freddie, Financial Times, September 7, 2008.

²⁶ SAFE Investment Company, the Sovereign Wealth Fund Institute.

According to the action plan approved by the 28th meeting of Standing Committee of National People’s Congress (NPC) to have a commercial agency to invest surplus reserve in diversified way, the Finance Ministry will issue 1.55 trillion Yuan special treasury bond in three batches to the public with outstanding terms of more than 10 years to buy into \$200 billion reserve from PBOC as the registered capital of CIC. Last year, the Ministry issued two batches with total 1.2 trillion Yuan and injected it into CIC.²⁷ The specific process can be divided into six steps as described in the below chart:



Since its formation, CIC has always been confronted critique and comment for its financial performance. Especially, the huge losses in last two year attracted much public bombardment on its investment policy, expertise and accountability. When Lou Jiwei, chairman of CIC, announced that “CIC has booked small losses in its external investments in 2008...(CIC’s) financial performance is far better than other sovereign wealth funds in the world”,²⁸ several economists and observers pointed out that Lou’s explanation hidden the fact that all the overseas investments of CIC expose huge losses, more than \$10 billion in total and the position was balanced by stock price appreciation of state-controlled financial institutions at Shanghai or Hongkong Stock Exchanges. They continued on concluding the salient feature of CIC’s investment was “being strong at civil war and fragile at overseas competition”.²⁹

B. CIC’s Legal Status

²⁷ Xinhua News Agency, “Quanguo Renda Changweihui Biaoju Jueding Pizhun Faxing 15500 Yiyuan Tebie Guozhai Goumai Waihui (The Standing Committee of NPC Approves the Issuance of RMB 1550 Billion Special T Bonds to Purchase Foreign Exchange Reserve)”. Available at http://news.xinhuanet.com/fortune/2007-06/29/content_6308361.htm.

²⁸ Reuters, China CIC made small overseas loss in ‘08, Mar 30, 2009.

²⁹ For example, up to 26500 webs can be found at google.com for “中投-败家子”(CIC and “waster of state asset” in Chinese respectively) as keywords.

Although CIC is generally considered as a typical SWF, several significant differences from IMF's working definition of SWF³⁰ exist in term of capital resource. For the following grounds, CIC should be legally classified as a special State-Owned Enterprise (SOE) rather than an SWF.

First, the registered capital of CIC is from fiscal revenue rather than foreign exchange reserve. While, just as the above chart illustrates, the final result is that CIC gets \$200 billion from PBOC through the Finance Ministry, this deliberately-designed pass-through structure, as a matter of legal fact, has its own significance than what appears at first sight. On the one hand, the structure successfully enables the central bank to avoid violating Article 29 of Act of the People's Bank of China (PBOCA), which explicitly prohibits the central bank from overdrafting for any level government and subscribing bonds issued by domestic governmental agencies, such as treasury bonds.³¹ To legitimize transferring the \$200 billion reserve to a commercial entity, namely Agriculture Bank of China, certain measures must be taken. Although producing the same factual effect, this sale in the payment balance of central bank is still one of legitimate and proper methods to manage the reserve in line with PBOCA.³² On the other hand, this way of capitalization does not affect the total amount of basic currency lest the inflation be exacerbated at the cost of substantial growth of Finance Ministry's debt. The adoption of the pass-through structure changes nature of the money. This means, in term of registered capital, there is no difference between CIC and the other SOEs of China.

Second, there is no dynamic link, neither institutional nor practical, between PBOC and CIC, suggesting that CIC will operate on the basis of registered capital separately without any governmental functions related to reserve administration. As issuance of a special bond must be approved by the NPC or its Standing Committee, if the surplus reserve grows further, PBOC cannot transfer them to CIC automatically; rather, any plan about that will involve at least another three parities: NPC or its Standing Committee as an approval agency, the Finance Ministry as an issuer and one or more

³⁰ One of the essential requirements of IMF's definition is that capital resource is foreign exchange assets. See IMF, *Sovereign Wealth Funds—A Work Agenda*, at 5, February 29, 2008.

³¹ Article 29, PBOCA.

