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Are we sincere about regulating sovereign wealth funds?

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Table of Contents

I. Introduction

II. Definition of SWFs, On Paper Objectives and Main Differences between Other State-Related Financial Tools

III. A Brief History and Current Statistics

IV. The case of Abu Dhabi Investment Authority (ADIA)

V. Background of Investment Strategies and Fear of China

VI. Corporate Governance Principles and SWFs

- a. Can SWFs be taken as companies?
- b. Similarities with Institutional Investors
- c. Shareholders of SWFs
 - (i) Who are the shareholders of SWFs?

(ii) Do SWFs become shareholders themselves once they invest in corporations?

d. Shareholder benefit

e. Applying corporate governance principles to SWFs

VII. Regulating SWF Regulation under classical regulatory governance theories

a. SWF Regulation under classical regulatory governance theories

b. SWF-Specific Regulation : Santiago Principles

VIII. Investment protectionism

IX. Conclusion

I. Introduction

Sovereign Wealth Funds (SWFs) took considerable academic attention especially in the years 2007-2008 after their contribution to Western markets at the wake of the recent financial crisis. Nevertheless they raised national security and market efficiency concerns in the investment receiving countries because of the alleged deficiencies in their transparency, governance structures and more importantly the organic relationship they are in with the sovereign state.

Professor Nouriel “Doom” Roubini claims that the ability of the US to dictate the terms of new reforms to prevent a crisis is limited. He believes that the changes in global economic governance will play out under the eye of new stakeholders, namely Brazil, Russia, China, India and the other countries that make up the ascendant G-20 and that the increasing power of these nations and new players and institutions, including the SWFs will change the shape of future crisis.¹ He further analyses that the central banks and SWFs may start to hold currencies of emerging-market economies as part of their reserves instead of U.S dollar and- although it won't threaten the role of the dollar as the major reserve currency as it doesn't have significant alternatives, if the U.S. keeps running large deficits, the resulting high inflation will accelerate the decline of the U.S. dollar as a major reserve currency, with unpredictable results.² Roubini also alleges that the SWFs –like the China Investment Corporation- have already started avoiding U.S. Treasury debt and instead focusing on higher yield investments, from hedge funds to mineral rights.³ Therefore, one can say that SWFs will eventually stop investing in dollar and go seek out benefit in other markets, especially emerging ones, without the necessity of U.S. keeping the entry barriers high or low, if it does not financially gussy up.

What might be frightening or threatening about them is maybe not the current position they hold in overall investment nor their actual management style but the enormous speed of their growth as the aggregated size of their assets has reached

¹ Nouriel Roubini and Stephen Mihm, *Crisis Economics, A Crash Course In The Future Of Finance*, (Penguin Books, 2011)

² *Ibid*, 265.

³ *Ibid*, 256.

-\$4,436.2 billion by June 2011, where more than its half, -\$2,628.7 billion, is oil & gas related-⁴ and the forecasts suggesting that this number could approach \$10 trillion by 2015.⁵

SWFs also caught the attention of IMF which resulted in the formation of International Working Group of Sovereign Wealth Funds (IWG) in order to determine Generally Accepted Practices and Principles (GAPP) relating good governance, transparency and accountability, for SWFs to adopt to ease target countries concerns.

Can the governments resist the temptation of the market and not become an actor themselves in it?

II. Definition of SWFs, On Paper Objectives and Main Differences between Other State-Related Financial Tools

The first definition of SWFs adopted in academic world is the one made by the US Treasury Department. Robert Kimmitt identified SWFs in 2008, as government investment vehicles funded by foreign exchange assets and managed separately from official reserves whose managers typically have higher tolerance for risk and seek higher returns than do official reserve managers.⁶

The most up-to-date legal definition of SWFs is the one made by IWG under Santiago Principles. IWG defined SWFs as special purpose investment funds or arrangement that are created by the general government for macroeconomic purposes and owned again by the general government itself.⁷ They hold, manage or administer assets to achieve financial objectives and employ a set of investment

⁴ Sovereign Wealth Fund Rankings, *Largest Sovereign Wealth Funds by Assets Under Management accessed on <http://www.swfinstitute.org/fund-rankings/>* (July 19, 2011)

⁵ Jen. S. and S. Andreopoulos, *SWFs: Growth Tempered – US \$10 Trillion by 2015*, Global Economic Forum, (November 2010)

