PATTERNS OF INTERNATIONAL FINANCIAL REGULATION:
A CASE STUDY OF SOVEREIGN WEALTH FUNDS

by

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Abstract

Sovereign Wealth Funds (SWFs) have been under severe scrutiny and the object of enormous criticism during the past years. These government-owned investment vehicles have created, and will continue to create, a significant debate about whether they can operate within the established International Financial Markets (IFM). Indeed, their relevance to the current economic, political and financial landscape cannot be overstated, as they challenge received notions of practice and governance embodied in the IFM regulatory framework. In this thesis, I suggest a different approach to how SWFs phenomenon is dealt with. In contrast with other authors, my analysis and prescriptions go beyond trying to reshape SWFs' governance mechanisms or management; it takes into consideration patterns of international financial regulation and assesses the deep roots of IFM regulatory framework and operational rationale in order to provide answers to the SWFs problem. The endeavor questions the premises from which international financial regulation derives by considering the rational choice theory of compliance and regulatory models based on self-interest as models to prescribe normative action. The contribution of this thesis is to provide a new regulatory approach towards SWFs.

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List of abbreviations

BCBS	Basel committee on banking supervision
CFIUS	Committee on foreign investment in the united states
CGFS	Committee on the global financial system
CPSS	Committee on payment and settlement systems
FSIA	Foreign sovereign immunities act
GAPP	General accepted principles and practices
IASB	International accounting standards board
IASI	International association of insurance supervisors
IFM	International financial markets
IOSCO	International organization of securities commissions
IWG	International working group of SWFs
ISDA	International swaps and derivatives association
RCT	Rational choice theory
SWF	Sovereign wealth fund

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To my mom,

Chapter 1: Introduction

A new and important phenomenon in the international financial market (IFM) is the rise of Sovereign Wealth Funds (SWFs). These government-owned investment vehicles have created, and will continue to fuel, a significant debate between politicians, lawyers, and professors about whether they can operate within the established IFM.

SWFs have existed for decades, but today they face heightened scrutiny due to their recent rapid growth and concomitant shift in their investment strategy from primarily conservative debt instruments to higher risk/reward equity investments[1]. Whereas central banks have traditionally invested their foreign exchange reserve in financial assets, principally U. S. treasuries, SWFs seek more diversified investments (shares, bonds, derivatives etc) that could potentially be of political or strategic interest. The 2007 IMF Global Stability Report[2] indicates the existence of 40 SFWs that together manage assets in the range of about US$ 2-3 trillion and, although

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1 *See* Richard Epstein & Rose Amanda, "The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow," (2009) 76:1 *U.Chi.L.Rev.* 111.

2 *See* World Economic and Financial Surveys, "Global Financial Stability Report - Market Developments and Issues" *International Monetary Fund* (13 May 2011), online: International Monetary Fund <http://www.imf.org/external/pubs/ft/gfsr/2007/01/pdf/text.pdf>.

SWFs represent only a small part of total global financial assets ($ 190 trillion), in the coming years these numbers are likely to grow sharply[3].

Historically, the vast accumulation of capital experienced by the Middle East countries during the 70's, Japan in the 80's, China and most recently other developing countries, combined with the fall of interest rates, led to a global phenomenon whereby sovereign states – seeking profitable means to enhance financial reserves – started to take higher risks[4] and invest its reserves in the Capital Market[5]. This situation favored the appearance of SWFs.

As SWFs become a more significant player within IFM, concerns associated with these funds' motivation (rationality) seem to represent the point of stress among regulators and market participants. It is not clear yet whether SWFs' investment initiatives, structure and nature are compatible with IFM's organizational and operational rationale; a more realistic understanding of the IFM is imperative to answer such question. The

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3 *See* "IMF Intensifies Work on Sovereign Wealth Funds" *International Monetary Fund* (27 November 2009), online: *International Monetary Fund* <http://www.imf.org/external/pubs/ft/survey/so/2008/POL03408A.htm>.

4 *See* "Sovereign Wealth Funds: Super-Sized Investment Vehicles Accelerate Purchase" *Financial Times* (27 November 2009), online: Financial Times <http://www.ft.com/cms/s/0/913d5aa4-c28f-11de-be3a-00144feab49a,s01=1.html?nclick_check=1>; and "Sovereign Wealth Funds Return to the Fray" *Financial Times* (12 December 2009), online: Financial Times <http://www.ft.com/cms/s/0/06aa7db4-7f8b-11de-85dc-00144feabdc0.html>.

5 *See* Paul Krugman, "A Model of Balance of Payments Crises," (1979) 11:3 *J.M.C.B.* 311.

current thesis addresses such concerns and provides answers to such questions. I have concluded that the current IFM regulatory framework and operational rationale are not able to provide safety to the global community and eliminate concerns raised due to SWF investment activities within IFM.

The following section will briefly provide an overview of the central problem related to SWFs as well as a brief definition for SWFs.

1.1 Definition of the fund and central problem

Andrew Rozanov first coined the term 'sovereign wealth fund'[6] in 2005 by defining it as

> *"neither traditional public pension funds nor reserve asset supporting currencies, but a different type of entity altogether."*[7]

SWFs differ in size, age, structure, funding sources, governance, policy objectives, risk/return profiles, investment horizon, eligible asset

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6 *See* Andrew Rozamov, "Who Holds the Wealth of Nations?" (2005) 15:4 *I.J.C.B.* 152.

7 *See* Andrew Rozamov, "The Sovereign Wealth Fund Debate" *State Street Global Advisors* (27 November 2009), online: State Street Global Advisors <http://www.ssga.com/library/esps/The_SWF_Debate_Andrew_Rozanof_1.8.08CCRI1200431495.pdf >.

classes and instruments, not to mention levels of transparency and accessibility.[8]

The US Treasury, for instance, observes that SWFs are:

> "government investment funds, funded by foreign currency reserves but managed separately from official currency reserves. Basically, they are pools of money governments invest for profit." [9]

Bortolotti, Fotak, Megginson and Miracky understand that:

> SWFs are also stand-alone, unregulated pools of capital, managed by investment professionals, and often take large stakes in publicly traded companies. [10]

Although both definitions might seem right at first sight, Scholar Ashby H. B. Monk provides a more complete definition[11], which can be used

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8 For further debate *see* Jen Stephen, "The Definition of Sovereign Wealth Funds" *Morgan Stanley* (03 December 2009), online: Morgan Stanley <http://www.morganstanley.com/views/gef/archive/2007/20071026-Fri.html>.

9 *See* Lawrence Summers, "Funds that Shake Capitalist Logic" *Financial Times* (07 December 2009), online: Financial Times <http://www.ft.com/cms/s/2/bb8f50b8-3dcc-11dc-8f6a-0000779fd2ac.html#axzz1SxTmYuIf>.

10 *See* Bernardo Bortolotti et al., "Sovereign Wealth Fund Investment Patterns and Performance" *Fondazione Eni Enrico Mattei* (13 February 2010), online: Fondazione Eni Enrico Mattei <http://admin.darden.virginia.edu/emUpload/uploaded2009/SWF-invest-patterns-perform-nov288.pdf> at 15.

11 "SWFs are government-owned and controlled (directly or indirectly) investment funds that have no outside beneficiaries or liabilities (beyond the government or the citizenry in abstract) and that invest their assets, either in the short or long term, according to the interests and objectives of the sovereign sponsor" *in* Ashby Monk, "Recasting the Sovereign Wealth Fund Debate Trust Legitimacy and Governance" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862>.

as a platform to derive a workable theoretical prototype. His definition encompasses three commonalities related to ownership, liability and beneficiaries.

- ***Ownership*** - Concerning the first, governments, both central and sub-national, own and, to varying degrees, control SWFs. Control can be exerted either directly or indirectly through the appointment of the SWF board.
- ***Liabilities*** **-** SWFs have no direct liabilities. In short, SWF liabilities, if they have any, are part of the broader national balance sheet.
- ***Beneficiaries -*** despite certain explicit goals, SWFs are managed according to the interest and objectives of the government sovereign. The ultimate beneficiary of a SWF is not a specific individual, but either the government itself, the country's citizenry in abstract, the taxpayer generally or is simply left unidentified.

These three characteristics suggest the following definition:

> SWFs are government-owned and controlled (directly and indirectly) investment funds that have no outside beneficiaries or liabilities (beyond the government or the citizenry in abstract) and that invest their assets, either in the short or long term, according to the interests and objectives of the sovereign sponsor.[12]

12 Ibid at 7.

This definition underscores the vulnerability of SWFs to political influence (which seems to be the main problem for SWFs' investment recipient countries) because assets are a) owned by the government; b) owed back to the government, instead of an outside beneficiary; c) unconstrained by non-governmental property rights or fiduciary duty to any individual beneficiary; and d) invested in accordance with the government interests.

Having a definition of SWF, we can now move forward with a roadmap to the rest of the thesis by outlining the topics covered in each part and giving a very brief description of how they are dealt with in each part. In this section I will try to link the description with the descriptions of the issues in previous parts and provide a logical connection to the issues to be dealt with in the next part of the thesis.

1.2 Roadmap of the thesis

The aim of this thesis is to address the international legal framework for SWFs and verify if such investment vehicles are able to freely operate within the current IFM operational rationale without raising any concerns from the global financial community.

The hypothesis from which I derive my arguments to answer this question is based on the major assumption that, due to the current IFM regulatory framework and operational rational, SWFs cannot be treated as ordinary participants in the IMF, because they might have other motivations or investment orientations besides maximizing their wealth.

In order to prove my argument, I have divided the thesis into six major Chapters. Each Chapter approaches the issue from a different perspective. Chapter II informs the methodology of the thesis by setting up the premises from which answers to the proposed hypothesis are developed. This Chapter is extremely important to the thesis as it provides my understanding about the IFM, market participants' expected behavior and IFM operational rationale. After defining such premises, Chapter III presents a different approach to international financial regulatory design and compliance. The endeavor of this Chapter is to analyze regulatory design and compliance from a different perspective; assessing the rationale behind regulatory design and motivation for compliance will further help the reader's understanding about the regulatory proposals presented later in this thesis. Chapter IV will finally deal with issues and concerns associated with SWFs' performance within IFM; as well as examine the concept of trust in relation to how SWFs, market participants and regulators interact. Afterward, Chapter V will then move forward to inform and analyze the international regulatory actions taken to reduce such issues and concerns. Chapter VI will analyze how the issue has been dealt by United States and how regulators have currently addressed the issues related SWFs' performance within the American market. Later in this Chapter I will finally provide regulatory prescriptions to the issues and concerns presented hereto. At last, I will conclude that the current IFM regulatory framework and operational rationale are not able reduce concerns raised so far against SWF. Indeed, in order to address all issues related to SWFs performance within IFM, regulators and market participants need to start looking at these investments vehicles from a different perspective, one that effectively takes into consideration all peculiarities of IFM and SWF.

Chapter 2: Methodology

2.1 General introduction – assimilating theories

Assessing whether Sovereign Wealth Funds are able to normally and freely operate within international financial markets without raising any concerns from market participants is a question not yet answered. Many issues relate to this topic, which is of complex dimension. Hence, providing an answer for these "potential issues" requires an approach that considers different fields of social sciences, such as sociology, anthropology, economics and so on.

Sovereign wealth funds are different from other market participants. The scrutiny around the problem is at the core of the regulatory debate, but unfortunately that debate has not yet taken into account the reality of international markets. By reality – and I do not wish to leave my area of expertise – I mean the practical operation of international regulation and compliance with and effectiveness[13] of legal rules.

A good understanding of how regulation is designed and how market participants operate within international financial markets are key issues

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13 "The difference between effectiveness and efficiency is that effectiveness is the extent to which the outcomes of an activity achieve the stated objectives, while efficiency is the extent to which the use of inputs is minimized for a given level of outputs. In short, efficiency is doing things right and effectiveness is doing the right things" *in* Commonwealth of Australia, "Literature Review: Measuring Compliance Effectiveness" *Australian Taxation Office* (13 February 2010), online: Australian Taxation Office <http://www.ato.gov.au/corporate/content.aspx?menuid=39508&doc=/content/00105122.htm&page=1&H1>.

that I have to deal with in order to develop answers to my hypothesis. Two fields of social science, in particular, provide instruments to achieve my goals: economics and sociology.

If the concerns raised so far (by legal scholars, politicians, citizens, so on) are related to whether investments by sovereign wealth funds might be of political or strategic interest[14], then defining ideal managerial behavior boundaries for market participants within the context of international financial markets is essential, as it will help me to investigate whether sovereign funds could theoretically affect market motivation.

In this regard I assume market participants will always operate as profit maximizers. I adopt this behavioral assumption due to the necessity of defining the scope of the managerial function of SWF in comparison to other market participants. The main point is, and I do not intend to extend myself into theory, to determine an ideal behavioral assumption – in reference to rationality - to all market participants; one that will allow the construction of arguments based on an "expected" behavior[15] for regular market participants and assess whether sovereign wealth funds match this

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14 *See* Suad Cehajic, "Sovereign Wealth Funds: Contingent Risks and a Laissez-Faire Approach Complemented with a 'just in Case' Reactive Regulatory Framework" *Social Science Research Network* (27 December 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1494291>.

15 "Transaction cost economics characterizes human nature as we know it by reference to bounded rationality and opportunism" *in* Williamson, Oliver E., *Economic Institutions of Capitalism*, 1st ed. (London: The Free Press, 1985) at 18.

expected behavior. Focusing the theoretical debate on my hypothesis is one of my major concerns and I do not intend to discuss whether other forms of rationality would also serve as workable behavioral assumptions. If behavior is taken into consideration (in this context), I would argue that prediction (of behavior) enhances regulatory design and consequently increases regulatory compliance. This former aspect is intrinsically related to regulatory effectiveness.

Aside from managerial behavior, regulatory design and patterns of international legal compliance are fundamental elements of my thesis. From the analysis of these two elements I expect to provide prescriptions and verify whether current regulatory proposals/actions regarding sovereign wealth funds are actually effective.

This methodology section aims to provide a method and combine each theory I am using in my thesis. I have divided the theories into three theoretical clusters: a) economic models and behavior; b) international financial markets – design and framework; and c) regulatory design and compliance. The idea is to provide a more intelligible explanation of my thoughts.

The first theoretical cluster will justify my theoretical choice for a predefined market participant expected behavior. The objective is to posit the reasons behind choosing wealth maximization and bounded rationality as theoretical premises to support the analysis about whether or not SWFs performance within the market influence market motivation. There is a great importance behind such justification, once IFM operational rationale is structured over economic neoclassical principles.

In addition, the second cluster provides my understanding about IFM's design and framework. Assessing how these regulatory structures emerge from sovereign States will justify the assumption that market participants, while pursuing cross-border investment activity, shop for the best return among various jurisdictions, which I have called function jurisdictions.

The third and last theoretical cluster brings into focus the rationale which orients these functional jurisdictions and provides a theoretical explanation about market participant’s compliance.

2.2 Scope of research

The scope of my research is limited to investment operations within the US Market. According to the Sovereign Wealth Funds Institute[16], the United States is the most targeted country (for sovereign wealth fund investment) and, due to the repercussions of regulatory debate, seems to be one of the major proponents for regulatory action.

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16 *See* "Sovereign Wealth Fund Transaction Database" *Sovereign Wealth Fund Institute* (19 December 2009), online: Sovereign Wealth Fund Institute <http://www.swfinstitute.org/products-services/swf-transactions/>.

In addition, time and thesis size constraints would not allow me to assess other markets and perform a deeper analysis. I acknowledge my approach is mostly international, but not considering other jurisdictions will not affect my theoretical analysis, which is the part I am more interested in.

2.3 The market - definition

Bryant defines Financial Markets as being:

> "the entire complex process through which the myriad independent decisions of individual […] savers and individual […] investors are reconciled." [17]

Through this inter mediation, surplus resources – that is, resources which are not consumed – can be transferred from savers to borrowers[18]. In addition to this definition, Financial Markets can also be seen as a system of risk transfer between protection buyers and risk takers. Ott[19] described the process as the creation of a form of corporate governance and industrial organization enabling firms to enhance their competitive position by creating cross-border corporate networks (or financial networks).