³² *Ibid*, Article 4-(7).

commercial banks as subscribers or underwriters in line with the Budget Act.³³ So, this legal procedure separates CIC and PBOC, unless someone is authorized by the supreme legislator.

Third, CIC is viewed as a full ministerial enterprise. As a well-known practice and part of the command and control economy's legacy, almost all of the state- or collectively-owned enterprises and their leaders are categorized into different administrative levels like civil servants. They have been periodically scaled and estimated by the State Assets Supervision and Administration Commission (SASAC) and Organization Department of Communist Party of China (CPC) in terms of administrative ranking, such as full ministerial, deputy-ministerial and so on, according to the strategic importance and performance of the enterprise.³⁴ And the leaders' promotion and remuneration are, in a large part, determined by the evaluation of these agencies. In consequence, the leaders consider themselves more as administrators or cadres than professional managers and are probably promoted, demoted or transferred to other positions by the commands of relevant authorities. Especially, it is believed CIC is a full ministerial-level enterprise, ranking higher than common SOEs under the supervision of the central government SASAC, for its chairman Lou is the former vice Secretary-General of the State Council, a full ministerial-level position and all the other directors are deputy-ministerial cadres. Therefore, in terms of administrative ranks, CIC is a rare enterprise controlled directly by the State Council and enjoys the same political status as PBOC, SASAC, Finance or Commercial Ministry. This special arrangement preserves its independence and protects its operation from governmental interference on the one hand, and shadows CIC with non-commercial motivation as well as low risk awareness and market sensitivity, on the other hand.

In addition, although whether or not the bureaucratic competition between PBOC and the Finance Ministry has been serious remains unclear, CIC will difficultly stay independent and unaffected. Based on PBOCA and related rules, SAFE should be the sole actor in charge of regulation, management and operation of reserves subject to the

³³ According to Article 39 of the Budget Act of China, issuance any kind of special Treasury bond must be approved by NPC or its standing committee.

³⁴ Barry Naughton, Top-Down Control: SASAC and the Persistence of State Ownership in China, paper presented at the conference on "China and the World Economy" at University of Nottingham, June 23, 2006.

principles of safety, liquidity and profitability, in turn. Also, it has established the professional commercial corporation for almost a decade. From this aspect, it does not seem necessary to have another outside manager under the control of the State Council. Nonetheless, the battle between CIC and SAFE Corporation becomes evident now, if not intense, which, then may well pose a certain impact on their operation and increases the difficulty in forecasting the future of China's outbound investments.³⁵ For there is no direct hierarchical relationship between them; this impact will be detailed later in Part III.

C. A Comparative Analysis with Selected SWFs

Compared with some other high-profile SWFs, big room remains for having an effective legal accountability arrangement around CIC.

Among all the SWFs, Singaporean funds, i.e., Temasek and GIC, probably are the most aggressive and profitable in recent years.³⁶ Actually, both of them have specific and clear institutional orientations in domestic law, even in the Constitution.³⁷ Under the Constitution, each of them has been designated as a "Fifth Schedule Company" and is regulated correspondingly. For example, the appointment and removal of their Directors and Group Managing Director require the assent of Singapore's President. Also, they shall be periodically audited by the national auditor-general, and the boards are accountable to the President to ensure that every disposal of investment is transacted at a fair market value.³⁸ Moreover, neither the President nor the Government is involved in directing investment, divestment or other business decisions. Such legal arrangements erect a firewall between government companies and relevant agencies under strict supervisory legislation in personnel, reporting and disclosure, asset transfer and lay a firm foundation for purely commercial operation of both companies.

The different capital resource between Temasek and GIC, however, should not be overlooked and probably inspires to clearer understanding of CIC. Temasek is the owner of the assets under its management, yet GIC just plays a trustee role – like a professional asset manager. As to GIC, the clients set the investment objectives and monitor its overall

³⁵ Logan Wright, *CIC and SAFE: Coordination or Bureaucratic Conflict?*, China Stakes, June 24, 2008.

³⁶ According to Temasek's announcement on its website, the total shareholder return since its inception 34 years ago is more than 18% compounded annually. In last financial year, its profits hit a record S\$185 billion. Available at <http://www.temasekholdings.com.sg>.

