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Rethinking Global Investment Regulation in the SWFs Era

Dr. Efraim Chalamish, Esq.[1]

I. INTRODUCTION

The number and size of Sovereign Wealth Funds ("SWFs") globally have increased substantially between 1990 and today[2]. SWFs have benefited from an increase in commodity prices and significant amount of foreign exchange reserves[3]. Additionally, unlike traditional reserve funds, one of the current SWFs' goals is diversification of investments and providing the home government with competitive returns on its investments[4]. This approach allows SWFs, for example, to purchase majority and minority stakes in public companies in the developed world. Thus, SWFs' contributions to the global capital markets, stabilizing financial markets and providing equity injection to troubled institutions, are highly recognized[5]. However, global concerns around SWFs' activity, especially using commercial investments for political goals and neglecting risk-adjusted returns, have arose and triggered a legal and economic debate as for the need to

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[1] Global Fellow, New York University Law School; S.J.D. (University of Michigan), LL.M. (Michigan), LL.B., LL.M., M.B.A. (Bar Ilan University). This draft was prepared for the Asian Society of International Law and National University of Singapore SWFs Conference, Singapore, September 2009. Email: Efi.Chalamish@nyu.edu

[2] Gerard Lyons, *State Capitalism: The Rise of Sovereign Wealth Funds*, 14 Law and Business Review of the Americas 179 (2008).

[3] Among the new SWFs we can mention the Heritage and Stabilization Fund (Trinidad and Tobago) and the Future Fund (Australia), both launched in 2006.

[4] The country where the SWF is incorporated will be called here the "home country" and the country where the investment is made will be called the "host country". The governments will be called "home government" and "host government" respectively.

[5] *Id.*

address these concerns through regulation and multinational cooperation[6]. Although most recent studies relate to SWFs as a stand-alone phenomenon[7], these concerns should be understood in the context of the larger picture of the new state capitalism.

While several scholars have been trying to identify a homogeneous jurisprudence of international economic law, this important legal field is still fragmented and consists of various international legal instruments, such as World Trade Organization ("WTO") agreements, bilateral and regional Free Trade Agreements ("FTAs"), bilateral investment treaties ("BITs"), and international financial arrangements. Moreover, these international legal instruments overlap with national regulations that aim to regulate international economic activity. Thus, it is not surprising that the growing practice of SWFs, an important international economic phenomenon, is not an exception. As discussed in the following sections, the new state capitalism has raised global concerns that triggered protective national legislation in many developed countries and initiated a parallel multilateral debate in various financial and trade forums.

Each one of these forums represents, indeed, different interests and proposes or implements a legal instrument from another point of view. Nevertheless, this fragmented reality raises the questions whether existing legal instruments can provide a better respond to SWFs instead of adopting new ones, and which field and forum within the international economic law space can serve as the most appropriate forum to deal with this phenomenon. These concerns are not only academic but have important implications, since fewer, consolidated, and comprehensive legal instruments can provide a clear and consistent legal response, if indeed such response is necessary. Also, it will allow us to integrate the SWFs phenomenon into the existing international economic law jurisprudence. This paper will first review the recent regulatory response to SWFs, focusing on protective measures against SWFs in host economies. Then, I will examine several potential regulatory frameworks to deal with these protective measures. Finally, my analysis will show that the international investment law framework is the most equipped to deal with SWFs and can provide a comprehensive and appropriate response with some necessary adjustments.

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[6] Larry Summers, *Sovereign funds shake the logic of capitalism*, Financial Times, July 30, 2007.
[7] *See, e.g.*, Fotak, Veljko, Bortolotti, Bernardo and Megginson, William L., *The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies* (September 18, 2008), *available at* http://ssrn.com/abstract=1108585

II. SWF – GLOBAL REGULATORY RESPONSE

A. Background

The new state capitalism triggers a wide range of responses from developed and developing economies. On one hand, the new wave of SWFs had a strong positive impact on global markets. Several of these government-owned funds in the Gulf and Asia provided a crucial capital for Western financial institutions that had to receive capital injections in order to sustain liquidity and going concern status during the financial crisis of 2008[8]. At the same time, some of these funds provided a safe and stable source of capital in emerging markets since they have not been heavily influenced by the volatility of capital and commodity markets[9].

On the other hand, SWFs have experienced severe criticism in developed economies as SWFs' investments in strategic industries, such as financial institutions and technology, have been perceived as attempts by the SWFs' governments to increase their political influence on the developed world through strategic investments, which will be influenced by political or military motives. Board representation and membership in executive decisions are potentially among the available tools for SWFs' management to control their investments and have a strategic advantage over the host states that receive the capital. While many of these developed economies have been using political economy as a leading tool in their foreign policy, they react differently when they are the ones being invested by the foreign entities. Several proposed investments by SWFs and other state-owned entities have also highlighted national security concerns due to the nature of these investments[10]. Additionally, SWFs have been criticized by their own states for being over-diversified and investing extensively in the West, especially in Western financial institutions. Most of these financial investments have generated significant losses during the 2008 financial crisis to many SWFs and, indirectly, to the governments of their home countries. Many of these investments are perceived as outside of the core investment strategy of most SWFs and

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[8] *See, e.g.*, the 5 billion dollars CIC (China Investment Corporation) investment in Morgan Stanley on December 19, 2007, which accounts for 9.9% of the company.

[9] For a detailed description of SWFs' role in recent strategic financial investments see David Marchick, *Sovereign Wealth Funds and National Security* (OECD/City of London Conference on Sovereign Wealth Funds in the Global Investment Landscape: Building Trust, March 31, 2008), *available at* http://www.oecd.org/dataoecd/38/12/40395077.pdf (last visited August 6, 2009).