⁶ Robert Kimmitt, Public Footprints in Private Markets. Sovereign Wealth Funds and the World Economy. (Foreign Affairs, January/February 2008)

⁷ Sovereign Wealth Funds, Generally Accepted Principles and Practices- "Santiago Principles", Objective and Purpose, IWG International Working Group of Sovereign Wealth Funds, May 2008. It is further explained in the Appendix I of Santiago Principles that the term *arrangement* is chosen on purpose as an alternative to *funds* in order to allow for a more flexible interpretation of the legal arrangements through which the assets can be invested.

strategies that include investing in foreign financial assets.⁸ They are a heterogeneous group, comprising fiscal stabilization funds, saving funds, reserve investment corporations, development funds and pension reserve funds without explicit pension liabilities.⁹ Yet the IWG excluded *inter alia*, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary purposes, state owned enterprises in the traditional sense, government- employee pension funds or assets managed for the benefit of individuals.¹⁰ Furthermore in the Appendix I to the Santiago Principles, IWG points out that: "(...) *the SWFs are commonly established out of balance of payment surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses and/ or receipts resulting from commodity exports.*"¹¹ This illustration reflects both the traditional background to the creation of SWFs –the mineral wealth based revenues- and the more recent approach of the "excess reserves" transfer.¹²

The *excess reserve* sub-type of SWF, non-commodity funds are established through transfers of assets from official foreign exchange reserves often arising from an exchange-rate intervention involving a domestic debt to avoid unwanted inflation.¹³ Kimmitt argues that the assets of this type of SWF may be thought of more as borrowed money than traditional wealth as their net return depends on the difference between the yield earned on investments and the yield paid on domestic debt.¹⁴

Blackburn on the other hand, brings in three different alternatives to SWFs: "Voluntary" SWF where a private citizen decides whether he/she wants to invest in a fund; a lump sum remitted to citizens- similar to a tax rebate program in the United States and a paying fixed percentage to every generation.¹⁵

⁸ Ibid.

⁹ Ibid.

¹⁰ Ibid, note 6.

¹¹ Ibid, Appendix I.

¹² Ibid.

¹³ Ibid,3.

¹⁴ Ibid.

¹⁵ John Blackburn, Brent DelVecchio, Ira Fox, Carl Gatenio, Omar Khayum and Daniel Wolfson, *Do Sovereign Wealth Funds Best Serve The Interests Of Their Respective Citizens?*, (University of Chicago, Graduate School of Business, 24 March 2008), accessed on <http://ssrn.com/abstract=1309285> 21.

He further underlines the differences between SWFs and other state-related financial entities. He argues that SWFs are different from public pension funds, international reserves and state-owned enterprises yet all have common traits. Public pension funds are dominated and funded in the local currency; international reserves are external assets controlled by and readily available to ministries and central banks for direct financing of international payment imbalances that countries keep them on hand to cushion export shortfalls.¹⁶ SWFs also differ from state owned enterprises as they do not have a particular company objective in a *strict ultra vires* sense and SWFs either have a legal personality established under a specific constitutive law- also established by specific constitutive laws- some established by general fiscal (budget or fiscal responsibility) laws, and one under the central bank law- or they constitute a private corporation established under company law, that is usually controlled by the Ministry of Finance and operationally managed by the central bank or a statutory management agency.¹⁷

SWFs are moreover confused with hedge funds and central banks. They differ from central banks as SWFs do not control monetary policy –only influence it-, do not have the power to control the amount of credit-money created by the banks, do not have a regulatory authority nor do they take direct preventive actions in the event of a financial crisis. They are not the legal tender of notes and coins. The sole resemblance between SWFs and central banks is that although unofficially, forex based SWFs act as the agent of the government with foreign exchange matter whereas it is legally central bank's duty to intervene in the foreign exchange markets on behalf of the government in order to influence the exchange value of the domestic currency.¹⁸

As for the hedge funds, there are different from one another and there is no generally agreed-upon definition of a hedge fund.¹⁹ Alon Brav et al. deduced four common characteristics for hedge funds: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional

¹⁶ Kimmitt, 2.

¹⁷ Simone Mezzacapo, *The so-called "Sovereign Wealth Funds": regulatory issues, financial stability and prudential supervision*, (Economic Papers 378, April 2009, European Commission Directorate-General for Economic and Financial Affairs Publications.)