³⁷ Articles 22A, 22C, the Constitution of the Republic of Singapore.

³⁸ The Fifth Schedule of the Constitution of the Republic of Singapore.

performance. Then GIC receives fees to finance its operating expenditure. Actually, the gold model of SWFs, the Norwegian Pension Fund – Global falls into this category as well. This is the very reason why Temasek is reluctant to be described as an SWF³⁹ and declines to accept the nine principles reached by the U.S. Treasury, the governments of Singapore and Abu Dhabi, and the Abu Dhabi Investment Authority and GIC.⁴⁰

It is not difficult to find that CIC and Temasek share the same kind of capital resource, that is, fiscal revenue rather than foreign exchange reserve; both of them are not the channel or conduit to invest reserves on behalf of their Government, but legally own their assets by themselves.

The SWFs of some other countries such as the Russia, Norway and South Korea also have clear-cut legislation to regulate corporate governance, portfolio decision-making procedure, asset transfer and the qualification and appointment of directors and senior managers.⁴¹ These arrangements explicitly define the relationship among SWFs and relevant administrative agencies in the respective countries and then, in some degree, address the distrust of SWFs' mere commercial motivation partly resulting from ideologies, the massive concentration of economies power and a political "black box" in the course of decision-making.

D. Negative Effects of CIC's Legal Arrangement

Apart from the misunderstanding of its capital resource, lack of legal accountability arrangement seems a more pressing problem to be solved for CIC. Most decisions, if not

³⁹ Ho Ching said in 2008 that "Temasek is just a unique experiment to take over a mixed bag of new investments and start-up companies. Singapore had no oil money, no natural resources. Temasek was not managing the country's foreign reserves, the little there was. It was more like a 'sovereign poverty fund'." Ho Ching, Story of a "sovereign poverty fund". Available at http://app.mfa.gov.sg/pr/read_content.asp?View.10478. Besides, its chairman S. Dhanabalan said Temasek is an atypical SWF rather than a conventional SWF in his speech on the "Role of Sovereign Funds in Today's Globalization" at the TIE (The Indus Entrepreneurs) event on August 21, 2008 at Singapore. Available at http://www.temasekholdings.com.sg/media_centre_news_speeches_210808.htm.

⁴⁰ U.S. Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi. Available at <http://www.treas.gov/press/releases/hp881.htm>.

⁴¹ Relevant legal bases for these SWFs are: (1) The Budget Code of the Russian Federation; (2) Korea Investment Corporation Act, Enforcement Decree of Korea Investment Corporation Act, Articles of Incorporation of Korea Investment Corporation; (3) Act No. 36 of 22 June 1990 on the Government Petroleum Fund, Regulation on the Management of the Government Petroleum Fund, Management Agreement between the Ministry of Finance and Norges Bank, Guidelines for the Government Petroleum Fund's environmental portfolio, Guidelines for the Investment of the Foreign Exchange Reserves, Guidelines for the Money Market Portfolio, Ethical Guidelines for the Government Pension Fund – Global, Royal Decree 19 November 2004 (to establish the Council on Ethics).

all, about and by CIC seem insulated from public participation and an effective accountability mechanism even when the \$200-billion fiscal debt was generated overnight. Although it is much better than SAFE Corporation, this problematic has still brought about much critique and many doubts. Concretely, it is bringing many aftereffects both at home and abroad.

First, legally, CIC is accountable to nobody for its operation in the market and will be directly exposed to considerable domestic public opinion. Being short of firewall with the government attracts more publicity at home for citizens' worries about its return in context of growing taxpayer awareness and the concern over possible corruption in the course of running this huge asset. Although in politics, CIC is supervised directly by the State Council, the latter, however, is still traditionally viewed as a more responsible, people-caring government entity than local and other subordinating departments and agencies. Another catalyst is the completely-realized press freedom in the finance area. So CIC is exposed to both pretrial and after trial publicity by mass media and internet for any practical and potential tiny loss. For lack of legal and express mandates as well as investment policies in place, any defense and explanation is viewed as an excuse for its wrong decision, and then its expertise and even loyalty would be questioned. In consequence, the management and decision-making will unavoidably be broadly influenced, and its independent and professional status could not be sustained, finally all of which are politicized at home. If taken account of the political-cadre commitment of the leaders and the high-level managers, CIC probably has to stress more on external feedback from both higher level and bottom line of China with their investment and performance. Here, lack of a legal accountability mechanism is a double-edged sword: it makes CIC enjoy more flexibility in decision-making, meanwhile its legitimacy and efficiency is confined and criticized. In this circumstance, it seems a difficult undertaking to keep commercial and professional operation.