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17 *See* C. Ralph Bryant, "International Financial Intermediation," (1988) 24:2 *J. Int'l Econ. L* 187 at 192.

18 *See* Solomon, Robert, *The International Monetary System, 1945-1981*, 1d ed. (New York: Harper & Row, 1982); and Oatley, Thomas, *International Political Economy*, 1st ed. (New York: Pearson-Longman, 2008).

19 *See* Ott, F. Attiat, *The Public Sector in the Global Economy: From the Driver`s Seat to the Back Seat*, 1st ed. (Northampton: Edgar Elgar Publishing, 2002).

As a result, IFM can be roughly defined as a variety of independent, connected and interdependent social networks whose primary objective is to transfer resources and credit risk among different participants internationally (sellers/buyers or protection buyers/risk takers).

2.4 Model and behavior

2.4.1 Defining rationality and participant's goals

Friedman, in a brilliant essay published in 1953, raised the question about whether economics would ever use models of analysis based on the real world. He asserted that "there are an infinite number of theoretical worlds; there are only a few real worlds". He also critiqued the oversimplification of economic models:

> The attempt to construct a system of models leads the theorist to make each a formal entity. And this, in turn, leads him to consider an enormously oversimplified universe and to make classifications within that universe that have no direct empirical counterpart. The complexity of the approach, the limited range of factors it can comprehend, and the urge to have the results bear on pressing current problems are likely to, though they need not, lead him into positive error. [20]

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20 *See* Friedman, Milton, *Essays in Positive Economics*, 1st ed. (Chicago: Univ. Chicago Press, 1953) in Williamson, Oliver E., *Economic Institutions of Capitalism*, 1st ed. (London: The Free Press, 1985) *supra* note 15 at 43.

Friedman's statement has great importance and influence over the development of legal and economic scholarship. There is no doubt that the idea of "realism" has substantial impact over regulatory systems. Though I acknowledge that a theory which considers an enormously oversimplified universe and a limited range of factors may lead to positive error, for legal purposes, in order to capture a behavior or a "fact" and frame it into a legal rule or a system of rules, there must be a set of premises which the law will rely on or will be influenced by. In such context, behavioral economic analysis and economics are not an exception.

Various models[21], from which economists try to analyze human behavior and predict economic outcomes, are available, but positing which one would offer a better understanding of the "real world" is a hard to task to accomplish. Due to the great level of uncertainty, over generalization and narrow applications of behavioral economics or economic analysis, mainly with regards to economic efficiency, I will not deal with such concepts in my thesis[22]. What I am interested in, nevertheless, is the adoption of a general

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21 The most famous and common one is the one developed by Vilfredo Pareto, denominated Pareto Efficiency, which states that in a given initial allocation of goods among a set of individuals, a change to a different allocation that makes at least one individual better off without making any other individual worse off is Pareto Improvement and consequently leads to a situation of Pareto Efficiency. From this point, several theories related to economic efficiency have been developed; the most significant ones were: Kaldor-Hicks Efficiency, Allocative efficiency, Distributional efficiency and X-Efficiency.

22 I do not intend to analyze forms of efficiency such as: Pareto Efficiency, Kaldor-Hicks Efficiency, Allocative efficiency, Distributional efficiency and X-Efficiency.

rational behavioral pattern, which would, in theory, induce market motivation.

Still, there is a difference between assuming that – if you want to promote utility or wealth then these are the rules you should adopt – and saying – because these rules would promote utility or wealth in the abstract we should adopt them[23].

I definitely adopt the former assumption, a more tautological approach to theory, one which allows me to verify my hypothesis, by understanding the framework of the market and gathering some commonalities among market participants. Although I believe understanding of man's actions requires more self-conscious attention to the study of how the minds of men work[24], such enterprise is completely out of the scope of my thesis.

Behavioral assumptions are a matter of convenience[25]. The realism of such assumptions is unimportant and the fruitfulness of a theory turns on its implications[26].

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23 *See* Jules L. Coleman, "Efficiency, Utility, and Wealth Maximization," (1976) 8:1 *Hosfra L. Rev.* 509.

24 *See* Bridgeman, Percy, *Reflections of a Physicist*, 2nd ed. (New York: Oxford University Press, 1986) in Williamson, Oliver E., *Economic Institutions of Capitalism*, 1st ed. (London: The Free Press, 1985) *supra* note 15 at 45.

25 Ibid.

My aim is not to quantitatively/qualitatively analyze a specific sector of the market, but purely to realize a normative study[27] about whether Sovereign wealth funds could normally operate within the market without raising any concerns from participants and recipient countries. I will take in consideration two assumptions regarding market participants: Firstly, market participants are wealth maximizers and secondly, they have limited rationality.

2.4.2 Wealth maximization

I shall state *ab initio* that a well-motivated financial market can only operate if market participants within the market have, as their main goal, the ambition to increase their wealth or profit. At this particular point, I adopt Posner's wealth maximization theory as a measure for the state of affair of market participants:

> The value in dollars or dollar equivalent […] of everything in society. It is measured by what people are willing to pay for something or, if they already own it, what they demand in money to give it up. The only kind of preference that counts in a system

26 Ibid.

27 Normative law and economics goes one step further and makes policy recommendations based on the economic consequences of various policies. The idea is to first develop a normative conception and then applying that normative conception to the law. For further debate see Parisi, Francesco, "Positive, Normative and Functional Schools in Law and Economics," (2004) 18:1 *Eur Jnl Law & Econ* 259.

> of wealth maximization is thus one that is backed up by money. [28]

My hypothesis is based on the premise that financial markets participants seek to maximize their goals, which is in turn their wealth. I do not presume financial markets are efficient only if market participants are totally rational. I also do not wish to discuss if, within transactions, Pareto or even Kaldor-Hicks efficiency is achieved. My assumption is therefore not related to efficiency, but to motivation and functionality of financial markets.

I also have no desire to use neoclassical economic models to discuss or posit whether international financial markets are efficient at all (under neoclassical terms). As a matter of fact, at least in theory, market participants are "intendly" rational, but limited by external bounds[29]. Considering *intention* is completely different from *certainty*; as suggested by Jones, within financial markets, "intendly rational actors might deviate from fully rational actors", but the deviation is "attenuated in well-functioning institutions"[30]. I take this assumption for granted.

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28 *See* Richard A. Posner, "Utilitarianism, Economics, and Legal Theory," (1979) 8:1 *JLS* 103.

29 As it will demonstrated in the next section, market participants are actually rational, but bounded by external factors that limit their cognitive actions. Roughly, this concept is known as "bounded rationality".

30 *See* Bryan D. Jones, "Bounded Rationality," (1999) 2:1 *Annu Rev Polit Sci* 297.

This premise is based on the fact that participants` rationality is goal-oriented (to maximize wealth), but it is bounded to external limitations such as lack of information. However, in a well-regulated (functioning) financial market such deviation is absorbed. I will return to this point in the following section.

The point I want to make by adopting wealth maximization as a measure of "state of affairs" is: Pareto standards rank social-states; they do not provide the characteristic in virtue of which one state may be compared with another[31]. In the other hand, wealth and utility maximization are express characteristics which allow them to be compared under Pareto standards. In this regard, I do not consider Pareto criteria to be a utilitarian model, as Posner does[32], nor wealth maximization as a replacement. Wealth maximization is not criterion for efficiency. Let me explain:

The Pareto criterion establishes that further allocation of resources are Pareto-optimal only and only if at least one person is better off and no other person is worse off[33]. Under this criterion, which serves as a measure for efficiency, participants are fully rational and tend to maximize their

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31 *See* Jules L. Coleman, "Efficiency, Utility, and Wealth Maximization," (1976) 8:1 *Hosfra L. Rev.* 509 *supra* note 23 at 523.

32 *See* Richard A. Posner, "Utilitarianism, Economics, and Legal Theory," (1979) 8:1 *JLS* 103 *supra* note 28 at 104.

33 *See* Clement, Allan & Tisdell, Keith Hartley, *Microeconomic Policy: A New Perspective*, 1st ed. (London: Edward Elgar Publishing, 2008) at 22.

utility in the process of exchange. The difference between these criterions of efficiency and wealth maximization is that, instead of maximizing utility or welfare, in the latter participants maximizes their wealth (which works as a measure). The point to note is that utilities have no measure, whereas Posner's theory offers one, which is that of money value.

In sum, I do not intend to claim that efficient financial markets should match any given Pareto criteria in order to be efficient; I make no claim towards efficiency. The system of wealth maximization is not an alternative efficiency criterion. It is not a means of ranking social states, but is instead a characteristic of social states that enable them to be ranked by both the Pareto and Kaldor-Hicks criteria[34].

Thus, wealth maximization offers a measure. Instead of positing financial market participants aim to maximize their utilities (which involves many variables), by using wealth maximization theory I am able to say that in a well-motivated and functioning financial market every participant seeks profit *vis a vis* wealth.

I acknowledge wealth maximization might have its drawbacks. Although initial entitlements cannot be assigned[35] and right conduct where

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34 *See* Jules L. Coleman, "Efficiency, Utility, and Wealth Maximization," (1976) 8:1 *Hosfra L. Rev.* 509 *supra* note 23 at 518.

35 "The problem of relying on prices arises again when we reach the question whether one could employ wealth maximization to assign basic entitlements. Wealth maximation requires a fixed set of relative prices. The

price does not exist is not taken in consideration, in the context of capital markets, the theory seems to give a powerful contribution[36].

2.4.3 Rationality and decision-making

I have previously stated that I would not make any economic efficiency claims. In fact, I have only used the Pareto criterion to demonstrate that wealth maximization theory works as a "state of affairs" measure and not as a substitute for efficiency.

At the outset of neoclassical theories, I must define what I consider efficient. A financial market is efficient whenever it allows investors to earn above-average returns without accepting above-average risks[37]. Markets are amazingly successful devices for reflecting new information rapidly and, for the most part, accurately. Even though the "efficient market hypothesis" is

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prices of goods depend, among other things, on the relative demand for them. The demand for goods depends in turn on the distribution of wealth. And the distribution of wealth is of course a function of what individuals are entitled to. Therefore the system of wealth maximization must presuppose a set of initial entitlements in order to get started; and these initial entitlements cannot by hypothesis, be accounted for on wealth-maximizing grounds. The system of wealth maximization therefore cannot provide a basis for an initial assignment of entitlements" *in* Ibid at 524.

36 These two major criticisms over Posner`s wealth maximization theory seem not to have much impact over the context of this thesis; therefore it would not be productive to deeply analyze these drawbacks for the purposes of the current debate. Although I do not wish to extend myself into the subject, I consider wealth maximization as a measure and I am not really concerned about the assignment of initial entitlements, neither whether certain things cannot be priced (I assume that stocks or commodities can be easily priced).

37 *See* Burton G. Malkiel, "The Efficient Market Hypothesis and its Critics," (2003) 17:1 *J. Econ. Perspect* 59 at 64.

questionable, its tautological predictions incorporate the rationale for regulatory design.

Malkiel makes a very good point in relation to the theory:

> […] I suspect that the end result will not be an abandonment of the belief of many in the profession that the stock market is remarkably efficient in its utilization of information. Periods such as 1999 where "bubbles" seem to have existed, at least in certain sectors of the market, are fortunately the exception rather than the rule. [38]

I am aware that fully rational actors, symmetric information and full evaluation of securities are myths. Perhaps the "efficient market hypothesis" will never hold, but the rationale for regulation, within financial markets, is still linked to the "efficient market hypotheses" premises. Regulators tend to desire greater disclosure and capital requirements[39]

Nevertheless, despite limitations on information and unintended irrationality (limited), every participant within the market has one objective, which is to maximize its wealth. Market participants are rational if they tend to act somehow optimally in pursuit of their goals. My assumption is based

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38 *See* Burton G. Malkiel, "The Efficient Market Hyphotesis and its Critics," (2003) 17:1 *J. Econ. Perspect* 59 *supra* note 37 at 94.

39 *See* "Compendium of Standards" *Financial Stability Board* (05 February 2010), online: Financial Stability Board <http://www.financialstabilityboard.org/cos/index.htm>.

on the institutional school of economics, which has Oliver E. Williamson as its main proponents:

> Transaction costs economics acknowledges that rationality is bounded and maintains that both parts of the definition should be respected. An economizing orientation is elicited by the intended rationality part of the definition, while the study of institutions is encouraged by conceding that cognitive competence is limited.[40]

As we can see, the definition of rationality is divided into two parts. The first concerns decision process (the economizing orientation) and the second involves governance structures (cognitive competence). Although I firmly believe the second form is of major importance within the context of understanding the "contractual man", due to the scope of my research and in order to remain within my own area of competence, I will not attempt to analyze cognitive competence. The economizing orientation is what interests me the most.

My behavioral assumption is: market participants making decisions, within financial markets, are intendly rational; goal oriented, and intend to pursue those goals rationally[41]. By defining participants as being intendly rational I acknowledge the reasoning process of making an investment

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40 *See* Williamson, Oliver E., *Economic Institutions of Capitalism*, 1st ed. (London: The Free Press, 1985) *supra* note 15 at 45.

41 Ibid.

decision might be limited by incomplete information and consequentially a certain degree of uncertainty, excluding any kind of emotion or contagion. The goal orientation will always be to maximize wealth. Let me use the case of investment funds as an example:

Usually investment funds consist of pools of assets managed by financial specialists in accordance with a fund's prospectus. In this case, management will always try to maximize profit, attending as far as possible to the limits imposed by the prospectus – which sets the investment policy of the fund – and to potential lack of information. This is a clear example of a player who intends to maximize profit, but it is bounded by external limitations.

As proposed by Jones, any irrational deviation will be absorbed by well-functioning institutions[42]. The rational reasoning must always be related to a process from which market participants tend to maximize wealth. In this regard, I am certain that the behavior of organizations mimics the bounded rationality of the actors that inhabit them[43] and being goal-oriented to maximize wealth is essential to this process.

The question about whether sovereign wealth funds could normally operate within the financial markets depends on their objectives, external

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42 *See* Bryan D. Jones, "Bounded Rationality," (1999) 2:1 *Annu Rev Polit Sci* 297 *supra* note 30 at 313.

43 Ibid.

influence/limitations and transparency; in other words, the investment policy of a SWF is intrinsically related to its own rationality; providing the premises to identify IFM's expected behavior rationale (or expected motivation) as to verify potential SWFs' irrationality is the major point of this section.

Therefore, now that I have set a model for motivation and the decision making process of market participants, the following chapter will show how the design and framework of IFM is built around the motivation and decision process I have just outlined.

2.5 International financial markets – design and framework

2.5.1 Identifying transnational assemblages

As globalization started to reshape the conventional structure of local financial markets, the scope for public sector regulation narrowed substantially. Sovereign States, due to their inability to cooperate internationally[44], continue to differ radically in their most relevant legal

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44 Due to this inability to cooperate most of the regulatory regime established at the international level of Financial Law was based on the arm's length regulatory project which endorses the premise that the proper role for the state is to assist the market to regulate itself. Under this model, a new system emerged; a system where jurisdiction and territory is broken, and, as new forms of international organizations and authority arise, it is replaced by “functional jurisdictions”.

rules[45], including in particular the laws of property and insolvency. Legal scholar Kanishka Jayasuriva remarked that:

> “Sovereignty can no longer be adequately understood as the exclusive property of a unitary state. Because global markets extend beyond the territories of any single state, global market regulation is more than a matter of agreements between sovereign states”.[46]

This view perfectly describes the current international regulatory system, which basically stems from the roots of neo-liberalism and has self-regulation[47] as its main rationale. Global markets are, therefore, integrated to a higher economic sphere; one which transcends territorial barriers or jurisdictions: a global economy.

Robert Cox[48] defines global economy – of which international financial markets are a part – as a “system generated by globalizing production and global finance”. The definition puts forth two major points. First, the

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45 In relation to local Contract Law.

46 *See* Kanishka Jayasuriya, "The Rule of Law in the Era of Globalization: Globalization, Law and the Transformation of Sovereignty: The Emergence of Global Regulatory " (1999) 2:2 *Ind.J.Global Legal Studies* 425.