¹⁸ Barbara Casu, Claudia Girardone and Philip Moyneux, *Introduction to Banking*, Pearson Education, (2006) 111

¹⁹ Securities and Exchange Commission roundtable discussion on hedge funds considered 14 different possible definitions.

investment managers with performance-based compensation and significant investments in the fund; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements and more specifically, hedge funds avoid the Investment Company Act of 1940 by having a relatively small number of sophisticated investors...²⁰ In these premises, SWFs and hedge funds seemed to be lookalikes only because basically both are funds and thus escape some regulation.

IWG further discusses SWFs' definition in detail in the Appendix I to the Santiago Principles and determines three key elements defining an SWF: ownership type, investment strategies and its purposes and objectives...²¹

To begin with, the ownership criterion as concluded by IWG indicates that the term *general government* comprises both central and sub-national governments. As for the investment strategies, IWG emphasized that it is solely focused on foreign international assets, thus excluding the funds investing in domestic assets. Finally, SWFs macroeconomic financial objectives result in the liabilities that are only broadly defined thus allowing them to employ a wide range of investment strategies with a medium- to long-term timescale...²²

IWG also outlines three main guiding objectives for SWFs:

- i. To help maintain a stable global financial system and free flow of capital and investment;*
- ii. To comply with all applicable regulatory and disclosure requirements in the countries in which they invest;*
- iii. To invest on the basis of economic and financial risk and return-related considerations; and*

²⁰ Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, (The Journal of Finance Volume 63, Issue 4, pages 1729–1775, August 2008)

²¹ Santiago Principles.

²² Ibid.

iv. To have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability.”²³

To concretize the abovementioned arguments, we think it is necessary to take a closer look at some of the most contradictory SWFs management structure, their investment policies and some of their prominent investments.

III. A Brief History and Current Statistics

After the World War II, the governments' direct intervention in the business affairs was welcomed since it was seen as the guard of public interest in business life.²⁴ It has been since argued whether public finance is cheaper than private finance. As in corporate finance the risk of the project is key to determining its cost, public finance appears to be cheap because the risk is borne by future taxpayers.²⁵ Ken Arrow and R.C. Lind allege that government projects bear less risk for two main reasons: risk pooling and risk spreading. Risk bearing by the government results in a truly risk-free discount rate reflecting the risk-neutrality of government and as for risk spreading, the government can spread it out among the entire tax base, idiosyncratic risk is reduced as far as it can be.²⁶

Nuno Fernandes categorizes SWF waves in two parts: The first wave set up by oil producing nations after the price increase in the 1970s and 1980s whereas the second characterized by the late 1990s East Asian financial crisis which motivated region's emerging markets shift from being debtors to being creditors as today they hold more reserves than they actually need.²⁷

The oldest SWF is Kuwait Investment Authority (KIA) founded in 1953 as Kuwait Investment Board which later embodied both state funds the Future Generations Fund (FGF) and General Revenue Fund (GRF). Kyle Hatton and

²³ Ibid, Objective and Purpose.

²⁴ Especially in post-war France and Japan. USA stayed mostly out of it apart from the defense industries. See Hansmaan; Andrew, Shonfield, *Modern Capitalism : The Changing Balance of Public And Private Power*, (1967).

²⁵ K. Arrow and R. Lind, "The Uncertainty and the Evaluation of Public Investment Decisions", *American Economic Review*, 1970., cited in Blackburn.

²⁶ Ibid, 20.

²⁷ Nuno Fernandes, *The Sovereign Wealth Funds: Investment Choices and Implications around the World*, (IMF International, Research Paper, March 2011) 7.

Katharina Pistor who made a case study on Kuwait resumes its naissance as “*When the 1982 Souk al Manakh stock market crash threatened the survival of almost every large company in Kuwait, the government stepped in to purchase shares in the traded companies from the public—and a new entity was needed to manage these companies. Thus, the KIA was born.*”²⁸ The authors further claim that the fund (i) separates the private affairs of the ruling family and the public affairs and (ii) distributes the wealth in some way since it cannot be distributed directly to merchant class as it is not a sustainable policy for loyalty building and royal family wouldn’t agree on it anyway; thus the fund serves transforming a natural resource monopoly into an effective monopoly on capital.²⁹ Therefore it wouldn’t be wrong to generalize this implication and say that royal wealth backed SWFs are efficient political catalysts, considering they are based on countries facing serious unfairness in income distribution and democracy issues. The authors’ prediction on royal family’s future financial course is not absurd that it will still have the control over the wealth generating fund when the oil stuck runs out.³⁰