[10] The climax of these concerns was the purchase of P&O, a British port operator, by Dubai Port World, a UAE state-owned entity in 2006. The assets included a US port facility. A serious political criticism in the US has forced DP World to sell the US asset, which eventually was not part of the deal. See Matthew Byrne, *Note: Protecting National Security and Promoting Foreign Investment: Maintaining the Exon-Florio Balance*, 67 Ohio St. L.J. 849, pp. 876-880 (2006) (describing the DP world controversy).

many local conservative voices have called for investing conservatively and mainly in the geographical region of the respective fund. According to this argument, a large amount of capital managed by the long arm of the government can be a source of mismanagement and risk taking without a proper care for long term goals.

Several other factors have contributed to the growing concern in Western economies about the motives behind SWFs' investments in strategic industries in developed countries. Lack of proper transparency in these funds makes it difficult to evaluate their investment strategies and motives. Lack of clear governance rules, responsibility and accountability increases the role of a government in its SWF, which makes the case for a politically-motivated function. For all these reasons, many SWFs have responded voluntarily to the global concerns about their actions and publicly shared their size, source of funding, investment allocation, and investment strategy. Similarly, they have adopted more concrete rules of governance and increased the level of accountability of their money managers. However, these self responses have been sporadic and inconsistent.

When looking at the link between international economic law and the new state capitalism and how the above-mentioned global concerns are translated into various international legal instruments, we should differentiate between regulating SWF activity, either at the home state or host state, and adopting protective measures taken by governments, mainly Western, to block SWFs' investments or diminish their negative impact. As demonstrated below, the legal framework for each one of these realms is different and should be analyzed as such. It is important to note that, although I will describe both categories, this article will focus on protective measures and related regulation.

B. Regulating SWF investments

A SWF, as a corporate entity, is governed by both national laws of the home state where the SWF is incorporated and the host state where the investment is made. Most of these laws are general laws that apply to both corporations and SWFs. For instance, national securities laws that enforce disclosure rules for both local and foreign corporate entities can be applied to SWFs' participation in public capital markets[11]. Additionally, antitrust, banking, and corporate laws can be equally applied. However, due to the public feature of SWF, and depends on the level of

[11] *E.g.*, in the US SWFs have to report a 5 percent or greater acquisition of equity stake in a public company according to section 13(d) of the Securities Exchange Act of 1934.

involvement of the home government, a SWF can be regulated by additional laws that deal with this public element. Such laws can include, for example, relationships between the Central Bank and the Treasury, under which the SWF is managed in many home countries. A detailed comparison between these national laws is not within the scope of this article as these laws are extremely diverse. Nevertheless, several recent attempts to regulate SWFs' activities on a more global level in order to respond to various critics call for a closer view at the nature of such attempts. These critics find national laws and SWFs' voluntary actions, which deal with transparency, governance, and accountability concerns, insufficient. Accordingly, only international cooperation can bring a standardization of SWFs' norms that are accepted by the industry itself and the various home and host governments. Cleary, those who find the existing legislation sufficient to address these concerns will reject this multilateral approach.

And, in fact, in addition to governments, multinational organizations have simultaneously responded to the new state capitalism by proposing rules which will govern SWFs. The IMF, in cooperation with the World Bank, in November 2008 came up with proposed rules, the Santiago Principles (GAPP), which will be adopted by SWFs voluntarily[12]. The purpose of these rules is to create a level playing field for SWFs and increase their transparency and accountability. Adoption of these rules by the SWFs' community will help host states to build trust, be more comfortable with any proposed investment, and build long-term relationship between the funds and host states[13].

Although several SWFs have implemented various internal and external changes in their operations to respond to the global concerns around their motives and governance, these changes have a limited scope and are not applicable to many other SWFs. Consequently, there is still a strong need to follow closely the global reaction to the new state capitalism, both on the governments and the multinational organizations sides. Since SWFs function as commercial entities in the respective capital markets of the host states, the host states themselves are in the best position to examine whether their national laws deal with SWFs effectively and provide the appropriate legal framework. Additionally, the IMF, as an institution with a strong technical financial expertise with global membership that strengths its legitimacy, is the appropriate forum to facilitate discussions among its members and SWFs on acceptable voluntary standards to

[12] The principles were negotiated by the International Working Group. More on this group see http://www.iwg-swf.org/

[13] On the significant of this project see Anna Gelpern, *A Sovereign Wealth Turn*, SSRN research papers series, paper No. 25.

SWFs across the board. National legislation, along with the supplementary rules of the GAPP, can provide an adequate response to the global concerns about the real motives of SWFs and the role of sovereign governments in their governance structure.

It is important to note that several scholars have criticized the global attempts to single out SWFs and to force them to adopt unnecessary governance or transparency rules, limit their ability to vote their shares, or impose investment restrictions on the funds. Professors Richard Epstein and Amanda Rose, for example, show that SWFs do not create a distinct problem in their markets since their impact can be off set by other investors both in equity trading and boards of directors' decision making[14]. They explain that the current regulatory framework is sufficient to mitigate any potential harm, and that the unintended consequences, such as switching investments to less democratic regimes or retaliatory actions by the home government, are significant[15]. According to their argument, the current wave of expensive overregulation in the SWFs field should be re-examined.

Our discussion so far, which shows a lively debate among corporate lawyers and policy makers on regulation of SWFs' activity, is not complete. When it comes to protectionist regulation against SWFs by host governments, an international cooperation, which can lead to an enforceable mechanism against defensive legislation and protectionist actions against specific investments, is necessary. SWFs should have access to the appropriate tools and remedies in case they are denied access with no justification. Since several trade and investment legal instruments can be applied to SWFs' investments, I will now analyze the applicability of these instruments to SWFs and argue that the trade instruments and the WTO do not provide sufficient solutions and that the trade agenda should not be extended to include political compromises on the SWFs front. Alternatively, investment agreements, already designed to encourage market access and protect foreign investment, can deal with the protectionist sentiments more effectively and enforce acceptable standards through investment tribunals.