47 *See* Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation," (1998) 107:5 *Yale L. J.* 2359; Erik J. Pan, "Single Stock Futures and Cross-Border Access for US Investors," (2008) 14:1 *Stan. J.L. Bus. & Fin.* 3; Robert A. Prentice, "Regulatory Competition in Securities Law: A Dream (that should be) Deferred," (2006) 66:1 *Ohio St. L.J.* 2.

48 *See* Cox, Robert W., "Global Restructuring: Making Sense of the Changing International Political Economy," in *Political Economy and the Changing Global Order*, eds. R. Stubbs and G. Underhill, 1st ed. (New York: St. Martin Press, 1994), 45-60 at 46.

international financial markets are not a universe with (or without) borders. Rather, it is a system, a socio-cultural economic structure, brought about by some event or events[49]. Second, it is a process encompassing modes of trade and finance.

These socio-cultural economic structures emerge from the inner core of the state, through a combination of individual coordinated actions, and transcend the boundaries of the state, creating globally interconnected "clubs" or "functional jurisdictions". This phenomenon encompasses the theory of "global assemblages" provided by Sassen:

> It is within these spheres that elements of physical and intellectual texture emerge that coalesce to produce border-crossing "global assemblages". These constitute distinct spheres that, famously fueled by the dramatic development of information technology, integrate territorial and de-territorial vertical and horizontal ordering patterns to produce a structured regime of societal activities. [50]

Sassen's depiction of globalization points back to the nation state and sub-national spheres of societal activity and decision-making. The balanced interaction among international societal forces – organized in interest groups, political parties or other voluntary associations – and the dispersion

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49 *See* Ott, F. Attiat, *The Public Sector in the Global Economy: From the Driver`s Seat to the Back Seat*, 1st ed. (Northampton: Edgar Elgar Publishing, 2002) *supra* note 19 at 8.

50 *See* Sassen, Saskia, *Territory, Authority, Rights. From Medieval to Global Assemblages*, 1st ed. (Oxford: Princeton University Press, 2006) at 196.

of power among a variety of social actors as the core elements of democratic governance[51] or "horizontal governance"[52] represents the core of these "clubs" or "global assemblages".

As examples of these clubs, at the national level, we have stock exchanges and aggregated self-regulatory organizations. At the international level, the International Organization of Securities Commissions (IOSCO); the Basel Committee on Banking Supervision (BCBS); the Committee on the Global Financial System (CGFS); the Committee on Payment and Settlement Systems (CPSS); the International Association of Insurance Supervisors (IAIS); the International Accounting Standards Board (IASB); the International Swaps and Derivatives Association (ISDA); among other "clubs" that constitute the framework of the international financial markets.

Sassen's and Cox's concepts influence how I see the interaction between these functional jurisdictions or clubs and the State. Vertical command and control is almost absent at the international level; the

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51 *See* Cunningham, Frank, *Theories of Democracy: A Critical Introduction,* 1st ed. (New York: Routledge - Taylor & Francis Group, 2002) at 72.

52 By Horizontal Governance I refer to a process of equal and horizontal policy-making. For further debate see Rhodes, R. A. W., *Understanding Governance: Policy Networks, Governance, Reflexivity and Accountability*, 2nd ed. (Philadelphia: Open University Press, 2001).

relationship is mostly horizontal, which favors self-regulation and regulatory models such as the Arm's Length Regulatory Project[53].

Therefore, if clubs with regulatory functions are considered as autonomous legal systems, then a legal pluralist approach fits perfectly the purpose of my argument, as it rejects “the ideology of legal centralism”[54] or the positivist notion that the law necessarily is the law of the state. This concept is central in Zumbansen’s proposed methodology for transnational legal pluralism[55].

In sum, international financial markets emerge from the interaction of “global assemblages”, which are constituted of “clubs” or “functional jurisdictions”. These assemblages are interlocked[56] and emerge apart from the State's boundaries. The underlying assumption is that at the international level these varieties of legal systems mutually exist and create a spatial transnational legal pluralistic system.

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53 The arm's regulatory project endorses the premise that the proper role for the state is to assist the market to regulate itself. For further debate see Benjamin, Joanna, *Financial Law*, 1st ed. (London: Oxford Press, 2008) at 517.

54 For further debate see Griffiths, John, "What is Legal Pluralim" (1986) 24:1 *J Legal Plur.* 1.

55 *See* Zumbansen, Peer, "Transnational Legal Pluralism" (2010) 10:2 *CLPE Research Paper Series* 141.

56 *See* Clemens, Valter C., *Dynamics of International Relations: Conflict and Mutual Gain in an Era of Global Interdependence*, 1st ed. (New York: Rowman & Littlefield Pub Inc, 2004).

2.5.2 Justifying transnational legal pluralism

Globalization constitutes a challenge to the study of law because of the dramatic transformation of institutional and semantic structures in an era of intensifying transnational communication and governance regimes[57]; it challenges the idea of "sovereignty" and allows the conceptualization of the law as a phenomenon without boundaries.

Rather than describing the advent of globalization as an end-point of legal development, the transnational perspective permits the deconstruction of the law-state association and an understanding of the law (in relation to international capital markets) in a pluralistic way[58]. Zumbassen considers the field of transnational law, which has been offered to capture the hybrid regulatory system between the national and the international, as a methodological device rather than a more or less definable legal field[59]. The formation of an international plurality of legal systems, defined as "clubs" or "functional jurisdictions" that form "global assemblages" constitute what Zumbassen defined as transnational legal pluralism.

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57 *See* Zumbansen, Peer, "Transnational Legal Pluralism" (2010) 10:2 *CLPE Research Paper Series* 141 *supra* note 57 at 48.

58 Ibid.

59 Ibid at 49.

Therefore, the combination of this sociological perspective (globalization) with a legal theoretical one (legal pluralism) provides the methodological basis for the reconstruction of the conventional "legal pluralism", with the aim of developing a concept of transnational legal pluralism[60]. It is essential to see international financial markets outside the boundaries of sovereignty, to understand them as conglomerates of functional jurisdictions that transcend the territorial boundaries of the regulatory state.

This concept provides a fundamental basis for my analysis on international regulatory compliance as it gives the element of plurality (of jurisdictions) needed to (roughly) determine how market participants "shop" for more profitable regulation and why.

2.6 Regulatory design and compliance

2.6.1 The rational choice theory

International legal compliance is a central issue in International Law. Many theories have been proposed to explain and predict patterns of compliance and non-compliance among international market participants. As legal theory evolves, the variety of arguments offering explanations for

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60 Ibid at 9.

international legal compliance increases. Bradford[61] provides a series of different "general theories" to explain compliance at the international level. However, the more important ones are: (a) enforcement theory, (c) rational choice, (d) reputation theory, (e) transnational legal process, (f) legitimacy theory.

The idea in this section is not to describe or point out the drawbacks of every single theory which deals with international legal compliance; it is to provide a quick overview and justify why I have decided to use the rational choice theory to support my argument. It is also important to remember my initial behavioral assumption of wealth maximization. At this point, the element of plurality, which I have explained in the previous section, will also determine my choice of theory.

Prior to any explanation I shall warn that my arguments in this section apply only to international capital markets; aside from this scope, the theory might not hold.[62]

Self-interest is the frame of the rational choice theory (RCT). Individuals will make their choices in accordance with their self-interests.

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61 *See* William C. Bradford, "International Legal Compliance: Surveying the Field" *Social Science Research Network* (05 February 2010), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=577104>.

62 This assumption is taken for granted. I do not wish to discuss whether the arguments presented in this section would apply to different fields of law. I feel such debate would deviate from the purpose of this section.

As defined in the previous sections, the Global Financial Market is composed of a plurality of different and self-regulated social networks whereby each individual is rational and acts according to its own self-interest, which is to maximize his wealth[63].

International financial markets are composed of social networks based on trade (the “element of plurality”[64]), which demand higher levels of reciprocity and coincidence of interests, because individuals will never enter into an agreement unless they foresee profit. Compliance itself is not likely to happen if regulation does not provide incentives for compliance.

Transnational legal process and legitimacy[65] are two very important theories within the field of international relations which try to explain international legal compliance. Although I understand both theories, to a certain degree, to be a function of the other[66], their assumptions do not hold as market participants do not comply with rules because of fairness

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63 I did not intend to provide a detailed explanation about the rational choice theory of compliance, but I had to do so otherwise the discussion concerning “my reasons” for the choice would seem vague.

64 For further debate see Hilary Charlesworth, "The Unbearable Lightness of Customary International Law," (1998) 92:1 *ASIL PROC* 44.

65 For further debate: *See* Franck, Thomas M., *Fairness in International Law and Institutions,* 1st ed. (Oxford: Oxford University Press, 1997).

66 “Compliance is a function of the degree to which substance and process of a legal regime is generally perceived as fair and inclusive of all stakeholders” *in* William C. Bradford, "International Legal Compliance: Surveying the Field" *Social Science Research Network* (05 February 2010), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=577104> *supra* note 61 at 5.

reasons, admiration or because such rules derive from any sort of legitimate legal procedure[67].

RCT is the only theory that optimally deals with compliance. Aceves suggests that existing international institutional designs are insufficiently legitimate because they fail to incorporate a great many sub-national groups[68]. That is again not the case; groups or participants are not incorporated in trade schemes, they choose which “functional jurisdiction” best suits their needs (maximizes their profit) and then decide to trade or list stocks.

The reputation theory is also very popular in the field[69] and it is of major importance within scholarship associated with international financial markets. Even though I am skeptical about the theory, I must admit, to a certain degree, that reputation plays a very important role in the market, as participants usually use reputation to measure trust or transaction costs. Nevertheless, assuming that compliance will be fostered based on participants' or functional jurisdiction's reputation is utopia. Due to the

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67 *See* Benjamin Brimeyer, "Bananas, Beef, and Compliance in the World Trade Organization: The Inability of the WTO Dispute Settlement Process to Achieve Compliance from Superpower Nations" (2011) 10:1 *Minn.J.Global Trade* 133 at 140.

68 *See* William Aceves, "Critical Jurisprudence and International Legal Scholarship: A Study of Equitable Distribution," (2001) 39:1 *J. Transnat'l L. & Pol'y* 299.

69 *See* Michael A. Jones and George W. Downs, "Reputation, Compliance, and International Law," (2002) 31:1 *J. Legal Stud.* 95 at 97.

"element of plurality" I would suggest that reputation is indeed a significant theory, but participants can always "opt out" of the market if they feel their reputation might be in jeopardy. Moreover, building reputation or trust will always be the result of an initial decision, which is normally based on economic premises.

Certainly, I have not included all theories related to international legal compliance; my discussion, although at a high level of generalization, has focused on only those theories which I think represent the core of the debate within the discipline.

I must also acknowledge that the rational choice theory has its drawbacks if neoclassical premises are used to interpret the meaning of rational (rationality).[70] Indeed, one might argue that market participants are not fully rational and a world with symmetric information and no transaction costs is not likely to ever exist. In addition, maximizing utility is extremely vague term, as there is no established definition of "utility"; in other words, there is no way to measure utility and believe in the existence of such "ideal world".

No doubt such critique is valid and represents a drawback to rational choice theory application; nevertheless, what I am mostly interested in is to

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70 I refer to models based on full transparency, no transaction costs and fully rational players.

posit that the rational choice theory – as model – provides in the abstract the best answer to why market participants comply with regulation.

At the same time market participants comply with regulation because complying with regulation seems to be the most rational decision or choice to make in order to increase their profit, regulators are likely to design to regulatory systems to provide incentives so market participants feel inclined to comply[71].

That said, after defining the reasoning behind regulatory compliance, the following section will explore my theoretical choice of self-interest as an ideal model to explain regulatory design.

2.6.2 Social control – self-interest model

The starting point to access patterns for international regulatory design is that given by Hurd[72] in his comments on Weber's ideal models of Social Control: Coercion, Legitimacy and Self-Interest. Although I acknowledge that there are conceptual and empirical difficulties in separating and justifying these models, for the most part, I will treat these concepts as ideal types for regulatory design. My goal is to provide a

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71 Regulators also have normative goals such as the enhancement of effective capital markets` which influence design choices. However, in addition to creating effective capital markets`, I suggest regulators tend to create a variety of options within their own regulatory system so market participants have options to conduct their businesses; the market participant`s choice for such option will be driven by profit maximization.

72 *See* Ian Hurd, "Legitimacy and Authority in International Politics," (2002) 53:2 *CJO* 379.

theoretical foundation from which to define how regulation is designed specifically to create incentives for compliance.

Coercion, self-interest, and legitimacy constitute Weberian ideal types for modes of social control, and each generates compliance with society's rules by a different mechanisms[73]. At the international level, adopting a Weberian self-interest model for social control, I will demonstrate that financial regulation is usually designed to provide incentives so parties feel inclined to comply with regulation.

In this section, I am not interested in why parties always calculate or review transaction costs of compliance in order to determine whether it is worth complying or adopting a different investment strategy; in other words, I do not wish to analyze motivation or behavior of market participants. My aim is to demonstrate that financial regulation cannot be seen as a burden for investors.

In this regard my assumption is that regulation can be designed in a variety of ways to force compliance. In the case of coercion, mechanisms of enforcement will always drive compliance; as per legitimacy[74], democratic

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73 Although each can be analytically separated from the others, in practice they are rarely found in pure isolation.

74 "The property of a rule or rule-making institution which itself exert a pull toward compliance on those addressed normatively because those addressed believe that the rule or institution has come into being and operates in accordance with generally accepted principles or right process" *in* Beetham, David, *The Legitimation of Power*, 1st ed. (New York: Macmillan, 1991) at 24.

legislative process and inclusiveness seem to be the best form to legitimize regulation. What I am positing is: international behavioral regularities, at least within the international financial markets, result from compliance with norms that provide streams of benefits (economic) and not because everyone feels legally obliged or coerced to follow.

In the other hand, self-interest involves a certain type of self-restraint on the part of an actor. This restraint is generated by the net of incentives and disincentives created by the law[75]. In the international financial markets, actors conceive of their situation *de novo* at each decision point and seek to create a maximally beneficial arrangement. Every transaction is a different one and being part of a "functional jurisdiction" depends on the array of benefits offered by the market.

Therefore, among the various models of social control, I suggest that self-interest offers a better explanation for regulatory design, as legitimacy and coercion appear to be weak models for regulatory compliance in the context of international financial markets, because of two main characteristics of the market:

- no-one will be willing to obey rules that reduce profit; therefore any loyalty by actors toward the system or its rules is contingent on the

75 *See* Ian Hurd, "Legitimacy and Authority in International Politics," (2002) 53:2 *CJO* 379 at 386.

system providing a positive stream of benefits. Actors are constantly recalculating the expected payoff from remaining in the system and stand ready to abandon it immediately should some alternative promise greater utility;

- the market is composed of many networks, allowing investors to shop for higher returns.

2.6.3 Conclusion

Given my assumptions, I expect to derive an ideal pattern of behavior which would, in theory, guarantee motivation and stability of capital markets. I use a variety of theories to explain how international markets emerge. From Sassen's global assemblages theory and Cox's theory of "clubs" to Zumbansen's methodology, I construct the methodological idea of transnational legal pluralism, which consists of autonomous forms of regulatory systems that emerge apart from the state's sovereignty and are globally interlocked, as suggested by Clemens.

Within international financial markets, participants will only comply with regulation as far as such suits their self-interest (rational choice theory of compliance) and usually international regulation is designed to foster and provide incentives for compliance (Hurd's understanding of Weber's theory).

This plurality of "functional jurisdictions" favors what I have denominated the "element of plurality", which in turn allows participants to “shop” among different jurisdictions or types of regulation at national and international level. Compliance and monitoring thus become a hard problem to solve.

It is important to emphasize that the methodology proposed in this Chapter establishes the background to discuss the hypothesis presented in this thesis. The idea behind defending the rationale, from which the theories presented in the following section are derived, is that it assists my endeavor to consolidate the main assumption that (i) IFM’s regulatory framework is designed to provide incentives for regulatory compliance; and (ii) market participants are profit-oriented and will only comply with regulation if they foresee profit. Using these two assumptions, SWFs serve as a case study to expose my concerns about how regulatory action is being carried out against SWFs and what is the regulatory path regulators should follow, considering the framework posited in this Section; these two questions affect directly the regulatory approach towards SWFs.