Second, CIC also confronts additional negative publicity from host countries for no proper legal accountability. Combined with conventional ideological biases, the transfer of CIC's colossal-scale assets with little supervision and regulation will get common people of recipient countries concern and even feel afraid for its real purpose other than economic objectives. Since no formal institution about CIC is taken in place,

for security and in their own interest, the public and legislature of the recipients become more inclined and active to make or search concerning rules to regulate CIC and the like foreign government investment as much as possible. Declaring that it will play as a long-term passive actor, CIC loses hard evidence to argue for its own commercial-based orientation and to justify its corresponding transactions, which is in sharp contrast to its initial intention.

Additionally, CIC can't be equated with common SOEs in China but a special one. CIC is a legal person exclusively funded by state fiscal reserve and sponsored neither by the Finance Ministry nor SASAC. It is approved by and under the direct authority of the State Council. At this point, CIC is an exception. Besides, after its merger with Central Huijin Corporation, CIC has become the biggest shareholders of all the main financial institutions in China, including several biggest banks and securities firms and the sole re-insurance company. Therefore, there are some concerns about whether CIC should be viewed as financial holding company subject to the supervision and regulation of the financial regulators.

All of these factors make negative difference on accountability and independence of CIC in decision-making, which has decreased the function of market accountability in the course of investment and offered reasons for trade protectionism. What's more, the reality in past year shows that home regulators should play a more important role in their development and should be afforded top priority for their lack of expertise and experience in international investment. Second, CIC's incorporation and investment can be considered a key step in deepening market-oriented economy along the path of reform and opening up since 1978, while in comparison with the peer SWFs in other countries neither its legal accountability nor market accountability is adequate. The history of China's reform probably can be understood as the history of marketization. Traditionally, the government held financial industry as a significant sector and hesitantly let foreign and private investor into market. It seems that the excessive reserve and financial globalization make the "state first policy" unsustainable and obsolete. CIC's investment suggests that China government began to outsource the state-held financial asset mainly to foreign asset managers to earn rational return in long term. CIC's investment, good return or bad, is a step forward to market economy, although, as the matter of degree,

there are some drawbacks in institution and market efficiency around the corporation as growing pains.

IV. CIC'S INVESTMENT POLICY AND MARKET ACCOUNTABILITY

If lack of legal accountability would be corrected in a proper way, CIC as well as other SWFs can be equated with other institutional investors in global financial market, such as hedge funds, private equities, and pension funds. In other words, on the condition that the noncommercial motivation is separated from the operation of SWFs by a trustable and predictable legal accountability mechanism, SWFs share plenty of similarities with other institutional investors, especially in decision-making and risk management. Since the final objective is a sustainable return rather than geopolitical influence, SWFs should play as reasonable and rational investors subject to the common principles of wealth management with all exposure to risks and competition. No other market-driven accountability exists for public funds different from private investors in this highly globalized finance market, which has three implications: first, SWFs should be treated as same as other investors by host countries' regulator in line with their rules, especially market entrance requirements. Second, in practice, SWFs should not restrain the proper functioning of market principles by themselves, such as giving up their shareholder rights in response to fears about their excessive influence. Third, the transparency problem of SWFs should not be exaggerated and can hardly be solved earlier than the other heavyweight investors which have been questioned for that too, especially, hedge funds and private equities.

An immediate conclusion can be drawn safely that the essential element of the controversies around SWFs is the distance or length between SWFs and their hosting governments, i.e., the legal accountability. Whether or not an SWF have an trustable and effective legal arrangement when its stepping into market, is the key to commercial running of the fund and should be given special note rather than the opaqueness of operation, given the latter is not unique or fresh, but a common and tricky problem to be tackled.