C. Protective regulation against SWFs

The growing criticism against SWFs in Western economies and their representation of the new state capitalism has brought several leading developed countries to introduce or improve

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[14] Richard Epstein and Amanda Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, 76 The University of Chicago Law Review 123-128 (2009).

[15] *Id.*, pp. 128-133.

existing legal instruments that enhance the ability of host countries to control better proposed investments by SWFs. While some scholars have proposed a minimalist approach that targets only governance concerns[16], most scholars have come up with ambitious proposals. From my point of view, these protective measures can be divided into four categories. The first, national regulation that blocks foreign investment by certain entities based on their identity as government-owned entities. The second, national regulation that blocks foreign investment based on the type of industry of the invested company. The third, a screening mechanism of a proposed acquisition or investment that gives the executive branch the ability to evaluate a specific investment and decide upon its commerciality and associated risks. Finally, the fourth, adoption of an open market policy with certain checks and balances to ensure that once an investment has been made, it is not serving purely as a long investment arm of a foreign entity. I would like to show now several examples for these categories.

First, the French government has recently announced its proposal to establish a governmental fund that will serve as a white knight when a foreign government-owned entity is bidding for a local champion[17]. This practically means a de-facto attempt to block hostile acquisitions by government-owned entities. The German government has criticized the French protectionist act, although it will be interesting to follow and see whether other European governments will establish their own SWFs to deal with hostile takeovers.

Second, several Western countries have excluded certain industries from being available for acquisition by foreign entities. According to customary international law, countries are not obliged to accept foreign investment and thus have the right to control the proposed investments entering into their territories. The US, for example, protects its nuclear energy and airline industries and prevents foreign control of companies in this space, which usually involves sensitive technology and defense elements[18]. These excluded industries appear as exceptions in various schedules to international investment agreements or as specific national laws that prevent foreign investors from investing in certain industries. Russia, for example, has recently adopted a legislation that prevents foreign investors from investing in the gas and oil industries.

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[16] *See, e.g.*, Ronald J. Gilson and Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A minimalist Response to the New Mercantilism*, 60 Stanford Law Review 1345 (2008).

[17] *Sarkozy plans new French wealth fund,* Financial Times, 23 October 2008.

[18] *See* Federal Aviation Act of 1958, Section 101; and Atomic Energy Act of 1954, Section 103(d).

Third, CFIUS is the American governmental committee that is used to screen proposed investments in sensitive industries. According to the CFIUS mechanism, several governmental departments are reviewing a proposed investment and then collectively decide whether to recommend approving this particular investment, blocking it, or taking protective measures to ensure that the purchaser is driven by commercial motives, such as separation between ownership and management in the invested company. Similar mechanism has been adopted or proposed recently in France[19], Germany[20], and China[21]. This mechanism can be used to screen investments that are proposed by commercial corporations and SWFs alike. While CFIUS and CFIUS-like models have been in existence for a long time, many of them have been adjusted as a result of the current wave of global SWFs' investments[22]. Thus, United States has recently revised its CFIUS regulation to improve the transparency of the CFIUS procedure and increase the range of investments that are being screened by the CFIUS committee. According to the revised regulation, an investment by a foreign government-controlled entity (such as SWF) will have to be reviewed by CFIUS, while in the past this review was discretionary. This legislative act has served as a response to the growing criticism in the Congress and the public that the existing mechanism could not provide an adequate review of hostile takeovers of US companies by foreign SWFs.

Finally, countries with a strong tradition of open market policies can frequently limit foreign investors' activities once the investors already operate in their host countries in order to mitigate the negative impact resulting from actions that are driven by political motives or goals related to national security. These limitations, such as revocation of a license to operate a TV channel, help keep the market access policy with a stricter approach when necessary.

These various categories of protective measures that can be applied against investments by SWFs highlight the intense legislation and its complexity in this field, a fact that encouraged

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[19] Journal Officiel de la Republique Francaise No. 304 of December 31, 2005, at 20779.

[20] *Germans Agree Sovereign Funds Law*, Financial Times, 10 April 2008. The new German law allows the government to block SWFs' acquisition of large stakes in German companies that could threat Germany's interests. The new law supplements Section 7 of the German Foreign Trade and Payments Act that restricts certain investments to protect essential security and external interests.

[21] *China Is Creating a Law to Protect Its National Security. It Will Probably Never Use It*, The Wall Street Journal, 26 August 2008.

[22] *See* Mark Plotkin, *Foreign Direct Investment by Sovereign Wealth Funds: Using the Market and the Committee on Foreign Investment in the United States Together to Make the United States More Secure*, 118 Yale Law Journal Pocket Part 88 (discussing the application of CFIUS to cross-border investments by SWFs).

several inter-governmental organizations to explore ways to offer additional and more cohesive rules which will balance this wave of protectionism in national legislation. The OECD, representing a club of leading developed economies that focus on the host states themselves, have called for adoption of voluntary rules for its members that prevent adoption of any protectionist measures and secure open market policies in the new SWFs era. These rules are scheduled to be releases this year following endorsement by the G-7 Group[23]. Clearly, it remains to be seen how OECD member states will implement these new rules on SWFs in light of the existing national legislation above-mentioned, whether by revising this existing legislation or by changing the policy towards future rules that limit market access of SWFs.

Meanwhile, SWFs will find themselves facing protective measures that are driven either by a genuine national security interests or classical protectionism. As mentioned before, host countries have responded to the new SWFs phenomenon and revised their rules to provide for a better review. This review will also provide investors with better transparency and predictability during the investment process. Any violation of the due process principle can be identified and proved. Under these circumstances, I argue, the existing legislation with some necessary adjustments can serve as a sufficient solution. On the other hand, when the protective measures are driven by classical protectionism and discrimination, SWFs can find themselves lacking the appropriate remedies. Global protectionism in trade and investment is increasing in times of economic recession[24], and so our discussion below is extremely timely.