The following section will introduce my understating about IFM's operational rationale and provide the basis to the debate which will take place in the following Chapters.

Chapter 3: Patterns for global financial governance and regulation

This chapter has been structured to illustrate how patterns of international regulatory design might influence compliance with international financial regulation. The intention hereto is to emphasize two major points which may influence regulatory design:

- how regulation is designed as a way to create incentives for compliance, and;
- a theoretical ground to determine how financial agents behave with regard to their compliance with rules.

In addition, this section also serves to introduce the fundamental and theoretical basis of the debate which will take place in the following sections. Demonstrating the operational structure of IFM will definitely assist our endeavor to assess whether SWF represent a threat or not to IFM.

3.1 Assessing international compliance

The IFM is basically structured around the coincidence of interests between contracting parties. The interest is profit; therefore profit maximization will always influence compliance and regulatory design.

Adopting a Weberian self-interest model for social control, I will demonstrate that financial regulation is usually designed to provide incentives so parties feel inclined to comply with regulation, set by what it has been defined as “functional jurisdictions”.

On the other hand, by adopting the rational choice theory of compliance, I will show the other side of the trade, which is related to behavioral economics, whereby parties are always calculating or reviewing the transaction costs of compliance and determining whether it is worthwhile to comply or adopt a different investment strategy.

Profit maximization plays a very important role in this relationship (designing vs. complying). The cost and return of an investment, combined with the financial benefits that these investments bring to a country, is the central point in all of these transactions. On one side, market participants desire to maximize their profit, obviously because they are rationally oriented and tend to seek jurisdictions which will increase their returns. On the other side, stock exchanges and countries worldwide wish to increase their profit as well, by boosting their portfolio of investors. This tricky combination may favor weak enforcement and regulatory framework, as a country's willingness to attract foreign investment could potentially lead to weak regulation; the opposite assumption is also true, considering over-regulation may increase safeness but also transaction costs, as it would require market participants to increase expenditures with disclosure and governance. Analyzing SWFs in this scenario is one of the intentions of this work.

The following sections will provide an overview of IFM`s operational framework. Two major theoretical approaches will be applied. Firstly, Weberian self-interest model for social control and, secondly, the rational choice theory.

3.1.1 The weberian ideal models for social control

Compliance arises from a sense of legal obligation. Therefore, determining whether an obligation exists and is enforceable is crucial to every model of social control. All legal systems possess some rules governing the conduct of actors, be they laws, directives or norms, and these rules vary in the degree to which they are followed and the reasons for compliance[76]. Coercion, self-Interest and legitimacy are three simplistic but efficient ways to determine patterns for regulatory design.

It is important to take note, however, that these models overlap each other and are not exclusive. Notwithstanding, as I have previously stated in this thesis, the model which is likely to have a greater effectiveness within IFM is the one defined as self-interest.

In the case of IFM, regulation is usually designed to create incentives so market participants feel inclined to comply; compliance reduces transaction costs as it potentially creates a safer environment for trade.

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76 *See* Ian Hurd, "Legitimacy and Authority in International Politics," (2002) 53:2 *CJO* 379 supra note 75 at 380.

Legal scholar Janis Sarra in an article entitled “The financial crisis and the incentive effect of credit derivatives”, while discussing international regulatory compliance, stated:

> […] There must be an economic incentive to derivatives dealers and other protection sellers or credit rating agencies to conduct due diligence in the assessment of derivatives products and to communicate the risks to purchasers. Aligning economic incentives with the objective of transparency and risk reduction will better align market conduct with public policy goals” [77]

Aligning economic incentives with the objective of transparency and the reduction of risk is a very problematic task to deal with. Market participants are always struggling and calculating between profit and information cost. In fact, regulators/policy makers have an interest in increasing their country´s capital inflow; whereas investors are always shopping for jurisdictions which will lower their costs and increase their profits.

This conflict of interests matches exactly with the last model of social control: self-interest. By definition, this model derives from the belief that compliance is beneficial to one's self. This view suggests:

> […] that any rule following by individuals is the result of an instrumental and calculated assessment of the

77 *See* Janis Sarra, *The Financial Crisis and the Incentive Effect of Credit Derivatives* (Vancouver: Law Faculty, 2010).

> net benefits of compliance versus non-compliance, with an instrumental attitude toward social structures and other people. The task of the governing agent becomes to structure incentives so that community members find compliance the most rationally attractive option.[78]

Self-interest involves a certain type of self-restraint generated by the net of incentives and disincentives created by the law. In the IFM, actors conceive of each situation *de novo* at each decision point and seek to create its maximally beneficial arrangement. Every transaction is a different one and being part of an exchange depends on the array of benefits offered by that particular market.

Incentives are often created to promote or restrict investment. As stated by Joseph E. Stiglitz, Jaime Jaramillo-Vallejo, and Yung Chal Park, incentives based regulations:

> [...] provide an environment in which the incentives of managers are aligned with those of regulators. Adequate net worth requirements, for instance, provide an incentive to be prudent. If the bank goes bankrupt, the owners have more to lose; it is as simple as that. There is a general theorem showing that when net worth falls below a certain critical threshold, banks switch from a risk-averse to a risk-loving stance; that is, of two investments with equal

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78 *See* Ian Hurd, "Legitimacy and Authority in International Politics" (2002) 53:2 *CJO* 379 *supra* note 76 at 386.

> total mean returns, banks would actually prefer the riskier loan[79].

As we can see, although the authors refer to fiscal policy – net worth requirements - , it is clear that policy makers want to pursue two potentially conflicting goals: to induce prudence in financial institutions and to obtain a greater share of the financial market activity by offering profitable conditions. The example above shows exactly this dichotomy between how market participants are constrained by regulation and how countries or regulators deal with such constraints.

I could illustrate the assumptions set forth in this section by basically stating that IFM offers an array of option and choosing where to list or trade asset/securities is a choice which is based on one's self-interest. However, in order to provide a more concrete example, I will briefly look at the U.S. market and review the variety of options issuers and investors have, to demonstrate that the regulatory system is designed to provide incentives and options for compliance.

Take for instance what happened with the US Markets once the *Sarbanes-Oxley Act* came into force in 2002. Due to the high costs imposed

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79 *See* Joseph E. Stiglitz, "The Role of the State in Financial Markets" *The World Bank* (02 February 2010), online: The World Bank <http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1994/03/01/000009265_3970702134931/Rendered/PDF/multi_page.pdf>.

by the new regulatory framework, the New York Stock Exchange ("NYSE") started to lose its competitiveness and companies began to delist and to offer their securities into the private market; some even listed in other (more attractive) jurisdictions, such as London and Hong Kong[80].

Although the NYSE started losing its competitiveness since 2002, that did not mean that the US market started shrink in size. Instead, due to the high costs imposed upon information disclosure, investors and companies started following a different path[81].

In fact, the US regulatory framework has always allowed companies to "shop" for better regulatory opportunity within its territory. Regulation D of the US *Securities Act of 1933*, for instance, allows US companies to issue securities without registering at the Securities Exchange Commission (SEC). In addition to these exemptions, many companies may also issue securities under the Regulation 144A or Regulation S.

Regulation 144A offers a safe harbor exemption from the registration requirements of Section 5 of the US *Securities Act of 1933* for resale of

80 For further debate see Marc Morgenstern, Peter Nealis and Kahn Kleinman, "The Impact of Sarbanes-Oxley on Mid-Cap Issuers," (2004) 37:21 *Rev. Sec. & Commodities Reg.* 245.

81 For further debate see András Marosi and Nadia Massoud, "Why do Firms Go Dark?"(2007) 42:1 *J. Finan. Quant. Anal.* 421.

certain restricted securities to qualified institutional buyers[82]. Regulation D limits offering size and exempts registration[83]. In addition, regulation S provides an exemption from registration under the Securities Act for offerings and sales of securities occurring outside the U.S., which in turn allows companies to "shop" for better jurisdictions, outside of their own.

It is important to bear in mind that the trade-off (the net between incentives and disincentives) in most of these cases is: a) the exemption from compliance with certain requirements established by the SEC – incentive; against b) the potential loss of liquidity, price or certainty, which are created by the factors that qualify the security for the exemption – disincentive.

Therefore, I would suggest that regulation – at the national and international levels – is designed to provide options and incentives for compliance. The regulator, seeking to reduce his costs of surveillance and

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82 "Rule 144 provides an exemption and permits the public resale of restricted or control securities if a number of conditions are met, including how long the securities are held, the way in which they are sold, and the amount that can be sold at any one time. But even if you've met the conditions of the rule, you can't sell your restricted securities to the public until you've gotten a transfer agent to remove the legend." *in* "Rule 144" *Securities and Exchange Commission* (06 March 2010), online: Securities and Exchange Commission <http://www.sec.gov/answers/rule144.htm>.

83 "Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D (or Reg D) contains three rules providing exemptions from the registration requirements, allowing some companies to offer and sell their securities without having to register the securities with the SEC. For more information about these exemptions, read our publications on Rules 504, 505 and 506 of Regulation D." *in* "Regulation D Offerings" *Securities and Exchange Commission* (06 March 2010), online: *Securities and Exchange Commission*<http://www.sec.gov/answers/regd.htm>.

attract capital to his country, will always provide a variety of options so international investors will want to list or trade on his local exchange. The incentives to comply are associated with the return of the investment, trading or listing, which matches with the participant's market orientation: maximize profit.

In this section, what I have tried to show is that regulation for financial markets is always designed in a way that allows market participants to have an option for the "best investment". The goal is to maximize profit and to promote liquidity in the market. Regulation is designed to provide incentives for compliance. I will now turn to the other side of the trade relationship and try to define why market actors comply with IFM "soft" regulation.

3.1.2 The rational choice theory

There is no better way to start this section than quoting one of the most famous statements in the history of economic liberalism:

> Every individual [...] generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in

> many other cases, led by an invisible hand to promote an end which was no part of his intention.[84]

The *coincidence of interests* is what motivates compliance at the international level; a participant will choose where to list or trade its assets/securities only if he foresees economic return. The costs of compliance shall never exceed the profit; participants are always driven by their own self-interest. This is the foundation of the rational choice theory (RCT).

Under RCT terms[85], international law reflects the agreements of self-interested states that cooperate to maximize their individual utility[86]. Although I pose objections as to consider utility as a measure[87] of "state of affairs", the premise is: States will only make agreements if doing so makes them "better off".

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84 *See* Smith, Adam, "The Wealth of Nations" *Library Economics Liberty* (01 February 2010), online: Library Economics Liberty <http://www.econlib.org/library/Smith/smWN13.html>.

85 I must acknowledge that the rational choice theory has its drawbacks if neoclassical premises are used to interpret the meaning of rational (rationality). Nevertheless, I base my arguments on Goldsmith and Posner's research, which does not take in to consideration neoclassical definitions for rational choice. For further debate *see* Jack Goldsmith & Eric Posner, "A Theory of Customary International Law," (1999) 66:4 *U.Chi.L.Rev.* 1113.

86 *See* Guzman, Andrew T., *International Law Works: A Rational Choice Theory*, 1st ed. (London: Oxford Press, 2007).

87 "Pareto standards rank social-states; they do not provide the characteristic in virtue of which one state may be compared with another. In the other hand, wealth and utility maximization express characteristics which allow them to be compared under Pareto standards" *in See* Jules L. Coleman, "Efficiency, Utility, and Wealth Maximization," (1976) 8:1 *Hosfra L. Rev.* 509 *supra* note 23 at 523 .

The same rationale applies to private actors acting within the boundaries of the international financial markets. Each individual is rational and acts according to its self-interest. As stressed by Goldsmith and Posner, behavioral regularities will result from the private advantage that each player obtains from the same action regardless of the action of the other[88]. In other words, market participants will not comply with any given regulation, unless it is profitable for them to do so:

> [States] do not comply with norms of Customary International Law because of a sense of moral or legal obligation; rather, their compliance and the norms themselves emerge from the [...] pursuit of self-interested policies [...][89].

Therefore, compliance is not likely to happen if regulation does not provide incentives for compliance. Hurd makes a very good point in this regard:

> Any loyalty by actors towards the system or its rules is contingent on the system providing a positive stream of benefits. Actors are constantly recalculating the expected payoff from remaining in the system and stand ready to abandon it immediately should some alternative promise greater utility[...][90].

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88 *See* Jack Goldsmith & Eric Posner, "A Theory of Customary International Law," (1999) 66:4 *U.Chi.L.Rev.* 1113 *supra* note 85 at 1123.

89 Ibid at 1173.

90 *See* Ian Hurd, "Legitimacy and Authority in International Politics," (2002) 53:2 *CJO* 379 supra 72 at 388.

These characteristics of the market are essential to understand the relationship between market participants and regulators. The reason behind the difficulties to regulate international financial markets is the fact that market participants can choose which jurisdiction betters suits their needs. Imagine, for instance, if one decides to trade stocks in a stock exchange. Prior to listing its stocks, the issuer will have to comply with certain rules set by the exchange. If those rules (mostly associated with disclosure) are costly and exceed his expected "profit", the issuer might consider other venues[91] to capitalize.

The same example can be used in the case of derivatives. If a participant is willing to trade in the "futures" market, but does not meet the criteria established by the futures exchange; an option would be trading "outside" of the exchange, in the OTC market.

Another example would be a firm cross-listing in a foreign exchange. If a stock exchange wishes to increase liquidity, profit, and lower the cost for capital, foreign firms are certainly an attractive target. A firm looking for cheaper capital will look and "shop" for the jurisdiction that provides the best cost-benefit (profit) in order to cross-list. Due to this competition[92],

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91 By other venues, I mean other stock exchanges with less restrictive rules.

92 "Concerns were largely directed to the fact that exchanges could no longer benefit from being a monopoly; they needed now to be run as efficient business enterprises" *in* Onnig H. Ombalagian,

there is no doubt that exchanges located across the globe have different regulation and levels of compliance.

As demonstrated in these three simple examples, market participants will always act rationally and choose the best option they have in order to maximize their profit. Compliance, therefore, is intrinsically associated with the idea of providing incentives and designing regulatory frameworks whereby the cost-benefit of compliance is always positive. This combination might be dangerous though, as members could threaten to shift transactions away from an exchange (and thus deprive the exchange of revenue) if the exchange threatens to impose burdensome regulation[93]. Markets need capital and the likelihood of strengthening regulation as opposed to providing incentives is low. SEC's Concept Release no. 34-38672 demonstrates how the problems of having self-regulatory mechanisms in a system based on trade may be critical:

> Pressures that inhibit effective regulation and discourage vigorous enforcement against members can arise for a variety of reasons, including member domination of SRO funding, member control of SRO [self-regulatory organization] governance, and member influence over regulatory and enforcement staff. In addition, the economic importance of certain SRO members may create particularly acute conflicts,

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"Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System," (2004) 39:4 *U.Rich.L.Rev.* 1069.

93 Ibid at 1075.

> especially in light of the consolidation of some of the largest securities firms. [94]

On top of that, it is important to bear in mind that the regulatory regime established at the international level of financial law is based on the arm's length regulatory project, which endorses the premise that the proper role for the state is to assist the market to regulate itself[95]. Under this model jurisdiction and territory are disregarded and, as new forms of international organizations and authority arise, are replaced by "function jurisdictions"[96], which operate at horizontal level of governance and have little or perhaps no effective mechanisms of compliance.

That said, considering that the IFM is composed of social networks based on trade, which demand higher levels of reciprocity and coincidence of interests, individuals will never enter into an agreement unless they foresee profit. This relationship between market participants and regulators influences how compliance works within the IFM.

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94 *See* "Regulation of Exchanges-Concept Release" *Securities and Exchange Commission* (06 March 2010) online: Securities and Exchange Commission <www.sec.gov/rules/concept/3438672.txt>.