A. CIC's Investment Practice

It seems that there is no coherent and concrete investment policy as some commentators suggested.⁴² In following part, the investment of CIC both at home and abroad will be examined respectively and then based on a comparative study with selected SWFs, the implications of a market accountability mechanism will be given.

1. Overseas Investments

Despite criticisms of lack of transparency, the basic outline of CIC's initial investment strategy is relatively clear. Roughly \$110 billion of the fund's capital has been dedicated to the domestic financial sector. The remaining \$90 billion, slated for international markets, has drawn the most interest from international observers.⁴³ Table 1 presents the investments that CIC has made or announced intentions to make to date.

Table 1: CIC Overseas Investments

2008	Amount	2009	Amount
Morgan Stanley	\$5.6 bln	Australian Goodman Group	\$158.9 mln
Blackstone	\$3 bln	Morgan Stanley	\$1.2 bln
J.C. Flowers fund	\$3 bln	Canadian Teck Resources	\$1.5 bln
Visa	\$100 mln	Diageo	\$365mln
China Railway	\$100 mln	Tesco	n/a
		CITIC Capital	\$258mln

The first \$8 billion of international investments went to high-profile stakes in Blackstone and Morgan Stanley. The Blackstone deal was a direct, pre-IPO stake that has lost nearly half of its value, provoking considerable criticism from the public in China. CIC's stake in Morgan Stanley, however, was structured to limit CIC's potential downside: CIC held convertible bonds with a 9% return, convertible to stock after a tie-up period. Still, the fund's leadership had grown wary of the U.S. financial sector as a result of its recent losses.⁴⁴ Both deals at least appeared to have been helped along by personal connections. The chairman of Blackstone's Greater China operations, Antony

⁴² Brad Setser, Does the China investment corporation (CIC) have a coherent investment strategy? Available at http://www.rgemonitor.com/setser-monitor/234551/does_the_china_investment_corporation_cic_have_a_coherent_investment_strategy.

⁴³ Initial plans were to dedicate only \$67 billion to international investments. In late April, however, Gao Xiqing announced that less cash than expected was needed at home, and the fund's international spending would increase commensurately. Jamil Anderlini, CIC Raises Global Spending Power, Financial Times, April 23, 2008.

⁴⁴ China Investment Corp Suspends Investments in Overseas Financial Cos—Report, XFN-Asia, March 7, 2008.

Leung, is a former finance secretary of Hong Kong and known to be on very good terms with the mainland's financial authorities.⁴⁵

CIC officials have gone out of their way to describe these two stakes as anomalous, insisting that most investments would be made in international stock markets through third-party managers. Chairman Lou has stressed that CIC would be “focusing on financial portfolios.”⁴⁶ President Gao Xiqing has specified that the fund would concentrate on “the cash market, fixed income, equity and hedge funds,” as well as private equity.⁴⁷

In addition to plans CIC has already confirmed, rumors abound of potential tie-ups with Chinese SOEs looking to expand abroad. Soon before the formal establishment of CIC in September 2007, Li Rongrong, head of SASAC, publicly lobbied for the new institution's funds to be used to assist Chinese state-owned firms to grow into more “influential” multinational firms.⁴⁸ Unnamed sources in December claimed that CIC would shift its attention to natural resources, and specifically work to assist Chinese SOEs in their outward investment plans. Rumors that CIC would assist China Petrochemical Corporation in acquiring overseas assets seemed to buttress these reports.⁴⁹ Later in the year, the fund was engaged in discussions with Hainan Province concerning a potential investment in a commercial crude oil reserve.⁵⁰ Following this, CIC also discussed assisting Shenhua Energy to purchase 15.85% of Fortescue.⁵¹

2. Domestic Investments

Though receiving less attention from outside of China, CIC's role in domestic economy may ultimately prove to be much more important than its role in global market. By absorbing Huijin, CIC has assumed ownership of a majority of domestic financial

⁴⁵ Pierre Pauldin, Stepping-Stone Interpreting the First Deal by China's State Investment Co. Institutional Investor, June 2007.

