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The Sovereign Wealth Fund Initiative
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Regime Changer?

Sovereign Wealth Funds and the International Investment System[1]

I. Introduction

In the past two decades, the use of bilateral investment treaties as vehicles to facilitate foreign direct investment has expanded significantly, creating an international investment framework so pervasive that it is now characterized as a "regime."[2] The regime now confronts the emergence of sovereign wealth funds, and in particular SWFs from formerly "developing" economies, as major investors. Growth in the capital available to SWFs – due largely to booming oil prices and the Western financial downturn of the late 2000s – has transformed oil-exporters and East Asian nations into net exporters of capital, effectively flipping the long-standing narrative of foreign direct investment.[3] SWFs have begun investing in Western financial institutions and infrastructure projects, investments which often generate significant controversy as host states contemplate security, political and control concerns and investors

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[1] This paper is adapted from the LLM thesis of David G. Fromm, Fletcher School of Law and Diplomacy, Tufts University 2011. Certain citations have been omitted for formatting and length restrictions. The author is deeply indebted to the work of Professors M. Sornarajah, Yvonne C. L. Lee and Jeswald Salacuse, among others.
[2] *See, e.g.*, Jeswald Salacuse, "*The Emerging Global Regime for Investment*," Harvard International Law Journal, Vol. 51, No. 2 (Summer 2010), at 427 *et seq.*
[3] *See* Michael Green & John I. Forry, "*Sovereign Wealth Funds: International Growth and National Concerns*," 127 Banking L. J. 965 (November/December 2010), at 2 et seq. ("both commodity and non-commodity funds have benefited from trade surpluses with developed nations such as the United States. Their sovereigns have established SWFs in order to invest in growth as opposed to stabilization, especially equity as opposed to U.S. Treasury Bonds or other sovereign debt instruments. SWFs allow these nations to diversify for greater returns than can be obtained from investing official reserves. […] Essentially, countries with large surpluses such as Norway, the People's Republic of China, the United Arab Emirates and others feel they have enough stability within their reserves that they want to achieve higher risk-related returns through equity investments.").

contemplate the protections afforded to their investments.[4] Commentators note that the lack of transparency and "ominous" investment strategies associated with SWFs make host states wary of accepting direct investment.[5]

> In the case of a [multinational corporation], a state has discretion whether or not to intercede diplomatically. In the case of a government-linked SWF, it is certain that a state would intervene to protect the interests of the fund, diplomatically as well as through other means. Since the investment it makes may be protected under the investment treaties made by the state on account of its status as an investor no different from a [multinational corporation], the SWF will also have standing to protect its own interests through recourse to treaty mechanisms of dispute resolution, usually arbitration mentioned in the provision on dispute resolution.[6]

SWFs have responded to the turmoil with non-binding conciliatory measures, such as the adoption of guidelines intended to assuage the concerns of nervous host states.[7] Such efforts notwithstanding, SWFs present significant legal and administrative issues within the regime framework.[8] Indeed, some commentators suggest that the growth of SWF foreign investment should give rise to a threshold "means-test" for such investment proposals – are they commercial in nature (and therefore presumably more like "normal" investors) and thus permissible, or are they political in nature, in which case they might be prohibited from investing?[9] Such a proposal, like others involving SWF investments, raises as many questions as it seeks to answer regarding the ability of the international investment regime to incorporate these new exotics.

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[4] For example, in 2006, a government-affiliated fund from Dubai sought to invest in United States port operations, an effort that met with both political and legislative resistance, and ultimately with renegotiation of agreement terms between the United States and Dubai. "*The Changing International Economic Balance of Power*," Remarks at the American Society of International Law Proceedings, April 9-12, 2008, 102 Am. Soc'y Int. L. Proc. 293, at 294 (remarks by Faryar Shahzad). It also led to the enactment of the U.S. Foreign Investment and National Security Act of 2007, which created the Committee on Foreign Investments and requires review of foreign investments within the United States. The 2006 Dubai Port World experience – as the investment controversy is known – was among several recent investment events which woke former capital-exporters from what had been "a fairly sleepy area of policy making" to the realization that these new investors presented novel issues relating to the regime's existing structure. *See* Yvonne C. L. Lee, "*The Governance of Contemporary Sovereign Wealth Funds*," 6 Hastings Bus. L. J. 197 (2009), at 200-04 (noting further that "[t]hese forms of *ex ante* protective measures arguably violate relevant provisions in bilateral agreements that protect foreign investments in recipient countries under 'national treatment' and 'most-favored-nation treatment' principles").