95 For further debate see Benjamin, Joanna, *Financial Law*, 1d ed. (London: Oxford Press, 2008) supra note 52.

96 For further debate: Cox, Robert W., "Global Restructuring: Making Sense of the Changing International Political Economy," in *Political Economy and the Changing Global Order*, eds. R. Stubbs and and G. Underhill, 1st ed. (New York: St. Martin Press, 1994), 45-60 *supra* note 48; and Ott, F. Attiat, *The Public Sector in the Global Economy*, 1st ed. (Northampton: Edgar Elgar Publishing, 2002) *supra* note 19.

3.1.3 Conclusion

Among the various models of social control, self-interest based models offer a better explanation for international regulatory design, mainly due to the lack of coerciveness at the international level. The creation of a superior entity which is responsible for surveillance and regulation is far from reality.

Although some voluntary and cooperative initiatives, such as the creation of the IOSCO and the financial stability board, tend to foster legal standardization – which would, in theory, limit this variety of regulatory system, not allowing participants to "shop" – the adoption of standards is voluntary and, again, constrained by the self-interest of the regulatory body. Considering that capital markets are entirely linked to a country's financial system, any regulatory move will have political consequences. Imagining that a country, which is losing capital, will not relax regulation or create incentives to attract foreign investor is naïve.

On the side of market participants, the rational choice theory offers a great contribution because of two basic characteristics of the market, which were already mentioned in Chapter II, but are worthy to be mentioned again:

- no-one will be willing to obey rules that minimize profit; therefore any loyalty by actors towards the system or its rules is contingent on the system providing a positive stream of benefits. Actors are constantly recalculating the expected payoff from remaining in the system and stand ready to abandon it immediately should some alternative promise greater utility;

- the global market is composed of many jurisdictions or “options”, allowing investors to shop for higher returns.

These peculiarities of IFM have supported and fueled all the debate around SWFs’ influence and performance within IFM. Cross-Border compliance represents the major challenge for regulators, mainly due to the lack of enforcement and surveillance.

The problem is that SWFs’ rationality and lack of transparency conflicts directly with IFM’s operational rationale. Indeed, as will be demonstrated in forthcoming Chapters, SWFs are different market participants and, by nature, should be treated differently.

Social control in a system whereby participants behave in accordance to their own self-interest, are profit maximizers and tend to move from one jurisdiction to another in order to maximize their gains, is not likely to be efficient in regulating SWFs, as any loyalty market participants may have in relation to the regulatory system they shall abide by ends up in jeopardy, mainly due to the lack of “willingness to obey rules that maximize profit”. As SWFs may not have the profit orientation to comply and might continue to move from one jurisdiction to another, I suggest that a system with these characteristics is not likely to be effective against SWFs, they might simply choose a jurisdiction for other reasons besides profit.

It is important to always bear in mind that in a system based on self-interest that allows market participants to choose where to invest, in order to maximize their profit, will certainly rely upon the market participants' orientation. The conclusion above relies on the assumption that market participants are profit maximizers who are rationally oriented.

Note that the two major assumptions above: "no-one will be willing to obey rules that minimize profit, when there are more profitable rules available and "the market is composed of many jurisdictions or "options", allowing investors to shop for higher returns" refer separately but equally to profit maximization.

The orientation set forth above, which is basically the main rationale of the rational choice theory, clashes with and influences the financial communities' perception of SWFs' performance within IFM. After all, are SWFs trustworthy? Does trust means SWF are rational players?

In the following section I will explore the debate about SWFs' performance within IFM and analyze whether such debate might be considered correct or not. The endeavor is to verify whether politicians, experts and market analysts are correctly tackling and examining the problem or if their attempt to regulate SWF is simply and solely an effort to constrain SWFs within IFM's framework.

I conclude they are addressing the problem partially because the question is not whether we should trust SWFs or not; it is about, in addition to legitimacy, as defined by A.Monk, being able to control SWFs' actions and enforce sanctions in the event such funds do not behave in accordance with the profit maximizing rules of regulatory system in the IFM.

Focusing the problem only on transparency seems more an alternative to preserve the efficient market hypothesis than to face the problem directly.

Nevertheless, the attempt to legitimize such funds is valid and will definitely assist market participants to price their assets correctly and protect themselves against any irrational investment move from SWFs. I only suggest that the legitimacy approach needs to be complemented by the idea of formal trust, which will be defined in the next Section.

3.2 Achieving trust among recipient countries

In the past years much has been said about the trustworthiness of SWFs. The element of trust as a proxy for institutional legitimization pervades the global debate among legal scholars, lawyers, regulators and so on, in the media. Joaquin Almunia, the European Commissioner for Economic and Monetary Affairs remarked, upon the conclusion of the negotiations that led to the creation of the Santiago Principles, that "the principles and practices of the GAPP amount to a global public good that can help foster trust and confidence between sovereign wealth funds, their originating countries, and the recipient countries". He also stated that:

> […] by individually implementing the set of generally accepted principles and practices voluntarily agreed, and that are presented here today, SWFs will prove that they are responsible and reliable players in the global financial system. [97]

During the same meeting, Hamad Al Suwaidi, the chief of the Abu Dhabi Investment authority emphasized:

> I believe that the process we have undergone over the last four months represents a significant step forward and will contribute to enhancing the way sovereign wealth funds are perceived around the world. For me, this process is about one word, it is all about trust. It is about collectively doing everything in our power to ensure that trust lies at the heart of everything we do, so make no mistake, our achievements to date have been significant, but we must also recognize that we cannot let up in continuing to meet the high standards that we have set out for ourselves. [98]

David Murray, the chair of the IWG's Drafting group and Australia Future Fund seemed to accept the same rationale arguing that SWFs "had to establish trust in recipient countries that the activities of sovereign

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97 See "Statement by the European Commissioner on the Santiago Principles" *International Working Group of Sovereign Wealth Funds* (13 February 2010), online: International Working Group of Sovereign Wealth Funds <http://www.iwg-swf.org/pr/swfpr0808.htm>.

98 Ibid.

wealth funds were all based on an economic orientation". Further, many initiatives tended to adopt this perspective (establishment of trust) as a core debate. In 2008, the OECD held a conference entitled "Sovereign Wealth Fund in the Global Investment Landscape: Building trust", which basically dealt with trust as an element of consent for institutional legitimacy. Most recently, the accounting firm Deloitte rekindled the same debate by launching a panel called "Establishing Trust in Sovereign Wealth Funds: The purpose and objectives of the Santiago Principles".

These are just examples of how the global community has dealt with what seems to be the major problem of SWFs: trustworthiness. Rather than accepting an elementary definition of trust[99], it is clear that the complexity of IFM and its unique characteristics demand a much deeper acknowledgment of what trust really represents.

3.3 Converging trust, compliance and regulatory efficiency

In the previous section I have shown that IFM regulatory framework is structured over the coincidence of interests (regulators versus market participants). I have also asserted that regulation within IFM is usually designed to provide incentives for compliance; these two conclusions were

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99 "At root, trust refers to an actor's willingness to place something valued under another actor's control" *in* Hoffman, Aaron M., *Building Trust: Overcoming Suspicions in International Conflict*, 1st ed. (New York: State University of New York Press, 2006) at 4.

basically justified by the self-interest Weberian model for social control and the rational choice theory.

In this section I will deal with what has been defined as the major problem of SWFs: trustworthiness. Does trust really foster compliance? Would international authorities be right asserting the main problem of SWFs is trust?

A. Monk stresses that:

> Evidently, "trust" is an important stepping stone for SWFs' integration into the global financial system; distrust is a problem that requires the attention of SWFs and policymakers alike. But is trust the primary issue? As illustrated above, SWFs clearly inspire concern and in some cases suspicion in the West. However, are these stakeholders and policymakers correct in labeling distrust as the primary hurdle? 'Trust' may in fact not be the appropriate label for what SWFs are lacking.[100]

These questions are fundamental as they help explaining the linkage between IFM's operational structure and the suitability of SWFs within the

100 *See* Ashby Monk, "Recasting the Sovereign Wealth Fund Debate Trust Legitimacy and Governance" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862> *supra* note 11 at 6.

market. Trust has several connotations[101], as delimited by McKnight[102], the typical definition of trust follows:

- risk of harm to the trustor if the trustee will not behave accordingly;
- the willingness of one party (trustor) to be vulnerable to the actions of another party (trustee); and
- the absence of trustor's enforcement or control over actions performed by the trustee.

Although these connotations might undoubtedly have a certain influence over the relationship established between compliance and regulatory design, the last two connotations influence the formal aspect of trust[103], which is the encapsulated profit maximization interest, not the psychological connotation of trust. The risk of harm and the willingness to be vulnerable would only be post deal potential risks that would serve to influence how parties deal with the last connotation: enforcement.

Trust mechanisms with a formal basis are the mechanisms that build trust that is, in the end, based on formal (legal) agreements and enforced by

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101 For further debate see D. Harrison Mcknight & Norman L. Chervany, "The Meanings of Trust" *Working Paper Series* (27 November 2009), online: The University of Minnesota <http://www.misrc.umn.edu/wpaper/WorkingPapers/9604.pdf>.

102 *See* F. David Schoorman et al, "An Integrative Model of Organizational Trust: Past, Present, and Future," (1995) 20:3 *Acad Manag Rev* 709.

103 Formal trust has similar meaning to what is known by other authors as instrumental trust, rational trust, calculative trust, fragile trust, self-interested trust, synthetic trust.

formal (legal) procedures. Therefore, trust will only be achieved if SWFs act as a rational player, under neoclassical terms; otherwise mechanisms needed for enforcement or control over their actions will always be more costly if compared to the ones imposed upon other market participants.

Frank A.G. Den Butter and Robert H.J. Mosch assert that:

> "Trust problems relate to the contingent behavior of (potential) trading partners: can they be trusted, or not, to be able (competence) and willing (intention) to perform in letter and spirit of the agreement, even when circumstances occur that make it favorable for B to deviate.[104]"

When David Murray stated that SWFS had to establish trust in recipient countries that all of its activities were based on an economic orientation, he basically stressed the formal aspect of trust, which is one of the elements of the rational choice theory, as defined by Coleman[105].

Greif explains:

> One will not enter into an objectively profitable exchange relationship unless the other party can ex-

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104 *See* Frank A.G. den Butter and Robert H. J. Mosch, "Trade, Trust and Transaction Costs" *Tinbergen Institute* (27 November 2009), online: Tinbergen Institute <http://www.tinbergen.nl/discussionpapers/03082.pdf> at 5.

105 Coleman combines principles of individual rational choice with a sociological conception of collective action. For further debate see Thomas Voss & Martin Abraham, "Rational Choice Theory in Sociology", in *The International Handbook of Sociology*, eds. Stella R. Quah and Arnaud Sales, 1st ed. (London: Sage Publications, 2000), 50-82 at 57.

> ante commit to fulfill his contractual obligation ex-post.[106]

Therefore, trust in the context of IFM means **encapsulated interest**[107]. Individuals deal with trust as a measure for transaction costs and use it as a tool to address their investments, based upon the risk of harm and/or the willingness to be vulnerable, as mentioned above.

The concept is much more related to formal and legal aspects of the trade or guarantees, then to a psychological aspect of the definition[108]. Frank A.G. Den Butter and Robert H.J. Mosch observe:

> These notions of trust are related to each other, in the sense that they see this type of trust as being about the calculation of selfish interests in pecuniary terms. It takes the *homo economicus* view of mankind as its central perspective. It expects that people take into account all financial incentives involved.[109]

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106 *See* Avner Greif, "Commitment, Coercion, and Markets: The Nature and Dynamics of Institutions Supporting Exchange," in *New Institutional Economics*, eds. Menard, C., Shirley, M., 1st ed. (Netherlands: Springer, 2005), 727-786 at 734.

107 *See* Braithwaite, Valerie, *Trust and Governance*, 1st ed. (New York: Russell S, 1998) at 175.

108 In the context of this thesis I do not consider trust as "a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another" *in* D. M. Rousseau, S. B. Sitkin and Burt, R.S., and Camerer, C, "Not so Different After all: A Cross-Discipline View of Trust,"(1998) 23:1 *Acad. Manage Rev.* 393 at 416; neither as "an individual's belief in, and willingness to act on the basis of, the words, actions, and decisions of another" *in* R. J. Lewicki, D. J. McAllister and R. J. Bies, "Trust and Distrust: New Relationships and Realities," (1998) 23:1 *Acad. Manage Rev.* 438 at 445.

109 *See* Frank A.G. den Butter and Robert H. J. Mosch, "Trade, Trust and Transaction Costs" *Tinbergen Institute* (27 November 2009), online: Tinbergen Institute <http://www.tinbergen.nl/discussionpapers/03082.pdf> *supra* note 104 at 9.

If transaction costs are defined as "the friction costs that appear while pursuing the gains of trade", then in the case presented here, the coincidence of interests aligned with the "trust" that parties have in each other constitutes a dual channel of acceptance whereby "A" must accept "B" terms and "B" must accept "A" terms; as long as both parties are better off and no one is worse off, the deal is likely to happen. The relationship between contracting parties and regulatory frameworks is synthesized by the following assumption: if one is better off and no one is worse off; there is efficiency.

The connection between "trust" and "regulation" is ubiquitous if taken to a level whereby regulatory action brings certainty that the "trustor's enforcement or control over actions performed by the trustee" is achieved. In this context, trust is directly linked to regulatory compliance and transaction costs; it is related to compliance because, presumably, actors tend to cooperate and obey peer-established norms if such are profitable[110]. In the other hand, it is related to transaction costs because the increase in levels of compliance reduces costs within international transactions, by bringing transparency and safety to the deal.

Trust, in the context of IFM, must be viewed as a function of regulatory effectiveness; there must be a guarantee that certain actions or

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110 Establish the basis to verify whether the trustee will behave in accordance with the Market's expectations, *vis a vis* be rational or the willingness of the trustor to be vulnerable to the actions of the trustee.

activities of SWFs will be controlled or might be controlled by the regulatory framework (the function jurisdiction) they are inserted into. Even though the debate posed in the previous section has confused trust with the idea of “acceptance” or “legitimacy”, as stressed by A. Monk, whereby SWFs must be transparent and fully rational in order to be accepted, I would suggest that trust is as fundamental as Legitimacy and must be treated the same way. If SWFs have not violated any predetermined rule, it is mainly because there are no rules to obey; SWFs need to be regulated so parties feel safe, in relation to their investment activities, and inclined to accept them as regular market participants.

3.3.1 Turning back to trustworthiness

A. Monk does not view trust as an instrument to achieve legitimacy, rather his approach seems to be correct but superficial in relation to the subject:

> Therefore, trust is an inappropriate label for what SWFs are lacking. A more appropriate label is legitimacy. While this may seem a semantic argument, like the definitional argument above, it has important implications for solutions and policies.[111]

A. Monk continues his argument by stating that:

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111 *See* Ashby Monk, "Recasting the Sovereign Wealth Fund Debate Trust Legitimacy and Governance" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862> *supra* note 11 at 15.

> Trust is not the same as legitimacy. Trust develops when a legitimate institution acts in accordance with its predetermined rules. So, labeling the problem faced by SWFs as 'distrust' implies that SWFs have already performed in a way that contradicts Western norms and expectations, which is empirically false. Conversely, labeling the problem 'legitimacy' suggests that—while SWFs may not have invested improperly to date—the principles and practices that underpin these institutions should be the focus of concern.[112]

As stressed in the previous section, trust can have several connotations and Monk seems to be tackling only one of them. Monk's approach is linked to an idea of "acceptance", which is an idea very close to the social capital theory[113], whereby SWFs would have to be accepted among the homogeneous group[114] of IFM as means to form bonding ties.

A. Monk concludes with these thoughts:

> In short, SWFs interested in establishing trust must first resolve their crisis of legitimacy. Indeed, the "trust" policymakers are seeking to achieve with the Santiago Principles is a function of legitimacy: "In this way, institutional legitimacy becomes a precondition of institutional trust because beliefs of institutional legitimacy define specific behavioral expectations of

112 Ibid at 16.

113 Robert Putnam defines social capital as "the features of social organization, such as networks, norms and trust that facilitate coordination and cooperation for mutual benefit" *in* Robert Putman, "The Prosperous Community: Social Capital and Public Life," (1993) 4:13 *TAP* 23 at 35.