⁴⁶ China CIC Chief Says Investment Focus to Be on “Portfolios,” Not Individual Cos, AFX Asia, February 4, 2008.

⁴⁷ Wealth Fund Hiring Foreign Money Managers, China Daily, February 29, 2008

⁴⁸ Li Yanzheng, “Li Rongrong: Zhongtong Gongsi jiang Bangzhu Yangqi Jiada Haiwai Touzi Lidu (Li Rongrong: China Investment Corporation Will Help Central SOEs to Increase Overseas Investment)”, Shanghai Zhengquan Bao (Shanghai Securities Journal), September 13, 2007, http://news.xinhuanet.com/newscenter/2007-09/13/content_6713982.htm.

⁴⁹ Tan Wei, China's CIC Likely to Diversify Away from Further US Banking Sector Investments, Source Says, Financial Times, December 30, 2007.

⁵⁰ China's Hainan Kicks off Oil Storage Project, Platts Oilgram News, December 14, 2007.

⁵¹ China Shenhua, CIC to Make Biggest Investment Yet in Reported Fortescue Bid, AFX, February 4, 2008, available at <http://www.forbes.com/afxnewslimited/feeds/afx/2008/02/04/afx4608890.html>.

industry. Table 2 presents its subsidiaries including affiliated companies and the amount of CIC's investment, most of which is through Huijin Corporation.

Table 2: CIC's Subsidiary and Affiliated Companies

Investment	Amount(bln)	Details
Agricultural Bank of China	\$20	One of the "big four" state owned banks
China Development Bank	\$20	policy bank
China Reinsurance	RMB 30	Biggest reinsurance firm in Asia; 85.5% stake
China Everbright Bank	RMB 20	71% stake
China Silver River Holding	RMB 5.5	1 st approved financial holding company
Guotai Junan Securities	RMB 2.5	1 billion to purchase its stake and 1.5 billion as a special loan
Shenyin & Wanguo Securities	RMB 4	2.5 billion to purchase its stake and 1.5 billion as a special loan; 2 nd biggest securities firm
China Galaxy Securities	RMB 10	Biggest securities firm in total turnover value
Industrial & Commercial Bank of China	\$15	Biggest bank both in China and the world
Bank of Communication	RMB 3	4 th biggest bank in China and 10 th in the world
China Jianyin Investment	\$ 2.5	3 rd biggest securities firm in total turnover value
China Construction Bank	\$ 20	2 nd biggest bank of both in China and the world
Bank of China	\$ 22.5	3 rd biggest bank of both in China and the world

Through a joint-venture with Morgan Stanley, Huijin also owns the China International Capital Corporation (CICC), the biggest investment bank in mainland. CICC has been involved in all recent high-profile outward investments: Chinalco, Shenhua, CNOOC, PetroChina, and Sinopec. CICC is also looking to expand its role in China's financial markets by developing into a full-service financial outfit offering private equity, asset management, and wealth management services. The firm's president is son of former premier Mr. Zhu Rongji.⁵²

B. Some Implications

CIC has announced that the asset under management would be roughly separated into three equal parts - one-third to take over Central Huijin Investment, one-third for overseas investments, and the rest to bail out unreformed state banks.⁵³ On account of its role played in these institutions and its special political background described above, CIC has to exert its influence and discharge the functions of SASAC(-like) in finance to

⁵² CICC Broadens Range of Services, Asia Money, September 2007.

⁵³ As the amount of injection to Agriculture Bank of China has been reduced to \$ 20 billion, CIC has \$ 90 billion rather than the initial \$66 billion for investment offshore. Jamil Anderlini, CIC Has \$90bn to Spend on Assets Abroad, Financial Times, April 24, 2008.