[5] *See, e.g.,* Lee, *supra* note 4, at 201.

[6] *Id*. (noting that the new ASEAN Comprehensive Investment Agreement specifically entitles SWFs to the same treatment as private foreign investors).

[7] Lee, *supra* note 4, at 205.

[8] *See, e.g.,* Note, "*Too Sovereign To Be Sued: Immunity of Central Banks in Times of Financial Crisis*," 124 Harv. L. Rev. 550 (December 2010); *see also* Daniel Etlinger, "*Sovereign Wealth Fund Liability: Private Investors Left Out In The Cold,*" 18 U. Miami. Bus. L. Rev. 59 (2010).

[9] *See generally*, Lee, *supra* note 4.

In this brief, I will first consider whether SWF investors can fit within the current investment regime from a jurisdictional perspective. Second, I will consider structural issues SWFs are likely to confront within that regime. Third, I will consider the implications of SWF investment on the regime's putatively "bilateral" structures. Finally, I will conclude by suggesting how SWF investments are likely to be accommodated by the regime.

II. Do SWFs Fit The Regime's Jurisdictional Model?

When considering the growth of SWF investment and its implications for the future of the international investment regime, one must first consider whether such investments "fit" within the regime at all – and if so, where – and are thereby entitled to the protections the regime affords.[10] In other words, the initial inquiry is jurisdictional.

A. Protected Investor? Protected Investment?

For numerous reasons, SWFs do not act like traditional foreign direct investors.[11] "[A] SWF will not invest conventionally, unlike [multinational corporations] which do so through the creation of a subsidiary in the host state or through a joint venture with a local business partner [but] will do so through the acquisition of shares in existing companies and businesses. Such an acquisition of shares [may] fall within the definition of assets that constitute investments within the [various bilateral investment treaties]."[12] However, to constitute a protected asset, such investments would also need to satisfy the definition of investment found in the documents, such as the ICSID Convention, governing the traditional international investment regime.[13] Moreover, some commentators suggest that SWF investors would struggle more than

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[10] As Sornarajah notes, "[t]he [bilateral investment] treaties were made for the protection of [multinational corporations] and not for the protection of [sovereign wealth funds]. The fit cannot be exact." M. Sornarajah, "*Sovereign Wealth Funds and the Existing Structure of the Regulation of Investments*," Asian Journal of International Law, 2011, at 13. For a detailed discussion of the jurisdictional threshold applicable to international investments, *see id*, at 13-18; *see also*, M. Feldman, *The Standing of State Controlled Entities Under The ICSID System: Two Key Considerations*, in Columbia FDI Perspectives, No. 65, April 16, 2012 (Karl P. Sauvant, Ed.).
[11] Indeed, there is ongoing debate as to whether or not SWFs constitute "nationals" of party states or arms of the party state itself. *See, e.g.*, Feldman, *supra* note 10 (discussing recent tribunal analysis of state control v. commercial purpose).
[12] Sornarajah, *supra* note 10, at 13-14.
[13] The ICSID Convention leaves the definition of covered "investment" vague, thus inviting the contention that sovereign wealth fund share acquisition may not be accepted by ICSID tribunals. Note that given the idiosyncrasies of BIT language, some BITs may cover share acquisition.