114 Social Capital Theory stresses that homogeneous groups are created through bonding ties. Schuller defines such concept as "to the links between like-minded people, or the reinforcement of homogeneity. It builds strong ties, but can also result in higher walls excluding those who do not qualify" *in* T. Schuller, S. Baron & J. Field, *Social Capital: Critical Perspectives*, 1st ed. (London: Oxford University Press, 2000) at 10.

> how representatives of those institutions are supposed to act, as well as the benchmarks for the trustworthiness of these representatives.” [115]

Although the concept of legitimacy might influence how market participants and regulators see SWFs, it would not be enough to solve or justify the problems related to SWFs' performance within IFM. In reality, even if SWFs are accepted, such Funds would have to prove that they would behave in accordance with the Market's expectations (be rational) and make sure their actions would be controlled and sanctions enforced. In addition, transparency would allow participants to access the risks involved in such transactions and calculate whether or not it would be worth it to deal with SWFs.

Therefore, I suggest Monk's approach to the problem is correct but limited, as far as the conception of trust is applied. The definition of legitimacy used by Monk expresses exactly the general consensus that SWFs need to be rational and transparent (conform to IFM operational rationale), but does not highlight that regulations need to exist or be enforceable against SWFs; aligned with legitimacy, the concept of trust provided in this section, fulfills this equation.

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115 *See* Ashby Monk, "Recasting the Sovereign Wealth Fund Debate Trust Legitimacy and Governance" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862>*supra* note 11 at 17.

As the next chapters will deal with regulatory actions taken or to be taken towards SWFs, I will not extend myself into the debate around legitimacy and trust. The endeavor in this section was only to emphasize that, in addition to legitimacy; trust plays a very important role in the debate about SWFs.

3.3.2 Conclusion

The way IFM is structured influences directly how regulation is designed. Chapter 3 demonstrates that regulation, within IFM, usually creates incentives and an array of options so market participants can choose where to invest. In addition, the rational choice theory applied to the context thereto demonstrates that market participants are only inclined to comply with certain regulatory regimes if doing so is profitable.

At the outset of these theories, SWFs were inserted, as a case study, to prove the hypothesis that IFM is designed based on the perfect market theory, as defined by neoclassical economics, and any attempt to regulate SWFs, within the boundaries of such theory, would fail.

In fact, the current IFM's regulatory framework would not give the security market participants are looking for whenever conducting a deal with SWFs, simply because SWFs cannot be treated as regular market participants; inherently there will always be the risk of political use or manipulation of these funds.

Chapter 4 and 5 will provide a good view on where we stand right now in relation to regulatory measures taken against SWFs. The Santiago Principles will be analyzed in order to verify whether such guidelines would be able to reduce the fear market participants have against SWFs. Afterward, I will propose a series of regulatory measures that would, in theory, minimize such concerns exponentially.

Chapter 4: Understanding the problem: issues and concerns associated to SWFs

4.1 Transparency: a call from the global capital markets

SWFs have been intensely criticized due to their lack of transparency and investment policy objectivity. Although such concerns have not yet become reality, since there is no evidence of political use or market manipulation by SWF[116], it is clear, by now, that SWFs cannot and should not be treated as regular market participants. As previously demonstrated in Chapter 3, IMF regulatory framework is based on the efficient market theory and underscores a major concern which is directly related to a more pro-active and aggressive (risk-taking) investment policy of SWFs.

Until most recently, most central banks had traditionally invested their foreign exchange reserve into low risk financial assets, primarily U.S. T-Bonds, whereas SWFs have started investing their reserves into diversified financial products (shares, bonds, derivatives etc), which could potentially have political or strategic interests.

The Kuwait Investment Authority stated their SWF have "been passive in all [its] investments [....] [It] has not played an active role or been an

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116 *See* Ashby Monk, "Recasting the Sovereign Wealth Fund Debate Trust Legitimacy and Governance" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862> *supra* note 11 at 2.

activist with [any] of [its] shares"[117]. However, "taking a more active role in investments [might not be] uncommon for large funds, and might perhaps become a necessity when shareholdings grow as large as CalPERS's or Kuwait's"[118]

In fact, large pools of capital need to diversify their portfolio. Take for instance SWFs or even regular market investors – which in theory are transparent and rationally oriented –, if such funds and/or investors decide only to invest in e.g. US T-Bonds, the logical result would be a decrease on investment return, followed by an increase in US T-Bonds prices. The simple logic behind this assumption lies on an offer/demand function, which is one of the bases for price determination.

Adding to this problem, despite price determination, the growth and consequent shift of investment policy triggers the fear that stocks might not be "perfectly priced according to their inherent investment properties, the

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117 *See* Kuwait Government, "Kuwait Investment Office in London" *Kuwait Investment Authority* (12 May 2011), online: Kuwait Investment Authority <http://www.kia.gov.kw/En/KIO/About/Pages/default.aspx>.

118 *See* "The Brave New World of Sovereign Wealth Funds" *Lauder Institute of Management and International Studies* (20 May 2010), online: The Lauder Institute <http://knowledge.wharton.upenn.edu/papers/download/052810_Lauder_Sovereign_Wealth_Fund_report_2010.pdf> at 11.

knowledge of which all market participants possess equally"[119], if SWFs are not transparent and rationally oriented.

Bortolotti, Fotak, Megginson and Miracky indicate the problems behind this concern:

> The recent history highlights that SWFs have become major players in the global economy. Yet, the structure, objectives, and investment strategies of these funds are poorly understood (...).[120]

Tao Sun and Heiko Hesse asserted that, in virtue of their size and nontransparent positions, SWFs might cause market disturbances and affect different sectors of the Markets:

> Having large and often intransparent positions in financial markets, SWFs – like other large institutional investor – have the potential to cause a market disturbance. For instance, actual or rumored transactions may affect relative valuations in particular sectors and result in herding behavior, adding to volatility. [121]

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119 *See* Burton G. Malkiel, "The Efficient Market Hypothesis and its Critics," (2003) 17:1 *J. Econ. Perspect* 59 supra note 37 at 93.

120 *See* Bernardo Bortolotti et al., "Sovereign Wealth Fund Investment Patterns and Performance" *Fondazione Eni Enrico Mattei* (13 February 2010), online: Fondazione Eni Enrico Mattei <http://admin.darden.virginia.edu/emUpload/uploaded2009/SWF-invest-patterns-perform-nov288.pdf> *supra* note 10 at 16.

121 *See* Tao Sun & Heiko Hesse, "Sovereign Wealth Funds and Financial Stability - an Event Study Analysis" *International Monetary Fund* (13 December 2009), online: International Monetary Fund <http://www.imf.org/external/pubs/ft/wp/2009/wp09239.pdf> at 4.

This understanding matches the common assumption within the market that SWFs might be politically driven and not rationally oriented. An article recently published by Forbes.com stated that:

> "The Chinese government has hinted that it may liquidate its vast holding of US Treasury bonds, potentially triggering a crash in the dollar, if Washington imposes trade sanctions to force a yuan revaluation[122]".

Adding to this tense relationship between objective/transparency and rationality, the French president's call for European SWFs to defend national and European interests showed how political interests might disturb the market. Mr. Sarkozy, in remarks at the European Parliament, said:

> "Stock markets are at a historically low level. There could be an opportunity to create our own sovereign wealth funds, which would make it possible to defend national interests and European interests". [123]

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122 *See* "China may Sell Off Treasury Bonds if US Imposes Trade Sanctions" *Thomson Financial Report* (07 December 2009), online: Forbes <http://www.forbes.com/afxnewslimited/feeds/afx/2007/08/08/afx3997945.html >.

123 *See* "Sovereign Wealth Funds" *World Economic Forum* (07 December 2009), online: Excess Liquidity <http://sovereignwealthfunds.wordpress.com/2008/01/27/sovereign-wealth-funds%E2%80%98it%E2%80%99-topic-at-2008-world-economic-forum/>

These are only two major events that served to illustrate part of the market's inherent and growing concern about the SWF's performance. Lawrence Summers, former U.S Treasury Secretary, remarked at the 2008 World Economic Forum that:

> Given we have made a decision that we are not going to invest our country's money in companies because of the risk of politicization, then it's legitimate to be concerned about other countries' use of those funds(…). The question is if we believe in market economies and we work very hard to create open markets and private enterprises – shouldn't we be concerned with transactions that have an element, albeit a small element, of cross border nationalization?[124]

Robert Kimmitt, U.S. Deputy Secretary of the treasury, raised the concerns, but with a softer tone:

> At this point, the history with sovereign wealth funds is they are generating higher investment returns without generating political controversy. (…) Importantly, both fund management and investment decisions we have seen have been made on commercial not political grounds. We welcome that kind of investment in the United States. We do not fear such investment. However, the growth in the size and the number of these funds is such that vigilance is required.[125]

124 Ibid.

125 Ibid.

Apart from such concerns, Stephen Schwarzman, Chairman and CEO of Blackstone group[126] posited that:

> Our experience with sovereign wealth funds is they are smart, long term, highly professional. All they are looking for is higher rate of return (...). We have a sovereign wealth fund as our largest stakeholder. It is indicative of the way a sovereign wealth fund would think. The first thing about that investment it is non-voting investment – that was important for them.[127]

From these three statements two major positions can be identified. On the government side, which is the one defended by Kimmit and Summers, the preoccupation about individual`s rationality and transparency determine the way governments usually see SWFs. On the other side, private players, such as the Blackstone Group, tend to protect SWFs, but usually make no attempt to guarantee rationality and transparency, perhaps because of the fees they collect in virtue of the transactions they carry out for these funds.

Most of these concerns relate to transparency and rationality. In such context, transactions are expected to perform as predicted by the perfect market hypothesis. Each transaction – within the market – shall represent a match of individual preferences in its optimal point and reflect a perfect

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126 Ibid.

127 Ibid.

combination of individual choices taken in an environment of symmetric information, no transaction costs and full rationality.

Transparency, as mentioned by Tao Sun and Heiko Hesse, is a tool that allows stock and/or financial products[128] price determination. It, together with full rationality, constitutes the basis of IFM Rationale. A system without such characteristics is more likely to present higher volatility as market participants will not be able to know and/or to anticipate the broad allocation of assets and risk preferences of market participants. In the case of SWFs, this risk is even higher due to their size and potential political orientation.

The G22 Working Group on Transparency and Accountability observed, back in 1998, that:

> Transparency contributes to the efficient allocation of resources by ensuring that market participants have sufficient information to identify risks and to distinguish one firm's, or one country's, circumstances from another's. Moreover, transparency helps to inform market expectations, thereby helping to stabilize markets during periods of uncertainty and also contributing to the effectiveness of announced policies.[129]

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128 For further debate see Burton G. Malkiel, "The Efficient Market Hypothesis and its Critics," (2003) 17:1 *J. Econ. Perspect* 59 *supra* note 37.

129 *See* "Reports on the International Financial Architecture" *Working Group on Transparency and Accountability* (12 February 2010), online: International Monetary Fund <http://www.imf.org/external/np/g22/taarep.pdf> at 7.

In this regard, as noted by the European Commission, since SWFs:

> "[...] are managed independently from a country's foreign exchange reserves, they are excluded from transparency mechanisms such as the IMF's Special Data Dissemination Standard, SDDS – for foreign exchange reserves". [130]

In fact, most SWFs do not even comply with the most basic IMF transparency guidelines[131]:

- Annual disclosure of investment positions and asset allocation, in particular for investments for which there is majority ownership;
- Exercise of ownership rights;
- Disclosure of leverage use and of currency compositions;
- Size and source of resources;
- Disclosure of home security regulation and oversight towards country's SWF.

The market's structural operational rationale is erected over two major pillars: symmetric information and full rationality. These two pillars relate, respectively, to transparency and investment policy (objective).

130 *See* Sauvant, Karl; Sachs, Lisa & Jo, Wouter Jo., *Sovereign Investment: Concerns and Policy Reactions*, 1st ed. (London: Oxford University Press, 2010).

131 *See* "The Guidelines for Foreign Exchange Reserve Management" International Monetary Fund (13 February 2011), online: *International Monetary Fund* <http://www.imf.org/external/np/mae/ferm/eng/index.htm>.

Stiglitz posits that:

> The standard theories of the efficiency of competitive markets are based on the premise that there is perfect information or, more precisely, that the information held by individuals or firms is not affected by what they observe in the market and cannot be altered by any action they can undertake, including acquiring more information[132]

Whenever concerns are raised about SWF`s investment objectives or policy, what is being questioned is whether SWFs can be considered rational players or not. The major concern, although hypothetical, is that contrary to regular market participants like pension funds[133] or even hedge funds, SWFs might have other objectives/interests besides maximizing their wealth.

On the other hand, questioning SWF's transparency is the only way to increase market information and correctly price assets. The understanding behind such assumption is mostly based on theory, *ex vi* the efficient market hypothesis, but does not match current regulatory practices applied

132 *See* Joseph E. Stiglitz, "The Role of the State in Financial Markets" *The World Bank* (02 February 2010), online: The World Bank <http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1994/03/01/000009265_3970702134931/Rendered/PDF/multi_page.pdf> *supra* note at 79 at 27.

133 "Sovereign Wealth Funds (SWF) and Public Pension Reserve Funds (PPRFs) share some characteristics, hence give rise to similar concerns However, their objectives, investment strategies, sources of funding and transparency requirements differ" *in* Juan Yermo, "Sovereign Wealth and Pension Funds Issues," (2008) 14:1 *OECD Working Paper on Insurance and Private Pensions* 1 at 3.

to other market participants. Due to this inconsistency, many scholars have criticized the calls for additional scrutiny of SWFs. Some understand that there is an inconsistent logic behind all transparency requirements and impediments imposed by governments and other market participants against SWFs. Balding states that:

> The criticism of sovereign wealth funds flow from logically inconsistent, politically protectionist sentiment and not from a sound empirical or economic understanding of sovereign wealth funds (...). The second logically inconsistent criticism of sovereign wealth funds concerns the obsession with transparency. Calls for sovereign wealth fund transparency exceed the demands for transparency from most financial institutions such as commercial banks, investment banks, hedge funds, or private equity funds.[134]

Perhaps the problems identified by Balding are not directly linked to creating equity among market participants as means of disclosure; they are mostly based on the assumption that SWFs are not rational players and, therefore, increased levels of transparency would help the market identifying behavioral disturbance (irrationality) from such players, allowing the market to auto-adjust and accurately price assets.

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134 *See* Christopher Balding, "Framing Sovereign Wealth Funds: What we Know and Need to Know" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335556> at 8.

At least in theory, the same requirements are not imposed or expected from other markets participants simply because they are assumed to be rational and profit maximizers; therefore, providing information will certainly reduce price inaccuracy. Balding asserts that:

> Companies accept the higher transparency costs to make similar levels of information available to the broader, public market and reduce the information asymmetry between owners and agents.[135]

In the case of SWF, the only cost would be political:

> [in relation to SWF] here owners have, or should have, access to all available information. The only information asymmetry is between politicians and a foreign corporation. The only relevant costs are political.[136]

Balding seems to minimize the impact of political influence within the market, but it is clear that SWFs, by their definition, might suffer some political influence. Even though it is not always easy to prove such concerns, a quick look over the legal nature of these funds might provide an answer to support the alleged threat. As previously discussed in Chapter I

135 Ibid at 3.

136 Ibid at 10.

and defined by Monk[137], SWFs' definition holds some attributes that would potentially increase their vulnerability to political influence.

Firstly, their assets are owned by the government and investment returns go back to the government, instead of an outside beneficiary. Considering the absence of external control, the requirement for accountability would be left to the sole discretion of the governments; secondly, SWFs are unconstrained by non-governmental property rights, which might generate accounting problems. If all assets belong solely to the government, there is no outside beneficiary to the assets held by SWFs; SWFs have no fiduciary duty to any individual beneficiaries, besides its citizens and last, SWF's investment strategy follows the interests of the government, which might not be economically rational and have political interest other than profit maximization.

Chairman Cox has warned, for example, that it would be extremely hard to prosecute an SWF for insider trading[138]. Lawrence Summers in an article published in the Financial Times pondered about some possible scenarios:

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137 *See* Ashby Monk, "Recasting the Sovereign Wealth Fund Debate Trust Legitimacy and Governance" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862> *supra* note 11 at 3.