improve the quality and competitiveness of the whole sector. It makes CIC like Temasek as well as de facto SASAC. Therefore, CIC is not only a business entity with a heavy weight or even a quasi-monopoly, but a quasi-governmental agency performing multiple functions. At least it cannot manage the stakes in domestic financial firms just as a purely commercial investor – not so long as China relies on the state banks and state-controlled securities market to support economic policy objectives, including exchange rate management. Ironically, though, the CIC’s non-commercial strategic stakes in domestic financial sector have been the most profitable of all CIC’s investments until now.⁵⁴ CIC also has a mandate to advance the governance of its affiliated Chinese enterprises and support them going global.⁵⁵ So it is safe to say CIC serve strategic purposes other than commercial one.⁵⁶

As CIC is fiscal debt-based, the cost of treasury debt and the expected appreciation of RMB becomes the “hurdle rate” which CIC must beat in order to be economically viable over long term. As most observers expect inflationary pressures to rise and RMB to appreciate much faster, the actual hurdle rate is probably going to be significantly higher. So if CIC is run as a long-term passive investor, it will be hard to reach success.⁵⁷

However, this mixture of public and private functions - in a similar way as the Gulf countries’ royal wealth funds - is blurring the boundary between public agencies and commercial entities, which will compromise its announcement to comply with

⁵⁴ Compared to the sharp decline in value of their overseas investments, Chinese banks are benefiting from little exposure to US sub-prime loans and the booming domestic economy. And Industrial & Commercial Bank of China even has become the most profitable as well as biggest bank in the world since 2008. China Bank Sees Top 2008 Profits, BBC, August 21, 2008.

⁵⁵ Li Rongrong, “Zhongtong Gongsi Jiang Bangzu Yangqi Jiada Haiwai Touzi Lidu (CIC will help the central government SOE go global quicker and more aggressively)”, Shanghai Securities Times, September 13, 2007. Mr. Li Rongrong is the chairman of SASAC.

⁵⁶ The evidence is that the list of 2008 top 500 Chinese enterprises released by the China Enterprise Confederation does not include CIC. See China’s Top 500 Enterprises Catching Up with Global Giants, GOV.cn, August 30, 2008.

⁵⁷ For example, if one assumes, very conservatively, that the annual cost of local debt is 4% and the expected annual appreciation of the RMB is 5%, CIC will need to make at least 9% annually just to break even. Andrew Rozanov, Will China Follow the Norwegian Model? State Street Global Advisors, January 2008, available at http://www.ssga.com/library/esps/The_SWF_Debate_Andrew_Rozanof_1.8.08CCRI1200431495.pdf.

However, CIC’s expected rate of return is around 5% in short term, said Mr. Wang Jianxi, Vice-President and Chief Risk Officer of CIC in a speech at the Credit Suisse Asia Investment Conference on April 2, 2008 at Hong Kong. Wealth Fund Aim Modest, China Daily April 3, 2008.

commercial principles. The conflicts of objectives then will lead to unnecessary ambiguities and some worries around investment principles, strategies and policies and other resultant difficulties in transparency.

Worthy of special note is the impact of CIC as a controlling actor of China's financial industry on the possibility of interest transfer and monopoly, especially in the context of the adoption of the Antimonopoly Law on August 2008.⁵⁸ Under the definition and standard of the "dominant market position" based on market share,⁵⁹ CIC will be presumed dominant at least in banking and reinsurance sectors. Besides, although there is no any explicit rule directly concerning financial holding companies in China, this behemoth, with both economic and political significance, will definitely impinge on the effectiveness of the financial regulation.⁶⁰ Therefore, there is a practical need to define the relationship between CIC and the financial regulators both in China and the rest of the world.

In sum, apart from lack of effective and explicit legal mechanism, the market accountability of CIC has been fragmented and incoherent. At home, CIC plays the role of quasi-administrator for state-owned financial assets, while it has been much self-restrained from involvement in the management of the affiliated companies and very careful to keep a lower profile than other private investors - a quasi-commercial actor. These two masks of CIC cause the problem around transparency about market mechanism.

V. CONCLUDING REMARKS: THREE STEPS TO DEPOLITICIZE CIC

How to draw the boundary between government and market has been explored as a tricky question particularly in this transitional as well as emerging country for more than thirty years, beginning from the implementation of open-door and reform policy in late 1970s. Historically speaking, in contrast with the suspicion that CIC may be a tool for geopolitical ends, the corporation is just the latest effort for building market-oriented

⁵⁸ Xinhua News Agency, China Adopts Anti-Monopoly Law, China Daily, August 30, 2007.