"traditional" investors to satisfy substantive "investment" tests, such as that set forth in the *Salini* matter.[14]

> If economic development of the host state is a criterion of the protected investment, it would be difficult for [sovereign wealth funds] to satisfy this requirement. They do not invest for anything but profit. This may also be so with [multinational corporations], but the theory is that their investments result in a multitude of benefits such as transfer of technology, creation of employment, and the upgrading of infrastructure. These incidental benefits flow from the investments made by [multinational corporations]. [Sovereign wealth funds], which have the solitary purpose of enhancing the wealth of their home states, simply do not have room for any altruistic result even as an indirect outcome of their investments.[15]

B. Pre-Entry National Treatment?

States might engage in pre-investment vetting of proposed investors to determine whether or not they are truly engaged in purely commercial activity rather than a commercial-political hybrid. This practice implicates pre-entry national treatment standards. "There is the possibility that the national treatment standard is violated where a state refuses to permit acquisition of shares by a [sovereign wealth fund] of a state with which it has an investment treaty granting pre-entry rights of investment."[16]

Further complicating the pre-entry national treatment issue is the fact that, pursuant to most BITs, a SWF investor alleging pre-entry discrimination would need to find a national "comparator".[17] Such a "comparator" would be difficult to identify, given the unique attributes of the typical SWF investor – deep pockets, state control, competing commercial and political motivations.[18]

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[14] *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*, ICSID Case No. ARB/00/4 (2001), 6 ICSID Rep. 398*; see also* Sornarajah, *supra* note 10, at 14.

[15] Sornarajah, *supra* note 10, at 14-15. Notably, Sornarajah also suggests that the very act of capital investment might be deemed sufficiently beneficial to economic development to satisfy this requirement, to the extent that it exists.

[16] *Id*., at 15. Sornarajah goes on to note that this possibility is mitigated by the relative infrequency of overly liberal pre-entry national treatment standards mandating rights of entry and establishment in their treaties. As it stands, SWFs can already be "discriminated against" on a host of pre-existing grounds in most BITs. Notably, the countries that regularly include more liberal pre-entry standards include formerly capital-exporting states such as the United States, Canada and Japan.

[17] Sornarajah, *supra* note 10, at 16.

[18] *Id*.

C. Minority Shareholding?

SWFs will usually be in the position of minority shareholders within an existing asset or enterprise, particularly in states with restrictions on the holdings of foreign shares.[19] Such minority shareholding may lack standing to sue where a host state takes action targeted not at the minority shareholder but at the asset (or enterprise) itself, arguing that the asset or enterprise itself would be the entity to determine whether or not to allege improper treatment.[20] While the current state of the regime appears to recognize causes of action for minority shareholders, recent UNCTAD publications note a trend towards carving out certain types of minority shareholding from BIT definitional terms.[21]

III. What Is The Effect of Jurisdiction?

To the extent that SWFs do meet jurisdictional requirements and gain access to the protections of the international investment treaty regime, the question then becomes: what is the effect of that access? Space requirements will limit this paper's consideration of the effects of that access to four areas: national treatment standards, expropriation, capital controls, and dispute resolution.[22]

A. Post-Entry Treatment Standards?

BITs typically define general standards of treatment and then stipulate specific standards for areas such as monetary transfers and the employment of foreign personnel.[23]

> One may divide the general standards of treatment of most BITs into six component parts: (1) fair and equitable treatment; (2) the provision of full

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[19] *Id*.
[20] *Id*.
[21] *See, e.g.*, ICSID cases such as *AAPL v. Sri Lanka* (ICSID/ARB/87/3) and *CMS v. Argentina* (ICSID/ARB/01/8) (noting that "nothing in general international law prohibits the conclusion of treaties allowing 'claims by shareholders independently from those of the corporation concerned… even if those share-holders are minority or non-controlling shareholders.'")*; but see generally,* "*Scope and Definition: UNCTAD Series on Issues in International Investment Agreements II*," United Nations Conference on Trade and Development 2011 (hereinafter "*UNCTAD*"), at 74-100.
[22] Sovereign wealth fund participation in the international investment regime also implicates other treatment standards, transparency, and operational standards of the investments, among other topics regularly covered in BITs.
[23] *See* Jeswald W. Salacuse and Nicholas P. Sullivan, "*Do BITs Really Work?: An Evolution of Bilateral Investment Treaties and Their Grand Bargain*," 46 Harvard Int'l L. J. 67, at 82; see also Kenneth VandeVelde, *"A Brief History of International Investment Agreements,"* 12 U.C. Davis J. Int'l L. and Pol'y 157 *et seq*.