138 *See* Christopher Cox, "Speech by SEC Chairman: The Rise of Sovereign Business" *Securities and Exchange Commission* (27 November 2009), online: Securities and Exchange Commission <http://www.sec.gov/news/speech/2007/spch120507cc.htm>.

> […] the day when a country joins some "coalition of the willing" and asks the US president to support a tax break for a company in which it has invested, . . . [o]r when a decision has to be made about whether to bail out a company, much of whose debt is held by an ally's central bank.[139]

Therefore it is undeniable that even though GAAP guidelines are completely followed by SWFs there would still be a risk of political interference and use of SWFs for other purposes besides profit maximization.

Indeed, as mentioned in this section, increased levels of transparency would not be sufficient to avoid any risk of political interference and/or irrationality from SWFs. As motivation may change from time to time (it is not a fix subject e.g. a new government or new manager may have a different policy orientation than the previous one), control must go beyond disclosure; there must exist alternative forms of regulation against SWFs in order to constrain such funds within IFM operational rationale. In this regard, there have been regulatory steps taken internationally and nationally (within United States); chapters 5 and 6 will, respectively, take a look at these steps taken to address global concerns.

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139 *See* Lawrence Summers, "Funds that Shake Capitalist Logic" *Financial Times* (07 December 2009), online: Financial Times <http://www.ft.com/cms/s/2/bb8f50b8-3dcc-11dc-8f6a-0000779fd2ac.html#axzz1SxTmYuIf> *supra* note 9.

Chapter 5: Santiago principles – SWFs' response to global concerns

The General Accepted Principles and Practices (GAPP) were in proposed in 2008 by the International Working Group of SWFs (IWG) following recommendations of the International Monetary and Financial Committee to initiate a study about the need for further analysis of key issues for investors and recipients of SWF flows, including a dialogue on identifying best practices.

As defined by GAPP, the principles are:

> […] voluntary set of principles and practices that the members of the IWG (International Working Group) support and either have implemented or aspire to implement. The GAPP denotes general practices and principles, which are potentially achievable by countries at all levels of economic development. The GAPP is subject to provisions of intergovernmental agreements, and legal and regulatory requirements. Thus, the implementation of each principle of the GAPP is subject to applicable home country laws.[140]

Commonly known as "the Santiago Principles", the set of principles and practices named after the city they were first promulgated, intended mainly to demonstrate to the financial community that SWFs' arrangements

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140 *See* "Statement by the European Commissioner on the Santiago Principles" *International Working Group of Sovereign Wealth Funds* (13 February 2010), online: International Working Group of Sovereign Wealth Funds <http://www.iwg-swf.org/pr/swfpr0808.htm> *supra* note 97.

are properly set up and investments are made on an economic and financial basis[141].

Joseph F. Norton, in relation to GAAP's purposes, asserts:

> The primary 'purpose of the Principles is to identify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices . . . on a prudent and sound basis'.[63]

Sven Behrend indicates the aim of implementing such principles and best practices:

> The publication and implementation of these Principles should foster the understanding of SWFs as financially and economically oriented entities, contributing to the stability of the global financial system, reducing protectionist pressures, and helping maintain an open and stable investment climate.[142]

Joseph F. Norton also asserts that the GAAP:

> [...] aims to contribute to the stability of the global financial system, reduce protectionist pressures, and

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141 *See* "Generally Accepted Principles and Practices" International Working Group of Sovereign Wealth Funds (14 May 2011), online: *International Working Group of Sovereign Wealth Funds* <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>

142 Ibid.

help maintain an open and stable investment climate.[143]

As stated in the GAAP, the Santiago Principles are underpinned by the following guiding objectives for SWFs[144].

- To help maintain a stable global financial system and free flow of capital and investment;
- To comply with all applicable regulatory and disclosure requirements in the countries in which they invest;
- To invest on the basis of economic and financial risk and return-related considerations; and
- To have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability.

These guiding objectives generated twenty four principles and recommendations to be freely implemented by each country in their respective SWF. Among the various principles and practices, there can be identified in almost each guideline the word "should" which implies the unbinding connotation of the proposed set of rules.

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143 Ibid.

144 Ibid.

Sven Behrendt[145] classifies the GAAP into three major groups. The first would relate to the disclosure of SWFs' legal framework; the second would cover SWFs' institutional framework and governance structure; and the third, would provide a series of guidelines to enhance decisions regarding appropriate investment and risk management for SWFs.

The first group is represented by articles one to four:

> **GAPP 1. Principle**
>
> The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).
>
> *GAPP 1.1. Subprinciple.* The legal framework for the SWF should ensure legal soundness of the SWF and its transactions
>
> *GAPP 1.2. Subprinciple.* The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and other state bodies, should be publicly disclosed.[146]
>
> **GAPP 2. Principle**
>
> The policy purpose of the SWF should be clearly defined and publicly disclosed.[147]

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145 *See* Sven Behrendt, "The 'Santiago Principles' of the International Working Group of Sovereign Wealth Funds: Blueprint from a 12-Point Action Plan" *Carnegie Middle East Center* (22 July 2011), online: Carnegie Middle East Center <http://www.carnegieendowment.org/files/S_Behrendt_IWG_12_Point_Action_Plan-final.pdf > at 3.

146 *See* "Generally Accepted Principles and Practices" International Working Group of Sovereign Wealth Funds (14 May 2011), online: *International Working Group of Sovereign Wealth Funds* <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> *supra* note 141.

147 Ibid.

GAPP 3. Principle

Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.[148]

GAPP 4. Principle

There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations.

GAPP 4.1. Subprinciple. The source of SWF funding should be publicly disclosed.

GAPP 4.2. Subprinciple. The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.[149]

The starting point of the Santiago Principles indicates clearly the intention of regulators to segregate State from investment vehicles. The purpose of such declaration, although not binding, is to establish a legal framework for SWF and assure that such funds do not confuse themselves or their legal structure with the State they actually belong to.

In addition, there is also an intention to demonstrate that SWFs are economically oriented. In fact, a clearly defined policy purpose facilitates

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148 Ibid.

149 Ibid.

formulation of appropriate investment strategies based on economic and financial objectives[150].

The GAAP explanatory section stresses:

> A sound legal framework underpins a robust institutional and governance structure of the SWF and a clear delineation of responsibilities between the SWF and other governmental entities. This framework facilitates the formulation and implementation of appropriate objectives and investment policies, and is necessary for an SWF to operate effectively to achieve its stated purpose[151].

The first group indicates the idea of implementing a framework from which objectives, policies and assets are identified. As we can see, regulators are mainly concerned with demonstrating to the financial community that SWFs have defined purposes, policies, accountability and legal structure. Notwithstanding, the proposals presented in this first group have also the objective to inform citizens about their country's SWF investment activities abroad and into its territory of incorporation:

> A clearly defined policy purpose will also ensure that the operational management of the SWF will conduct itself professionally and ensure that the SWF undertakes investments without any intention or

150 Ibid.

151 Ibid.

> obligation to fulfill, directly or indirectly, any geopolitical agenda of the government[152].

The explanatory section of GAAP also asserts:

> Public disclosure of the SWF's policy purpose provides a better understanding of what the SWF seeks to achieve and whether its behavior is consistent with the specified purpose.

It is obvious that distinguishing SWFs` legal structure from the State facilitates the identification of SWF's policy purpose and provides a better understanding of what SWFs seek to achieve and whether their behavior is consistent with the specified purpose or with the perfect market hypothesis.

Turning to the second group, there is a clear intention to try to segregate any political aspirations SWF may have, in virtue of their political exposure to its government, from its operational management[153].

The second group is represented by articles six to seventeen. The most important principles are described below:

> **GAPP 6. Principle**
>
> The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate

152 Ibid.

153 Ibid.

accountability and operational independence in the management of the SWF to pursue its objectives.[154]

GAPP 7. Principle

The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.[155]

GAPP 8. Principle

The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.[156]

GAPP 9. Principle

The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.

The second group covers SWFs' institutional frameworks and governance structures. The provisions of the Santiago Principles imply that any narrowing of this distance, expressed in weak governance and accountability arrangements, compromises the funds' financial return objectives[157].

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154 Ibid.

155 Ibid.

156 Ibid.

157 *See* Sven Behrendt, "The 'Santiago Principles' of the International Working Group of Sovereign Wealth Funds: Blueprint from a 12-Point Action Plan" *Carnegie Middle East Center* (22 July 2011), online: Carnegie

The provisions set forth in this group intend to set up a model structure whereby SWFs are able to have a governance structure that clearly and effectively is able to divide roles and responsibilities in order to provide sound accountability, management and operational independence. As conceived in the first group, the need to create a separate legal framework, reduce political influence and provide transparency is at the core of regulatory concern. Such assumption can be clearly identified in the explanatory section of GAAP:

> The owner [government] has two important roles. First, the owner determines the SWF's objectives. These include the broad policy purposes of the SWF and the investment mandate and acceptable levels of risk consistent with it. In some cases, the role of the owner is to determine objectives consistent with relevant statutory provisions; in other cases, these matters are determined by the owner without detailed legislative guidance or constraints. Second, the owner exercises its oversight responsibility in accordance with the legal structure of the SWF. For that purpose, there should be adequate reporting systems in place that give the owner a true picture of the SWF's performance, financial situation, and risk management practices in order to allow the owner to effectively oversee the SWF's performance (see also GAPP 23). In addition to these two roles, particularly in cases where the SWF is a separate legal entity, the owner generally appoints the members of the SWF's governing body(ies), the

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Middle East Center <http://www.carnegieendowment.org/files/S_Behrendt_IWG_12_Point_Action_Plan-final.pdf> *supra* note 145 at 4.

> procedures and competency requirements for which should be well-structured and transparent.[158]

Therefore, what the GAAP is trying to introduce is a governance structure similar to the principles that usually guide private market participants, as defined in Chapters II and III of this thesis. This regulatory framework is complemented by, following the classification given by Behrend[159], the third group of principles introduced by GAAP.

In this regard, the third group requests that SWFs employ appropriate investment and risk management frameworks. The most important principles are described below:

> **GAPP 18. Principle**
>
> The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.
>
> *GAPP 18.1. Subprinciple.* The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.

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158 *See* "Generally Accepted Principles and Practices" International Working Group of Sovereign Wealth Funds (14 May 2011), online: *International Working Group of Sovereign Wealth Funds* <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> *supra* note 141.

159 *See* Sven Behrendt, "The 'Santiago Principles' of the International Working Group of Sovereign Wealth Funds: Blueprint from a 12-Point Action Plan" *Carnegie Middle East Center* (22 July 2011), online: Carnegie Middle East Center <http://www.carnegieendowment.org/files/S_Behrendt_IWG_12_Point_Action_Plan-final.pdf > *supra* note 145 at 3.

GAPP 18.2. Subprinciple. The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.

GAPP 18.3. Subprinciple. A description of the investment policy of the SWF should be publicly disclosed.[160]

GAPP 19. Principle

The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.

GAPP 19.1. Subprinciple. If investment decisions are subject to *other than* economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.

GAPP 19.2. Subprinciple. The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.[161]

GAPP 20. Principle

The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.[162]

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160 *See* "Generally Accepted Principles and Practices" International Working Group of Sovereign Wealth Funds (14 May 2011), online: *International Working Group of Sovereign Wealth Funds* <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> *supra* note 141.

161 Ibid.

162 Ibid.

GAPP 21. Principle

SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.[163]

GAPP 22. Principle

The SWF should have a framework that identifies, assesses, and manages the risks of its operations.

GAPP 22.1. Subprinciple. The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.

GAPP 22.2. Subprinciple. The general approach to the SWF's risk management framework should be publicly disclosed.[164]

As stated above, the third group seems more to be concerned with providing guidelines to avoid mismanagement of SWFs, especially risks involving SWFs investment activities. The other preoccupation of these principles is to assure managers are rational; in other words, managers

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163 Ibid.

164 Ibid.

must only act as profit maximizers and have financial interests in relation to their investment activity.

5.1 Conclusion

At the outset, from these set of twenty four principles or guidelines, one thing is undeniable: SWFs are intended to behave like other market participants, or even better if such guidelines are implemented. Although designed as 'principles' and not as detailed rules, the document is intended to serve as a 'framework' within which greater 'rule-orientation' would evolve over time; that is, a work in progress but with a direction. At best, the set of principles establish a rationale from which SWFs should regulate themselves and attend to IFM operational rationale. The framework, therefore, would be quasi-self-regulatory or self-regulatory in a very constrained manner. As stressed by Joseph F. Norton, what transpired – from the Santiago Principles - has been a *sui generis*, *ad hoc*, 'multi-level, rule-oriented governance network process[165]. The author concludes by stating:

> Significant about the GAPP is that each of the Principles is accompanied by an 'Explanation and commentary' that endeavors to develop and to interpret the substantive issues related to each Principle. This approach is intended to provide general principles and practices that 'are potentially

165 *See* Joseph J. Norton, "The `Santiago Principles` for Sovereign Wealth Funds: A Case Study on International Financial Standard-Setting Process," (2010) 13:3 *J. Int'l Econ. L.* 645.

> achievable by countries at all levels of economic development'. As such, the GAPP should not be considered a final product, but rather a starting point in an ongoing dialog concerning SWFs and their role in the international financial and economic systems.[166]

This *sui generis*, ad hoc, multi-level and rule-oriented governance network process Norton is talking about refers to the notion that the GAAP is not really a final product or a regulatory system; it is a unique governance framework designed specifically to constrain SWFs within IFM's operational rationale. This view suggests that SWFs are trying to become legitimate institutions for the purpose of compliance with IFM's rationale and regulatory standards, as suggested by A. Monk and discussed in the previous section.

It is undeniable that GAAP had a positive impact over SWFs performance within IFM. It is also remarkable that over the past years we have seem a series of "annual reports" from the biggest and formerly secretive SWFs known in the world[167], which indicates an improvement in relation to disclosure and application governance mechanism. Nevertheless, we are still far from creating "trust" among market participants. In this regard, the GAAP seems more an attempt to "leave things as they are" and

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166 Ibid at 650.

167 *See* Ashby Monk, "Recasting the Sovereign Wealth Fund Debate Trust Legitimacy and Governance" *Social Science Research Network* (27 November 2009), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862> *supra* note 11 at 7.

intend SWFs can one day shape themselves in order to behave like a private player, under neoclassical terms. The approach does not take into consideration the IFM operational rationale; neither does it offer mechanisms of protection to market participants.

That said, I suggest this view solves the problem partially and a more appropriate regulatory approach towards SWFs should be taken, in addition to GAAP, as it will be demonstrated in the next Chapter.

Chapter 6: Regulatory response – dealing with SWFs

This Chapter provides an overview about how regulatory action has been taken towards SWFs. As stated at Chapter II of this thesis, this analysis will only take into consideration the United States regulatory system. Although a broader analysis of the subject would be valuable, such an endeavor is not included with the scope of the thesis that will provide only a broad, general, and theoretical overview of the subject. The hypothesis presented in this thesis relates to theoretical patterns of the market and not to an analysis of a specific market, such as the United States.

In addition, time and space constraints do not permit a detailed analysis. The choice of jurisdiction was only made as the United States seems to be one of the main targets for SWFs investment[168].

Therefore, the current section aims to addresses:

- Restrictions on SWF investment in the United States;
- SWF exposure to legal action in the United States Courts;
- Proposals to mitigate the impact of SWFs within IFM.

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168 *See* "Disclosure of Sovereign Wealth Enterprises and Critical Sovereign Wealth Fund Identifiers" *Sovereign Wealth Fund Institute* (04 July 2011) online: Sovereign Wealth Fund Institute <http://www.swfinstitute.org/statistics-research/disclosure-of-sovereign-wealth-enterprises-and-critical-sovereign-wealth-fund-identifiers/>.

The following section serves to inform the first steps taken in order to achieve formal trust, as defined in Chapter 4. I suggest that in addition to the efforts made to constrain SWFs within the IFM operational rationale; there should be additional regulation in place to avoid the problems previously discussed.