III. INTERNATIONAL ECONOMIC LAW: INVESTMENT AND TRADE AGREEMENTS

The preceding overview of regulation of protective measures against SWFs and SWFs' activities has focused on national legislation and self-regulation by multinational organizations. The remaining question is which already-existing international legal instruments cover SWFs and if they provide a sufficient framework within international economic law on this subject matter. As discussed below, such comprehensive framework on investment does not exist and existing instruments provide a limited solution through a patchy network of trade and investment agreements. This conclusion, however, should not be surprising to the international economic lawyer, who is familiar with the several attempts to regulate investment comprehensively on the

[23] For the statement of the G-7 Group see Department of Treasury, Statement of G-7 Finance Ministers and Central Banks Governors (October 19, 2007).

[24] *See, e.g.*, *The Return of Economic Nationalization*, The Economist, February 7, 2009.

multinational level. These attempts have failed, while there are limited investment rules within the WTO as part of the TRIM agreement and the General Agreement on Trade in Services ("GATS").

International legal instruments that may be available to SWFs mostly cover protective measures against SWFs and not SWFs' actual activity. The reason is that almost all these instruments deal with governmental behavior with respect to trade and investment, while avoiding regulating multinational corporations directly. Regulation of multinational corporations has been subject to a continuous debate in the international legal community and is currently primarily made of soft law instruments, such as the OECD Guidelines for Multinational Enterprises[25].

In any case, regulation of protective measures against foreign investments is very limited. The OECD, for example, enacted the OECD Code of Liberalization of Capital Movements[26] and OECD Declaration on International Investment and Multinational Enterprises of 1976, which was revised in 2000[27], in order to liberalize capital movements and prevent protectionist sentiments against foreign investment among OECD members. The effectiveness of these soft law instruments has proven to be questionable. In the absence of Multilateral Agreement on Investment, despite several attempts to conclude such an agreement in the OECD in 1998 and the WTO as part of the Doha round that started in 2001, such regulation can be found in bilateral and regional investment agreements (or trade agreements with investment chapter) and the GATS, one of the WTO agreements that deals with trade and investment in services. It remains to be explained how these agreements can be applied to the protective measures discussed above.

Trade Agreements and SWFs

In spite of several attempts to conclude comprehensive investment rules within the WTO framework, there is no WTO treaty on investment *per se*. Nevertheless, several WTO arrangements include investment provisions that aim to prevent discriminatory measures against foreign investment where the link to trade distortion is dominant.

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[25] *Available at* http://www.oecd.org/dataoecd/56/36/1922428.pdf

[26] *Available at* http://www.oecd.org/document/63/0,3343,en_2649_34887_1826559_1_1_1_1,00.html

[27] *Available at* http://www.oecd.org/document/24/0,3343,en_2649_34887_1875736_1_1_1_1,00.html

One such arrangement that can potentially be applicable to SWFs is the GATS. This agreement is designed to provide free trade platform for trade in services and prevent discriminatory measures against foreign investment in services as the role of services in the global economy is growing dramatically. In fact, when we look at SWFs' investments in services, 44% of the transactions were in the services sector.[28] Although the GATS covers only trade in services, it covers investment in services indirectly as one of the ways to build a 'commercial presence' in the recipient country is by acquiring a local supplier. By applying the anti-discriminatory standards to acquisition of local distribution company in the services sector, the GATS serves an important role in facilitating the freedom of capital inflows in the services sector. Thus, when a SWF of one WTO member is investing in a services company of another WTO member, any attempt to block such investment by using protective measures can involve WTO procedures based on WTO members' obligations in the GATS. These obligations can be based on the Most-Favored-Nation ("MFN") and National Treatment principles, where a member state is committed not to discriminate between a local company and a foreign company or between companies from different countries, or based on specific commitments in the schedules to the GATS as part of the market access principle.

Several obstacles to applying the GATS to investments by SWF entities and monitoring protective measures against them should be discussed. First, the above-mentioned GATS rules apply only when the foreign entity has control over the acquired company, and so a minority investment by a SWF will not be sufficient. Since the majority of investments by SWFs in recent years was a minority investment in Western institutions as part of their passive, long-term investment strategy, it is questionable whether these investments actually provide the SWFs with the required control for the purposes of the GATS[29]. In fact, several studies that examined the level of control of SWFs on their minority investments show a low level of influence on the acquired companies, a fact that supports the argument that these investments should not be covered by the GATS. Second, the GATS includes an exception for services which are provided by a sovereign government. The purpose of this exception is to ensure that the government can provide its services without competing with the private sector. The applicability of this exception will depend on the legal nature of the specific acquiring entity in any proposed investment, and since many SWFs are not incorporated as a separate legal entity the government exception may

[28] The Monitor Group, *Assessing the Risks, The Behaviors of Sovereign Wealth Funds in the Global Economy* (June 2008), pp. 38-42 (tracking SWFs' investment in services since 1975).

[29] *See* Paul Rose, *Sovereign Wealth Funds: Active or Passive Investors?*, 118 Yale Law Journal Pocket Part 104 (2008) (discussing the passivity element of SWFs' investments).

apply. Finally, the GATS includes general and specific exceptions that can frequently be applied to investments by SWFs. WTO members can list a specific commitment or limitations on this commitment as part of the GATS' obligations, and each investment by SWF should be analyzed separately. Thus, for example, when a SWF buys a minority stake in a US financial institution we will have to examine US' specific commitments in the financial services sector. Any interpretation of general exceptions in light of a specific SWF's investment will take into account international economic law jurisprudence, which includes international legal instruments that the WTO member states are party to.

The potential use of the GATS to address global concerns about protectionist measures against SWFs will need to address all these obstacles. The limited application to SWFs due to the nature of their entity and investment, along with the wide range of listed exceptions to the GATS, make the GATS a very partial solution. Several scholars have offered to use the WTO as the preferred forum to deal with protective measures against SWFs by WTO members due to the trade-distortion effects of these measures and the ability to strike political concessions within the WTO by extending the political agenda of the WTO, which will include lifting barriers to market access in the SWF context[30]. If, indeed, the WTO will follow this line, additional rules on SWFs may be required since the existing rules do not have sufficient coverage.