> protection and security; (3) protection from unreasonable or discriminatory measures; (4) treatment no less than that accorded by international law; (5) requirement to respect obligations made to investors and investments; and (6) national and/or most-favored-nation treatment. An individual BIT may provide for some or all of these treatment standards.[24]

Many BITs provide for some combination of "national" or "most-favored-nation" treatment, meaning that a contracting state agrees in the BIT to treat foreign investors as well as it treats either its own "national" investors or, in the MFN context, as well as it treats any other foreign investor.[25] But how does a SWF properly allege violations of national treatment standards without pointing to a domestic comparator "like it in all respects, but for the nationality of ownership"?[26] What domestic comparator has the same combination of political, financial and strategic motivators as sovereign wealth fund investors might have?[27]

Complicating this post-entry issue is the widespread use of "most-favored-nations" clauses and the increasing referral of matters to quasi-judicial dispute resolution processes. While bilateral investment treaties have the putative appeal of defining rights and obligations solely between the contracting states, terms incorporated therein nonetheless have ripple effects across the regime, either directly – through the application of the MFN clauses – or indirectly – as an inchoate norm incorporated into the decision-making of dispute resolution efforts. Thus, while some states, such as those former capital-exporters in the West, might seek to carve-out SWF investment from certain potential investors (such as the BRIC countries), the regime itself may struggle with how best to compartmentalize the exclusions.[28]

B. Expropriation

SWF investors present particular problems in the context of claims of expropriation. The modern trend in international investment law is towards a restrictive view of expropriation – that

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[24] Salacuse & Sullivan, *supra* note 23, at 83. Many of these standards continue to evolve as parties pursue claims before international investment tribunals. For example, the "fair and equitable treatment" standard has been the subject of much scholarly and arbitral interpretation as to whether it constitutes a "free-standing obligation" in international law or whether it is an obligation for the host state only to the extent that the host state recognizes the concept. *See* George M. von Mehren, Claudia T. Salomon and Aspasia A Paroutsas, "*Navigating through Investor-State Arbitrations – An Overview of Bilateral Investment Treaty Claims*," Dispute Resolution Journal, Vol. 59, No. 1 (Feb.-April 2004), at 72.

[25] *See* Salacuse & Sullivan, *supra* note 23, at 84-85.

[26] Sornarajah, *supra* note 10, at 18 (citing to the national treatment formula articulated in *Methanex Corporation v. The United States of America*, NAFTA Award (August 3, 2005)).

[27] *Id*. Note, also, the fundamental incoherence of applying precedential tests in the context of the private, quasi-judicial investment dispute regime.

[28] *See* Lee, *supra* note 4, at 217-18 (discussing carve-outs and pre-entry reviews in the context of most-favored nations clauses).

is, after *Methanex* in 2005, to limit the scope of such claims by agreement.[29] Host states, concerned that even the most tangential action that caused a dip in stock prices could be used in a claim for expropriation, have increasingly carved out types of activities from those that might be used as a basis for such a claim. For example, the U.S.-Singapore free trade agreement explicitly carves out regulatory activity for the purposes of promoting public welfare from the types of activities that might serve as a basis for compensable expropriation.[30] Claims for regulatory activity in the name of national security also increasingly provide a basis for host state expropriation without full compensation. The 2004 U.S. Model BIT provides a specific (and subjective) "national security" defense to liability, and Argentina has "striven mightily to argue the national security exception" in several recent investor-state disputes.[31]

This trend towards restrictions on claims of expropriation presents additional problems for potential SWF investors, whose size, liquidity, insulation and extra-territorial political roots may make host state governments particularly skittish about control issues.[32] Such skittishness may in turn lead to the increased imposition of national security or "public welfare"-type regulatory schemes on sovereign wealth fund investors.

C. Capital Control

Bilateral investment treaties often contain specific requirements for capital transfers, applicable exchange rates and currency requirements. In the case of SWF investments, these capital controls would restrict the movement of a foreign sovereign's wealth and potentially dictate the currency in which it is held. While SWF investors are potentially capable of negotiating exceptions to these terms, capital controls present yet another area in which such investors potentially require special treatment in order to fit within the existing regime. Moreover, the prevalence of most-favored-nations clauses can have the effect of turning such special treatment into a basis for claims of treatment violation by other investors and, eventually, into treatment norms themselves.