6.1 The regulatory status quo

SWFs must abide by the same rules as private pools of capital, such as private equity funds or hedge funds[169] and are considered "foreign government entities" whose investments in the United States are subject to review by the Committee on Foreign Investment in the United States (CFIUS)[170].

Lauder indicates the main attributions of CFIUS:

> CFIUS acts as a gatekeeper, created by and tasked with enforcing U.S. laws that restrict foreign investments that may impair national security interests[171]

James clearly explains the nature of CIFUS:

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169 *See* Richard Epstein & Rose Amanda, "The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow," (2009) 76:1 *U.Chi.L.Rev.* 111 supra note 1 at 113.

170 *See* "The Brave New World of Sovereign Wealth Funds" *Lauder Institute of Management and International Studies* (20 May 2010), online: The Lauder Institute <http://knowledge.wharton.upenn.edu/papers/download/052810_Lauder_Sovereign_Wealth_Fund_report_2010.pdf> *supra* note 118 at 59.

171 Ibid.

> The Committee is an interagency organization that serves the President in overseeing the national security implications of foreign investment in the economy[172].

The problem created by the qualification of SWFs as sovereign entities is the potential application of the Foreign Sovereign Immunities Act (FSIA). Although I do not wish discuss whether or not such act is applicable, the point must be stressed that SWFs do fall within the exceptions provided in the act. Therefore, the act allows U.S. Courts to exercise jurisdiction over foreign sovereigns under certain circumstances, including the following[173]:

- the foreign sovereign waives its immunity;
- the suit against the foreign sovereign arises out of a commercial activity in the United States or impacts the United States; or
- the suit arises out of violations of international law or involves money damages sought against a foreign state for torture, various acts of terrorism, or extrajudicial killings

Slawotsky while discussing the application of FSIA argues:

> Foreign sovereigns enjoy privileges, bear responsibilities, and are subject to restrictions over and

172 *See* James K. Jackson, "The Committee on Foreign Investment in the United States" *Federation of American Scientists* (18 June 2011), online: Federation of American Scientists <http://www.fas.org/sgp/crs/natsec/RL33388.pdf> at 4.

173 *See* "The Brave New World of Sovereign Wealth Funds" *Lauder Institute of Management and International Studies* (20 May 2010), online: The Lauder Institute <http://knowledge.wharton.upenn.edu/papers/download/052810_Lauder_Sovereign_Wealth_Fund_report_2010.pdf> *supra* note 118 at 62.

> above those applied to their garden-variety, nonsovereign counterparts. [174]

As observed by SEC Chairman Cox, SWFs while conducting commercial activities within the U.S. territory would fall within the exemptions provided in the FSIA:

> Neither international law nor the Foreign Sovereign Immunities Act renders these funds immune from the jurisdiction of U.S. courts in connection with their commercial activity conducted in the United States.[175]

This is how currently US Regulators see SWFs investment activity within the US territory. This view suggests an inherent duality[176] for SWFs. On one hand they are considered subject to the same rules private players shall abide to and, on the other hand, their investments are subject to review by CFIUS. This dichotomy affects how regulatory action is taken towards such investment vehicles and also stresses the relationship between politics and regulation, which seems to be a big issue among proposals to regulate SWFs.

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174 *See* Joel Slawotsky, *"Sovereign Wealth Funds and Jurisdiction Under the FSIA,"* (2009) 11:4 *U Pa J Bus L* 967.

175 *See* Christopher Cox, "Speech by SEC Chairman: The Rise of Sovereign Business," online: Securities and Exchange Commission <http://www.sec.gov/news/speech/2007/spch120507cc.htm> *supra* note 138.

176 *See* "The Brave New World of Sovereign Wealth Funds" *Lauder Institute of Management and International Studies* (20 May 2010), online: The Lauder Institute <http://knowledge.wharton.upenn.edu/papers/download/052810_Lauder_Sovereign_Wealth_Fund_report_2010.pdf> *supra* note 118 at 58.

In fact, if SWFs are considered to be private players, certainly they will have to comply with the same regulatory regime other private participants shall abide to. Epstein, in a great article entitled “The regulation of Sovereign Wealth Funds: The virtues of going slow” provides a good example about the application of the law:

> For example, they must make disclosures pursuant to § 13(d) of the Securities Exchange Act of 1934 (“Exchange Act”) if they acquire a 5 percent or greater equity stake in a public company[177], but are not subject to the more onerous reporting requirements that burden registered investment companies.

Epstein continues by positing:

> Just like domestic investors, SWFs are also subject to the antifraud provisions of the securities laws, the antitrust laws, and state corporate law. If, as some have worried, an SWF were to engage in industrial espionage, it could be held accountable in the United States under a variety of legal theories. In addition to the foregoing laws of general applicability, various US statutory regimes restrict foreign control in certain sensitive industries, like nuclear energy and airlines. Moreover, foreign investments in domestic companies are also subject to review by the interagency Committee on Foreign Investment in the United States (CFIUS), as recently codified in the Foreign Investment and National Security Act of 2007(FINSA).

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177 See Richard Epstein & Rose Amanda, "The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow," (2009) 76:1 *U.Chi.L.Rev.* 111 *supra* note 1 at 7.

From Epstein's approach to the subject, SWFs are subject to the *Securities Exchange Act of 1934*, as well as other US provisions such as the Antifraud Law and the *Foreign Investment and National Security Act of 2007* (FINSA). Notwithstanding, the most important regulation which can be used against SWFs investment activities is the FINSA, which established the CFIUS and provided oversight over investment activities that could potentially violated or infringe national interests and security.

6.2 Proposals to mitigate the impact of SWFs within IFM

Besides the foregoing restrictions, there no other requirements or restrictions in place against SWFs' activities. Although parties to a proposed transaction that falls within CFIUS's jurisdiction are under no legal obligation to notify the committee, they do so as a matter of course so as to avoid the possibility that their transaction will be undone later as a result of CFIUS review[178].

Currently, CFIUS does not create any alternative to foreign investments (direct investment or portfolio) which fall within the restrictions of FINSA, besides approving or rejecting the transaction. The Exon-Florio provision[179] grants the President broad discretionary authority to take what

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178 Ibid.

179 Following its creation by Executive Order, the Committee met infrequently and played a low-profile role in monitoring foreign investment in the economy until 1988, when Congress approved the Exon-Florio provision, *in* James Ke Jackson, "The Exon-Florio National Security Test for Foreign Investment" *Federation of*

action he considers to be "appropriate" to suspend or prohibit proposed or pending foreign acquisitions, mergers, or takeovers which "threaten to impair the national security". As a result, foreign investors willing to engage in an activity which would in theory "threaten to impair the national security", which is very discretionary and subjective, have no incentives to subject the proposed transaction to CFIUS mainly because:

- a foreign investor may decide not to disclose his position simply because in theory he is not obliged to do so or believes his transaction does not "threaten to impair the national security";
- if he decides to disclose, then the transaction will be subject to approval or rejection. There is no provision which allows CFIUS to propose an alternative or restriction to the proposed transaction.

The fact that there is no direct surveillance or duty to inform for transactions involving SWFs which may infringe national interests and security, as broad as such terms might be, is something that cannot be ignored. The question is: should parties have a legal obligation to inform whether they are conducting business with SWFs? The answer is: if we want to preserve the system as it is, then the answer is most definitely yes.

Take for instance, the following examples:

American Scientists (18 June 2011), online: Federation of American Scientists <http://www.fas.org/sgp/crs/natsec/RS22197.pdf> at 3.

- If a SWF decides not to disclose its position and, in order to perform certain investment, if the fund decides to use an special purpose vehicle (SPV) incorporated in a tax haven jurisdiction, with limited disclosure, nothing can assure that CFIUS will actually be effective in its duties.
- A SWF decides to lend money to a company (through the acquisition of bonds – convertible or not) and creating a security interest (or a lien) in the company's shares or assets, which would include limitation to shareholder rights. Using such structure, the fund would be able to have a risky influence over the company's decisions (due to the limitation of shareholders rights imposed by the lien or security interest).

From these two basic examples it is not an absurd to assure that the likelihood of these two transactions being detected by CFIUS, unless informed by the parties, will be extremely low, considering the system as it is.

Therefore, I suggest parties should be obliged to inform CFIUS whether they are conducting business with SWFs and, if by any reason the United States feels threatened by SWFs investment activities, it should then, in addition to rejecting or approving the transaction, create alternative mechanisms to reduce the impact of such investments within its market. This mechanism based on mandatory disclosure and case by case analysis of all investment activity (which falls within the scope of FINSA) has all the credentials, if duly executed, to create formal trust among market participants.

The duty to inform whether a deal is being conducted with a SWF would increase the effectiveness of CFIUS, as such obligation in theory would reduce the cost of surveillance. Nowadays, FINSA section 2, paragraph b(1)(A) leaves to the discretion of parties whether or not to inform CFIUS about a proposed transaction:

> IN GENERAL.—Upon receiving written notification under subparagraph (C) of any covered transaction, or pursuant to a unilateral notification initiated under subparagraph (D) with respect to any covered transaction, the President, acting through the Committee:
>
> (i) shall review the covered transaction to determine the effects of the transaction on the national security of the United States; and
>
> (ii) shall consider the factors specified in subsection (f) for such purpose, as appropriate[180]

CFIUS system works through a voluntary notification mechanism, therefore the likelihood of such mechanism identifying any intended covered transaction is extremely low, because it depends exclusively on the parties´ willingness to subject the transaction to CFIUS review. In a situation whereby a party wishes to disclose its transaction in order to avoid any

180 See *Foreign Investment and National Security Act*, FINSA, 2007, c.2, s.2., §1 (A).

future impediment or problem, this mechanism would work perfectly; however, there must be considered a situation whereby parties do not want to disclose their positions, then if no sanctions are imposed or incentives created, then the systems will not be effective; mandatory disclosure would in theory reduce such problems.

On the other hand, the case by case analysis offers an alternative and an incentive to simply rejecting the transaction. Imposing restrictions to SWFs investments (through CFIUS) would be an effective way to safely increase the share of SWFs' investments within United States and motivate SWFs to enter the American market.

The mandatory disclosure regime, combined with limitations/restrictions imposed by CIFUS (on a case by case basis) to investment activity performed by SWFs would in theory create formal trust within IFM. Some scholars have already suggested some good proposals to address the issues presented in this thesis.

Truman[181], for instance, was the first to propose limitations to shareholder rights to shares owned by SWFs. No doubt such proposal is valid and would in theory reduce problem related to political interference of

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181 *See* Edwin M. Truman, "A Blueprint for Sovereign Wealth Fund Best Practices" *Peterson Institute for International Economics* (07 December 2009), online: Peterson Institute for International Economics <http://www.iie.com/publications/pb/pb08-3.pdf> *supra* note 145 at 4.

SWFs over the invested company. However, I suggest that such proposal has limitations mainly for two reasons:

- Truman did not set out the mechanism by which such limitations would be legitimized or rules established.
- acquiring a stake in a company or corporation that cannot be controlled (or even influenced) by the fund seems to be a good investment only if directed to public corporations (listed companies), considering the goal of such investments are usually related to speculation. If the company or corporation is not listed, then having limited shareholder rights is not beneficial to the fund, due to the lack of liquidity of such invested shares.

In order to address the issues not tacked by Truman, I suggest that FINSA should be amended as to impose mandatory disclosure of any proposed transaction which falls within the scope of FINSA in order to set the foundation to create a system which combines mandatory disclosure with sanctions to parties that do not submit their transaction to CIFUS review (e.g nationalizing assets controlled by SWFs related to transactions that have not been submitted to CIFUS review).

In addition, reviewing every transaction and deciding on a case by case basis whether or not to approve, reject or impose restrictions to a specific SWF investment is a simple but efficient approach to the problem.

Obviously CFIUS decision would vary from one transaction to the other, but imposing certain restriction could be very effective.

For instance, CIFUS while reviewing a transaction would be able to determine specific disclosure requirements for certain transactions or even limitations to ownership or shareholders rights (as proposed by Truman). In this regard, CIFUS could impose, for a proposed transaction that falls within the scope of FINSA, that ownership of a SWF in a company or corporation must be limited to e.g. ten percent in order to avoid a controlling position of a SWF within the company.

In addition, CIFUS could also allow a SWF to have more than ten percent of share in a company or corporation, but limit its shareholders rights (as proposed by Truman) or require that SWF are only allowed to have a controlling position if all decisions taken in the invested corporation are taken by independent directors, duly certified by CIFUS. Therefore, the assets owned by SWFs would be managed by certified financial managers/experts, reducing any risk of political interference SWFs may have in the company. These managers would in theory be profit maximizers and attend to IFM operational rationale.

Another alternative would be determining that SWFs would only be allowed to invest in the United States only through SPVs incorporated within the American territory. That way, such companies would be under direct supervision of CIFUS, have special disclosure requirements and their assets would in theory guarantee any sanction a SWF may suffer if it decides to violate FINSA. CIFUS could also limit the size of these SPVs in order to reduce SWFs share within the market. Instead of controlling capital flows into the country, the creation of SPVs would limit or increase the flow of investment from SWFs within the American territory.

Amongst the proposals above, I believe investing through SPVs is the best one, mainly because CIFUS would be able to control SWFs' access to the American market and would consequently create trust among market participants as every transaction conducted by a SWF would in theory be under supervision of CIFUS. In addition, the assets owned by a SWF would necessarily belong to their respective SPV (incorporated within the American territory) facilitating enforcement measures eventually taken by the United States.

As we can see, there should be a more effective set of rules created to avoid any potential political interference, harm or instability SWFs may cause to the United States. I strongly believe that the proposals presented above would solve part of the problem regarding SWF investment within United States, but would not solve the problem in relation to investments performed abroad, as the IFM current regulatory framework is not able to provide formal safety for regulators and/or market participants, neither is able the create trust among recipient countries and SWFs, as demonstrated in Chapter 4.

Chapter 7: Conclusion

Throughout the thesis I have explored the theoretical rationale behind IFM regulatory framework. The way IFM is structured definitely influences how regulation is designed, as market participants have an array of options to choose which functional jurisdiction to invest. In this regard, I have stressed that the process of designing a regulatory regime versus the rationale behind regulatory compliance exposes the tension between the willingness of a country to receive investments and the safeness of its regulatory system; this claim is of major importance as it suggests a different approach to IFM regulation, an approach from which normative action is taken based on the assumption that SWFs are not regular market participants.

RCT proved that within IFM market participants usually comply with certain regulatory regimes if doing so is profitable. In the other hand, countries need foreign investment and tend to design regulatory systems based on self-interest models in order to create incentives and attract foreign capital. This combination may lead to weak regulatory regimes, whose efficacy against SWFs is questionable, due to the rationale from which IFM regulatory regime is designed.

At the outset of these theories, I have suggested that SWFs current levels of governance and transparency are not able to provide formal trust among regulators and market participants, neither are able the create trust among investment recipient countries and SWFs, as IFM current regulatory framework is based on the efficient market theory and any attempt to regulate SWFs, within the boundaries of such theory, would fail, simply because SWFs are not regular market participants; inherently there will always be the risk of political use or manipulation of these funds.

In this context, even though IWG`s proposed GAAP could help reducing concerns raised so far, the analysis carried out showed that GAPP does not take into consideration the IFM operational rationale; neither does it offer mechanisms of protection to market participants. The prescriptions I have made in Chapter 6 addressed these two major problems and in my viewpoint represent a fundamental stepping stone to creating formal trust within the U.S. market. In this particular matter, it is important to emphasize that the proposals regarding the U.S market are only feasible because they suggest a new regulatory approach; an approach which brings the entity and assets involved in SWFs transactions firmly within the sovereignty of the United States, creating the possibility to enforce any necessary legal action against SWFs and create formal trust.

In contrast, the IFM has no sovereign power and therefore formal trust would never be achieved, as IFM lacks enforceability. Although the meaning of enforceability and formal trust can be created in the IFM is beyond the scope of my thesis, it would be a good research question for further scholarly research; further regulatory action is indeed necessary.

The central point I wanted to make and prove is that the current IFM regulatory framework and operational rationale are not able to provide formal trust to SWFs activities within IFM.

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