Investment Agreements and SWFs

Bilateral Investment Agreements and regional trade agreements with investment provisions traditionally include anti-discriminatory provisions which apply investor protection standards to foreign investors in the host state. These standards include the MFN, national treatment, and fair and equitable treatment principles with respect to any specific investment. Administrative action by a government that blocks a potential investment by a SWF can be a violation of one of these standards. For example, if several foreign investors are bidding for a minority stake in a US company and the US government has adopted certain rules that give disadvantage to the Singaporean SWF among them, this SWF can claim a violation of the MFN provision in the US-Singapore FTA. This provision promises Singaporean investors to be treated equally to other foreign investors, while a Singaporean SWF in this context has a disadvantage in comparison to other third parties.

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[30] Arvind Subramanian and Aaditya Mattoo, *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization*, Working Paper Number 142, Center for Global Development (February 2008).

BITs offer foreign investors a unique dispute settlement mechanism to enforce the rights given to them by the investment treaties. This unique element of investment treaties provide an investor with the possibility of bringing a direct claim against the host state in an international arbitration forum, such as ICSID or International Chamber of Commerce ("ICC"). A discriminatory act against a SWF can follow by a direct claim by the SWF against the host state based on the applicable investment treaty between the host state and the home state of the SWF. Assuming no jurisdictional disputes, an arbitration forum will have to decide whether the legislative or executive act can be considered a discriminatory measure that violates an investor protection standard.

This proposed application of international investment agreements to SWFs can introduce several structural and substantive challenges. I would like to examine them in order to evaluate the feasibility of using existing international investment agreements to regulate actions against SWFs. First, investment agreements cover investments by a natural person or a legal entity. In other words, they do not cover investments by a sovereign government in the host state. BITs do not serve as a platform for international commercial disputes between governments. One can argue that SWFs as public entities do not qualify as private separate legal entities and thus cannot bring an investment treaty claim. If this is the case, BITs will not be appropriate legal instruments to deal with actions with respect to SWFs. We should have here a closer look at characteristics of SWFs.

Generally, SWFs as a group share common practices, such as not engaging in macroeconomic policies and conducting external audit by independent audit firms[31]. However, SWFs can be divided to several subgroups and SWFs in each one of these subgroups tend to share similar characteristics[32]. The most significant difference between different types of SWFs is between a legally-separate entity and the one which is not. Funds which are not legally-separate are usually owned by the Ministry of Finance or the Central Bank, their governing body is based on government officials, their asset allocation has a low risk model, and they tend not to disclose their financials[33]. Since 48% of the SWFs (almost half) are currently structured as a pool of assets

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[31] Cornelia Hammer, Peter Kunzel, and Iva Petrova, *Sovereign Wealth Funds: Current Institutional and Operational Practices*, IMF Working Paper, WP/08/254.

[32] For example, while SWFs with a pension liability component have to meet their future liabilities and thus have special restrictive funding and withdrawing rules, fiscal stabilization funds will not have such rules as a result of their different goal.

[33] *Id.*

and not as a separate legal entity, the case for a growing state capitalism and recognition of SWFs as government affiliates is getting more support.[34]

Various BITs have different definitions for 'investor', an important jurisdictional requirement in any investment treaty, and a closer case-by-case review is necessary by the arbitral tribunal to examine whether the structure of a particular SWF allows the SWF, similar to a 'person', to use a BIT to avoid discrimination and to sue the respective host state in case such discrimination has happened. The Washington Convention has a similar requirement in case of an ICSID claim, but international investment case law shows that the requirements are quite similar. A similar discussion took place in the trade context since governments can bring claims in the WTO as a result of use of illegal subsidies only if the subsidies are given to a private commercial entity by a sovereign government. The conclusions of this analysis can be very helpful for the debate on investment agreements and SWFs. It is important to note that, from an investment law perspective, ownership by the government and state funding do not by themselves exclude investors' protection as long as the state-owned entity serves a commercial function[35]. Global trend in national judicial institutions expands the applicability of investment law instruments to sovereign governments.

Second, most BITs cover investments in their post-establishment phase. In other words, they do not secure market access pre-establishment, but once an investment has already been made, investment agreements provide investor protection standards. Since most concerns around SWFs' investments in host state arise when they try to access the host economy, applicability of many BITs to SWFs pre-establishment is questionable. According to customary international law, governments have the right to decide which investments can enter their borders, and therefore international legal instruments cannot force them to do so. Nevertheless, it is important to note that the notion of investment encouragement and market liberalization is gradually becoming an integral part of the global investment discussion, and we may expect to see in the near future more BITs that expand investors' rights beyond the customary international law standards and apply their jurisdiction to investments pre-establishment, such as the North America Free Trade Agreement ("NAFTA"). Another way to apply investor protection pre-establishment if the rights

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[34] SWFs have different practices as a result of their diverse nature, original intent, and legal personality. These practices include different policy objectives, funding and withdrawal rules, institutional frameworks and accountability arrangements, investment policies and risk management framework. SWFs will look into previous practices and the Santiago Principles to evaluate the current practices.

[35] *See, e.g.*, CSOB v. Slovakia, Decision on Jurisdiction, 24 May 1999, 5 ICSID Rep. 335, par. 16-27.

are not explicitly included in the applicable treaty is to combine various treaties. An example would be a combination of a BIT between two European countries without a pre-establishment mechanism with a European treaty that forces liberalization of capital movement and facilities an open market for foreign investment.