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[29] Sornarajah, *supra* note 10, at 19.
[30] *Id*., citing to the Office of United States Trade Representative, *US-Singapore Exchange of Letters on Expropriation* (May 26, 2003).
[31] *Id*., at 21.
[32] *Id*., at 20.

D. Investment Dispute Resolution

BITs typically provide avenues for redress in the event that an aggrieved investor (or state) claims a violation of treatment standards.[33] Many BITs provide a two-pronged mechanism for dispute settlement, with disputes between contracting states resolved through negotiation and ad hoc arbitration and disputes between an investor and a state resolved through more formal arbitral proceedings, often in a specific international investment dispute forum such as the ICSID. Both types of arbitral proceeding, which are conducted before separate and discrete panels of international investment practitioners, are confidential and rulings emanating from them are not controlling on future disputes, making the development of investor-state jurisprudence difficult. As a result, while some standard constructions have gained traction in investor-state disputes, the majority of issues that arise are subject to variable interpretations on a case-by-case basis, exacerbated by the fact that the parties can and do object to panelists whose views on issues likely to arise are known ahead of time based on the panelists' service as arbitrators in prior cases. In this regard, investor-state dispute resolution becomes increasingly opaque and risky for the parties involved. Moreover, no current agreed-upon appellate procedure exists for investor-state disputes, adding to the risks of pressing a claim.

One potential issue for SWF investments relates to intra-investor disputes, which would not necessarily implicate investment treaty terms but which could nonetheless pit co-investors against sovereign wealth fund investors with relative financial and political power. More particularly, SWFs – with their deep pockets, opacity and complicated motivations – present numerous challenges to the existing dispute resolutions mechanisms.

IV. Implications for the Future of Bilateralism?

The international investment regime was created to facilitate the flow of western investment to developing countries. However, the mechanisms used, in name if not in intention, were "bilateral." Western capital exporters agreed to treat their foreign direct investors in the same manner as the developing countries did. And while these obligations might have been an afterthought at the time, they are nonetheless memorialized in treaties.

[33] Note recent attention given to the contention that SWFs and other "state-controlled entities" are not "investors" within the meaning of the regime framework, but are in fact "states," rendering the disputes "state-to-state" rather than "investor-state," and thereby implicating sovereign immunity issues. *See, e.g.,* Feldman, *supra* note 10.

The capital controls, reinvestment requirements and investment promotion that drew so many capital exporters to developing countries in fact swelled the coffers of those countries' capital reserves. The financial and oil crises of the past decades have now driven these SWFs to invest in opportunities in the original capital-exporters. The notion that those capital exporters now want to change the rules, as it were, citing national security, inflexibility and public policy concerns, seems unfair. Indeed, as one commentator notes, the concerned rhetoric about SWF loyalties, national security and sovereignty emanating from the western states "is ironically reminiscent of arguments advanced by developing countries against the 'free trade and market' and 'freedom of capital flows and investment' argument of developed countries."[34] What is good for the goose, the saying goes, is good for the gander.

Adages aside, however, the primary purpose of the international investment regime is functionality, not fairness. States are free to make and renegotiate whatever treaty bargains they want in order to facilitate their interests – historically, long-term direct investment for developing countries and property protection for capital exporters. Certainly, within those bargains (especially as they overlap with one another), the notion of fairness plays a role -- but it is a tactical role, rather than a strategic one, and it does not follow that the international investment regime cannot change course now that the investment shoes are on the other feet. If states wish to change the rules to exclude (or accommodate) SWF investment, they are certainly capable of doing so. Such changes might further confirm the colonial myopia that begat the regime, but they would be permitted nonetheless.

What might such changes look like? A non-exhaustive (and problematic) list might include:

- Further definition of investors and investment.
- Potential SWF carve-outs for industrial sectors, by investment size and domestic control.
- Capital controls that include liquidated damages provisions for early withdrawal of funds.
- Pre-entry commercial purpose testing.
- Acknowledgement by SWF investors of host-state regulatory concerns.

[34] *See* Lee, *supra* note 4, at 197.