⁵⁹ Article 17 and 19, Antimonopoly Law of China.

⁶⁰ In particular, the mode of "One Central Bank and Three Commissions" per se is lacking potent coordination and adequate independence and accountability, which has caused much regulatory overlapping and a vacuum. Whether or not CIC should be treated as a financial holding company and operates subject to existing financial rules remains to be seen.

economy and rule of law state and a transitional or intermediate form in depoliticizing the finance industry.⁶¹ In addition, the near future will witness more CIC-like state-controlled conglomerates or national champions emerging in certain businesses vital to the national interest and the people's well-beings for the ongoing reform of state-owned firms and the adaptation of a "go global" policy.⁶²

However, as a matter of reality, it is the opaqueness of the internal structure without a firewall between state and market that is stirring controversies among the public and policymakers on the drive and method of CIC's investment. So it is imperative for government to substitute the political mechanism with legal and market one. This means home countries should take the first step to address the various concerns, which are not all unreasonable. The State Council or NPC should clarify the legal status of CIC in a special legislation and set up the arms-length principle in dealing with the relationship among the corporation and administrative agencies. The governmental function should be separated from its commercial operation. All of these active measures will produce a comparatively clear boundary between government and market. It seems the best way to eliminate the concerns and controversies in foreseeable future. As to market accountability, special efforts should be taken to adopt an incentive-compatible remuneration scheme, which is different from valuation system for either civil servants or CPC cadres, to attract skillful staff. To further abate the worries about its motivation and objectives, CIC should take periodical the ex post disclosure principle in transparency: the annual report reveals the rough fiscal information and then in the next year it

⁶¹ A distinctive state system has taken shape from the interaction between the old state system and the new marketization of the past 30 years of Chinese reform. It is both the principal actor in the economic "miracle" of the past 30 years and the main source of the current social crisis. This state organization could become a rigidified system, but it could also be something still "in transition." See Philip C. C. Huang, *The State System of Reform China: The Root of Both the Economic "Miracle" and the Social Crisis*, Kaifang Shidai (Open Times), April 2009.

⁶² Li Rongrong, the chairman of SASAC, said at a press conference that after the Olympics, the government would intervene in the consolidation of centrally-administered SOEs instead of letting them regroup on a voluntary basis for its moving slowly and the target is reducing the total number of centrally-administered SOEs to 80 to 100 by 2010 from 147 at the end of 2007. Xinhua Net, *China Plans More Post-Olympics Reforms for State Enterprises*, August 11, 2008.

Besides, apart from CIC and PBOC and their subsidiaries, the state-controlled investment vehicles include the investment companies under the SASAC of both central and local governments and National Social Security Fund (NSSF), the total assets of which are over \$300 billion. In this way, CIC accounts for only about 10 per cent of the total asset of all state-controlled investment arms. Against this background, lack of accountability and transparency seems a universal and self-styled problem to all Chinese SOEs and other state investment vehicles rather than a unique one to CIC.

discloses the concrete portfolio and transactional details to avoid losing its competitive edge in market. In this process, the best benchmark of policy development is the Santiago principles.

The second step is abandoning all biased laws and regulations regarding SWFs. While host countries have a necessity to build effective mechanisms to prevent SWFs from distorting the market and threatening the strategic sector, they also should assume their own responsibility to advance the free flow of capital at the global level. The essential point may well be keeping recipient countries subject to regulatory neutrality: in principle, SWFs should enjoy the same and equal treatment as other investors, public or private, without any discrimination resulting from the nature of their ownership.

The final step is to involve SWFs and other sovereign or governmental investment into the ongoing negotiation of global investment legal architecture,⁶³ while the most feasible measure is redefining investment in Bilateral Investment Agreements. Then there will be no need to create national/international regulatory agencies or to formulate biased regulations after the depoliticization of SWFs.

⁶³ See, generally, Bart De Meester, *International Legal Aspects of Sovereign Wealth Funds: Reconciling International Economic Law and the Law of State Immunities with a New Role of the State*, unpublished draft.