Finally, the unique element of investment arbitration based on a treaty claim is the enforcement mechanism and the ability of the investor to initiate a direct procedure against the host state. This investment arbitration procedure is especially effective when the claimant is looking for direct or indirect damages as a result of discriminatory measures, or any other damage to the value of the original investment. It will be very difficult to show damages if the only protective action made by the government is preventing the SWF from entering the host country, unless the SWF as a bidder has already experienced significant expenses to prepare its bid, such as due diligence, financial analysis, or legal costs[36]. Regarding an already-established investment by a SWF, the fund can find itself facing extra scrutiny, which, in extreme cases, can lead to the risk of divestiture. Thus, for example, the CFIUS committee in the US can force divestiture if the SWF's investment turns to be a political action that leads to a significant threat to national security interests. While under these circumstances the element of damages can be proven easily, it will be challenging to show an unlawful discriminatory act. Investment in a critical infrastructure will frequently get scrutinized with the risks of conditions and divestiture regardless whether the investor is a SWF or a traditional foreign commercial entity.

The use of international investment law by SWFs is in its early stage. As we have seen with the first investment arbitration cases in the 1990s, it takes business executives some time to be aware of the possible use of investment law and to fully understand its costs and benefits. We have gone a long way since the first arbitral cases, creating practical know-how and judicial jurisprudence. This important evolution in international investment law will be very useful for SWFs in the future. The Singaporean SWF has recently contemplated filing a case against the government of Indonesia as a response to protective measures against it in the Telecom industry[37]. Additional cases may follow. One of the reasons for the limited use of investment

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[36] Although it is hard to identify a clear precedent in investment arbitration cases on this matter, investment tribunals tend to reimburse investors for their pre-investment expenditures only if there is a final agreement to receive the investment. *See Mihaly International Corporation v. The Democratic Socialist of Sri Lanka* (ICSID case No. ARB/00/2), 308 ICSID Reports 7.

[37] Temasek Holdings, Singapore's state-owned investment company, was required by the Indonesian antitrust authorities to sell its stake in either of the country's two biggest mobile-phone operators within a

claims by SWFs can be the need to achieve a preliminary settlement since these funds tend to invest on a repetitive basis and there is a need for building positive long-term relationships between the fund and its host government. However, a growing trade and investment protectionism, along with a dramatic rise in big developing economies with large SWFs such as China, may change this dynamic.

To sum, the potential use of investment treaties to regulate SWFs' activities is real but involves several limitations. Although the basic rationale behind an investment treaty, to foster an open investment policy and protect foreign investors from discriminatory measures, can be applied to SWFs as well, the unique character of the funds along with textual and jurisdictional challenges in the treaties could limit such application. In the vast majority of cases where the SWFs debate is taking place, protectionist measures that block foreign acquisitions by SWFs in their point of entry, the limits on the identity of the buyer and the current limited role of market access in BITs will serve as obstacles to the use of BITs. Nevertheless, as I claim later in this article, this framework should still be dominant in SWF international investment law regulation.

National Security, Public Order and Financial Crisis

As we have seen so far, the SWF debate within international investment law involves strong protectionist feelings and pro-market voices. Government officials, market actors, and academics have been looking for the right regulatory regime which will satisfy these diverse schools of thoughts. This challenge is not new to the global trade system. WTO members, while negotiating consensual trade arrangements, have been looking for ways to allow governments to use their sovereign power and regulate certain trade and investment activities unilaterally. Since the WTO functions on consensual basis, the dominant way to provide such regulatory power has been through specific and general exceptions. Similar exceptions have been adopted in investment treaties, as bilateral investment treaties include general exceptions for anti-discriminatory rules and specific excluded industries or other economic activities. Many countries include specific critical industries as excluded industries in these investment agreements. I would like to focus on one leading general exception, which is extremely important in the context of investments by SWFs. This exception would probably be invoked frequently by host governments when reply to SWFs' claims in international forums or tribunals.

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year. Temasek considered international arbitration procedures after exhausting local procedures in Indonesia.

The national security and public order exception, also known as the necessity exception, appears in multiple variations, forms, and languages. However, the spirit and goal are similar and they have a special importance in the SWFs world. This general exception allows governments to adopt protective measures in order to deal with national security risks, threat to public order, or other extreme economic circumstances that require immediate and protective responses. The Argentinean government, for example, has been using this exception to justify its protective response to the financial crisis of 2001. Although it seems like this provision includes various elements from different spaces, the common grounds are constrains on public life that force the government to impose measures that will mitigate the impact of such constrains. In order for a government to adopt these measures and comply with international law standards, the necessity requirement of this exception has to be met.

SWFs and the new wave of their global investments can fit this exception quite well. SWFs with political motives that invest in critical infrastructure should be treated differently due to the imminent risk to national security and can trigger an appropriate discriminatory response by the recipient state. In times of severe economic conditions, such as the ones we had in 2008, significant investments by SWFs can have an impact (both positive and negative) on liquidity of global markets and their stability. Extreme economic circumstances can also be followed by public unrest, which requires an immediate government response.

The concepts of 'essential security interest' and 'necessity' that appear in most treaties require a through analysis. Any process of interpretation or implementation of this general exception can benefit from similar exceptions in other investment or trade agreements where they find their origin. The necessity exception of the GATT[38], according to its language, is self-interpretative and allows governments to assess the necessity of any adopted measure on a subjective scale[39]. On the other hand, investment treaties are generally vague about this point[40], which can be understood as an indication that this general exception will be interpreted by some sort of a judicial process. Several arbitration tribunals have expressed different approaches

[38] GATT, Articles XXI(b) and XXI(c).

[39] This approach is supported by the Nicaragua Case, which compared between the necessity provision of the GATT and a similar provision in another treaty. *See Military and Paramilitary Activities (Nicaragua v. U.S.)*, I.C.J. 14, Paragraph 222.