- Use of domestic laws such as the U.S. Alien Tort Claims Act or the Foreign Corrupt Practices Act, as well as domestic financial controls, to ensure accountability by sovereign wealth fund investors.[35]
- Conflict waivers for counsel and arbitrators.
- Full faith and credit requirements for post-dispute arbitral awards.

Each of these proposed changes would represent a departure from the existing regime, and might necessitate significant renegotiation of terms between existing treaty partners, but there is no "legal" or regime impediment to such changes if states decided to undertake them. Professor Lee, who is optimistic about the ability of SWF states to make this new investment paradigm work, notes that:

> States may pursue their respective policy goals by entering into bilateral or regional arrangements that establish normative standards in line with the SWF Principles that incorporate access to arbitration venues such as ICSID without restraining their freedom to modify their laws or practices in pursuit of their national interests. Several examples of provisions [in the "SWF Principles"] that apply to SWF investments are: First, the relevant SWF country and its SWF covenant not to hold any position of control or management in specified "sensitive" industries without the prior approval of the recipient country. Second, SWF and recipient countries agree to negotiate a mutually acceptable set of disclosure and transparency rules concerning the SWF's strategy and management in relation to the relevant investment. Third, the meaning of "national security" or "essential security interests" includes severe financial crises, particularly defined as, for example, a continued and drastic contraction of the economy over several financial quarters. Indeed, the broad framework of the SWF Principles has facilitated overall discourse, participation and creation of "good principles, policies and practices" amongst recipient and home countries, and existing international and regional financial institutions and bodies. Within six months of the Santiago Principles' publication, the IWG established the International Forum of Sovereign Wealth Funds. Although the forum is stipulated not to be a "formal supranational authority" and "its work shall not carry any legal force", it facilitates the continued exchange of views and study of SWF activities among the SWF and recipient countries, international organizations and market functionaries. The forum serves as a foundational step towards the synchronization of differing domestic laws and practices and the eventual adoption of uniform norms for SWF investments by each State.[36]

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[35] Sornarajah, for example, suggests ATCA accountability for sovereign wealth funds investing in the territories of known human rights violators. Sornarajah, *supra* note 10, at 11.

[36] *Id*., at 226-27. The term 'SWF Principles' refers to a combination of the Santiago Principles and similar model guidance adopted by the OECD. *Id*.

This piecemeal effort may result in states pursuing policy reforms independently, emulating each other to the extent it serves their interests, and complicating their existing investment relationships. This approach may also result in the existing dispute resolution processes determining issues such as jurisdiction and treatment standards on a case-by-case basis, which, while not constituting a precedent, would begin to shape international norms and definitions applicable to investment relationships. To date, investment disputes involving SWFs have been rare and seemingly handled outside of the regime dispute mechanisms. The growing presence of SWF investors, however, suggests that the regime might soon be compelled to address these issues promptly and efficiently.[37]

V. Conclusion

Absent multinational coordination—which is unlikely to be forthcoming – SWFs face a long and costly integration effort, during which capital flows, investment vehicles and political winds will continue to shift. But the structure of the regime – decentralized, interwoven, amorphous, private, consent-based and confidential – admits of few alternatives. This, for better or worse, is how the modern international investment regime was created, one deal at a time.

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[37] Sovereign wealth fund investors may, however, be understandably reluctant to submit disputes to such arbitral panels without assurances that the panels would confer jurisdiction. By way of example, Temasek Holdings, the sovereign wealth arm of Singapore, apparently chose not to submit a dispute with Indonesia over telecom investments to an international investment dispute process despite (a) the existence of a bilateral investment treaty between the two states and (b) the implication in the new ASEAN Comprehensive Investment Agreement that sovereign wealth fund investors should be treated similarly to private foreign investors for BIT purposes. *See, e.g.*, "Indonesia fines Temasek $1.7 Million," MarketWatch (January 18, 2011), available online at http://www.marketwatch.com/story/indonesia-fines-temasek-17-million-2011-01-18 (reporting on the result of Temasek's submission of claims to an Indonesian domestic court); *see also*, Sornarajah, *supra* note 10, at 10 n.26.