[40] *See, e.g.* Article XI of the U.S.-Argentina Bilateral Investment Treaty.

towards application of the necessity principle in a specific set of circumstances[41]. Additionally, investment treaties do not provide a detailed description of 'essential security interest', and leave us with an open-ended concept with a dynamic interpretation process, including new grounds for applying the exception such as maintenance of public order. A list of essential security interests was provided, for example, in the GATT necessity exception and includes, among others, interests relating to the traffic in arms or actions taken in time of war or other emergency in international relations[42].

A review of investment arbitration cases show conflicting views on objective interpretation of the necessity exception, resulting especially from the conflict between the customary international law's view and the interpretation of the specific language of the exception. These conflicts led several scholars to propose new methodologies in order to help arbitrators in their application process of the exception. Thus, for example, Kurtz proposes to interpret the treaty defense on its own terms without importing the customary law principles[43]. It will provide investors with better certainty regarding the applicability of this exception and prevent opportunistic use of it by host countries. According to this view, applying the general defense in the SWF context will require a closer look at the grounds for exception listed in the applicable provision in an investment agreement. While a SWF's investment in a defense-related company can be perceived as a threat to essential security interest, measures driven by economic protectionism may not be legitimized by the necessity exception unless future investment agreements add additional elements to the exception, such as stability of financial markets. A specific reference to liquidity of financial markets, prevention of financial crisis, or mitigation of the impact of such crisis, may be a necessary addition in case countries are willing to rely on this exception in the future to defend their protective measures against SWFs. It is important to note, however, that recent investment agreements show a shift from an adjudication process to a self-interpretation process, which will reduce the importance of the exact wording of the exception. The 2004 U.S. Model BIT, for example, allows the parties to self-interpret the essential security interests and rely on this exception while any future tribunal will have to recognize this auto-judgment.

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[41] Jurgen Kurtz, *Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis*, Jean Monnet Working Paper 06/08, 22-54.

[42] GATT, Articles XXI(b) and XXI(c).

[43] *See Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis,* pp. 22-54.

Foreign investors are also concerned about the uncertainty around the application of the 'necessity' test. Case law and academic literature discuss extensively the 'proportionality' test[44], which is familiar to us from other aspects of public international law, which looks at the relations between the chosen means and the legally allowable objectives. The 'proportionality' test will force international tribunals to asses these relations and increase the level of uncertainty in the FDI market. Indeed, there is no ideal test for this purpose, but a test which will examine the reasonable less restrictive means can bring better and more certain results. Any government looking at a potential investment from SWF will have to decide what kind of means it can adopt with similar impact of control before it blocks the investment all together and be exposed to a protectionist criticism.

It is important to remember that governments can use the 'necessity' exception only in extraordinary times by the nature of this exception. As we learned from the Argentinean response to the financial crisis of 2001, governmental protective measures under extreme circumstances are easier to justify. In ordinary course of business, however, addressing SWFs' concerns around politicized governmental actions is even more important, while less legal arguments are available to the host governments.

IV. INTERNATIONAL INVESTMENT LAW, SWF, AND DEVELOPMENT

Our overview of existing international trade and investment legal instruments propose the applicability of these instruments to protective measures against SWFs. Both the application of trade and investment agreements involves several structural and substantive obstacles. Although both the WTO and investment tribunals can serve a similar goal, preserving market access in a SWFs environment, they present different forums, influenced by different rationales. Those who want to see the WTO dealing with any violation of the rules against SWFs emphasize the trade-distortion effect of SWF activity[45]. They also focus on the need to include private players, such as SWFs, in the WTO forum to increase its credibility and extend its agenda in order to increase the political capital of the member states who want to liberalize capital inflows[46].

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[44] For a general discussion on the proportionality test in WTO law see Axel Desmedt, *Proportionality in WTO Law*, Journal of International Economic Law 4(3), 441-480 (2001).

[45] Arvind Subramanian and Aaditya Mattoo, *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization*, Working Paper Number 142, Center for Global Development (February 2008).

[46] *Id.*

Indeed, the WTO suffers from a constant decline in its credibility and its ability to conclude core trade arrangements. Many important players, especially in the private sector, feel they have not been part of the trade debate. The Doha Round is about to come to its end without concessions on important agenda items. However, adding WTO rules on SWFs or using the Dispute Settlement Body (“DSB”) to decide on protectionist measures by a WTO member against another member state will complicate the work of the trade organization and hurt its ability to deal with its existing agenda more effectively. The ‘Singapore Issues’, which were added to the trade discussions in Cancun, included investment regulation in the WTO. It was part of an institutional attempt to have a serious debate on all trade-related items, including investment, and to provide developed countries with the opportunity to reduce agriculture subsidies for liberalization of capital in the developing world. Extending the trade agenda and including investment in the WTO, in fact, was one of the failures of Cancun and caused the member states to withdraw negotiating on trade-related items. As a matter of fact, the WTO has very limited institutional expertise in this field and not all investment regulation is trade-related. For the same reason, any inclusion of additional SWFs rules in the WTO or application of existing rules to SWFs will diminish the ability of the organization to conclude additional agreements on its core agenda.

The failure to negotiate investment rules in the WTO has empowered the existing BITs network, encouraged countries to negotiate new bilateral or regional investment agreements, and increased the number of investment arbitration claims. In a separate article I made the case that the BITs network can serve as a de facto multilateral investment agreement[47]. Its signing mechanism based on a pre-negotiated model, the MFN provision that creates a standardization of investor protection standards for all nations, and the developing investment jurisprudence – all these strengthens the multilateral aspect of the BITs network and increases its credibility to include additional investment-related items. Thus, the BITs network can be a natural forum to discuss SWFs and, as shown before, to apply protection standards to protective measures against them in investment arbitration tribunals.

Several additional factors support my analysis. First, the investment arbitration is a unique procedure that brings together a private investor and a public entity. This special private-public forum provides the tribunal and the parties with the opportunity to discuss the link between

[47] Efraim Chalmaish, *The Future of Bilateral Investment Treaties – A de facto Multilateral Agreement?*, 34 Brooklyn Journal of International Law 304 (2009).

the private and the public in international economic law. Thus, the forum can discuss a SWF, a private entity with public features, more effectively. Second, although the main component of the BIT is investment protection, the liberalization of capital is becoming a growing element in BIT's language and investment arbitrators' decisions. Applying investment agreements to SWFs and adding financial features to the necessity exception, as discussed, will empower the liberalization element of the treaties through protection of market access in an environment where many cross-border investments are made by SWFs[48].

Finally, as several authors suggested, investment treaties are a unique opportunity to include investors' obligations in the new global economic order, and provide arbitrators with the ability to enforce human rights standards when applying investor protection standards. It will allow us to use investment agreements to promote the development agenda within international economic law and to encourage private commercial entities to play a role in public policy through private-public partnerships in the host states. Similarly, SWFs have a very important role in developing economies, whether these are their home states or other developing economies where they invest. In their home states, these funds increase economic diversification and build national champions[49]. When it comes to international investments, they have a similar function to bilateral and regional development finance institutions[50]. These institutions usually use public-private partnerships to support development initiatives. The growing size of SWFs and the financial impact of their investments in developing economies can have a similar effect to financial aid. Nevertheless, it is important to remember that unlike direct financial aid, SWFs have other investment goals and their investments should be driven by returns and long-term performance. Thus, strengthening the sustainable development of the host state should be a side effect of well-calculated investments by SWFs, which gradually increasing their role in developing countries and their capital markets[51].

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[48] On the Japanese BITs and investment liberalization provisions see *Japan Grows Positive on Bilateral Investment Treaties*, The Japan Economic Review, 15 February 2004.

[49] Javier Santiso, *Sovereign Development Funds: Key Financial Actors of the Shifting Wealth of Nations*, OECD Emerging Markets Network Working Paper, October 2008.

[50] *Id.*

[51] See, for example, the announcement of Qatar Investment Authority to create a new investment fund, PME Infrastructure Management Limited Fund, which will invest in African transportation, communication and energy sectors.

As Javier Santiso points out, this development dimension is missing in the current debate on the real financial impact of SWFs and their investment policies.[52] The development analysis will have a significant impact on this debate in coming years as the level of SWFs' investments in developing countries will rise. The weakening western currencies, such as the US dollar and the Euro, the negative experiences some SWFs have recently had in investing in US financial institutions, and growing opportunities in the developing world due to its large growth rate – all these factors will encourage SWFs to consider investments in developing economies more seriously. While in developed countries SWFs act as rational investors, looking for good returns and diversified portfolios[53], in developing countries they add the additional element of development, providing capital for infrastructure and employing local workers. This unique know-how of well-run SWFs in emerging markets call for a deeper involvement in the international finance space. Indeed, Santiso calls for the establishment of south-south peer review and learning institution like the *Emerging Markets Network of the OECD*, which will provide SWFs the opportunity to share their knowledge and capacity building with new SWFs in the developing world and their governments. It will create a platform where SWFs, regional and bilateral development finance institutions, and international donors, can share their views and resources in order to maximize the development effect. Indeed, similar cooperation already started with several agreements between Western and developing SWFs[54], and ad hoc advice given by well-established SWFs to governments in the process of starting their own new SWFs[55]. To sum, a growing development element in SWFs' activity makes the case for a better integration into the BITs network and its new development agenda.

V. CONCLUSION

This article dealt with one of the most exciting and emerging topics in international economic law. SWFs, legal entities that combine both private and public elements, present a challenge for the international community how to have the benefits of SWFs' investments

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[52] *Id.*

[53] C. Balding, *A portfolio Analysis of Sovereign Wealth Funds*, University of California, Irvine, Department of Economics (2008).

[54] *E.g.*, the Vietnamese State Capital Investment Corporation (SCIC) and Qatar Investment Authority signed an agreement in 2008 to create a one billion investment fund to invest in Vietnamese companies.

[55] The US based Alaska Permanent Fund helped the Democratic Republic of Sao Tome and Principe with knowledge transfer when they wanted to establish their own SWF. *See* S. Cowper, *A Word to the Wise: Managing Alaska's Oil Wealth*, in Sovereign Wealth Management, Johnson-Calari, J. and M. Rietveld, eds., London, Central Banking Publications, pp. 219-230 (2008).

without being exposed to the negative impact which can result from political motives, non-transparent investments, and lack of clear governance structure.

Legal fields are frequently shaping realities, but at the same time they have been shaped by changing realities. The US Sarbanes-Oxley ("SOX") regulation of 2002, as an example, came as a response to the lack of trust in Corporate America following the collapse of WorldCom and Enron. Thus, a consequent public debate had to find ways to increase supervision and compliance in public companies with reasonable costs and without loosing potential investors. The revolutionary SOX regulation was the result of such debate. Clearly, times of crisis tend to foster pro-government regulation, where the real impact becomes clearer after the fact. The financial crisis of 2008 has triggered a large amount of such regulation, and the question would be whether the SWF dilemma should and will bring a similar reaction by national and multinational regulators.

An analysis of the existing applicable instruments in national and international investment law shows a wide range of reactions, from a minimalist approach of national corporate governance solution to a governance concern, via voluntary soft-law rules of industry norms, to application of WTO and investment treaties to protective measures. While the IMF is the most appropriate forum to discuss SWF activity and can do it as part of its growing role in re-shaping global financial regulation following the banking crisis of 2008, the investment agreements regime can provide an opportunity to regulate host countries' activity against SWFs in a more cohesive way. The BITs network integrates both concepts of liberalization of capital and promoting the global development agenda. SWFs, which have been playing an important role in market access and international cooperation, should be part of this network. As private-public entities, SWFs can find their legal remedies in investment arbitration tribunals that bring together private and public views. Any attempt to create a new forum to regulate SWFs or adopting new legal instruments, instead of applying existing tools with the appropriate adjustments, can create unnecessary complications and waste of resources.