Today, there exist fifty three SWFs, majority of which are of East Asian origin.³¹

Currently today, according to Sovereign Wealth Fund Institute’s database, by the end of July 2011, the wealthiest SWF is Abu Dhabi Investment Authority (ADIA) by \$627 billion assets, followed by Norway’s Government Pension Fund with its \$571.5 billion and by Chinese SAFE Investment Company holding \$567.9 billion assets out of the aggregated sum of a \$4,436.2 billion.³²

Geographically, Asia leads with 40% followed by Middle-East at 35% and Europe at 17% overall. Also the graphic shows that the major funding source is oil & gas related at 58% .³³ The most active SWF is Singapore’s Temasek Holdings.³⁴

²⁸ Kyle Hatton and Katharina Pistor, *Maximizing Autonomy in the Shadow of Great Powers The Political Economy of Sovereign Wealth Funds*, (Columbia Law and Economics Working Paper No. 395, March 15, 2011) online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787565

²⁹ *Ibid*, 14.

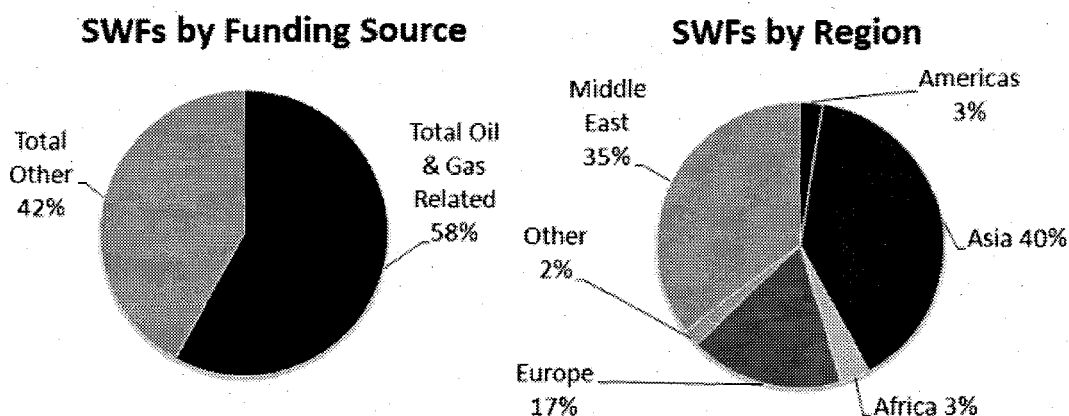
³⁰ *Ibid*, 15.

³¹ See <http://www.swfinstitute.org/> for the full list of SWFs.

³² SWF Institute Fund Rankings, July 2011

³³ See Deutsche Bank Research on *SWFs and foreign investment policies- an update*, (October 22, 2008) for a meticulous study on SWF statistics.

By adding up the assets of each SWF that belongs to a specific country, we reach the result that China has the biggest slice of the cake with its \$1,344.1 billion, followed by UAE \$719.1 billion; Norway with \$571.5 billion; Saudi Arabia with \$472.5 billion and Singapore with \$404.7 billion...³⁵ This shows that the three or four if we include Singapore as well -which raises doubt about its true colors- out of top five countries dominating SWF overall wealth belong to the *other side*.



*SWF Institute database, updated November 2010

IV. The case of Abu Dhabi Investment Authority (ADIA)

ADIA, the wealthiest SWF of the World constitutes an example of professionalism with its internal management structure, decision process and different committees each enjoying a significant role in these two. It is worth taking a closer look at some of its features to see how a state further a royal family fund can have a more sophisticated system where the balance between different interests are being even out despite the control of the Emir.

³⁴ SWF Institute Fund Rankings.

³⁵ Based on the latest data published by SWF Institute in July 2011.

ADIA, is a globally diversified investment institution that is wholly owned by the Government of Abu Dhabi, established in 1976. Contrary to corporations' objectives, SWFs have broadly defined missions. The mission that ADIA undertakes is .to invest funds on behalf of the Government of the Emirate of Abu Dhabi to make available the necessary financial resources to secure and maintain the future welfare of the Emirate thus take the role we of the guardian of Abu Dhabi's financial security.³⁶

On ADIA's official web page, it is stated that ADIA's decisions are based solely on its economic objectives of delivering sustained long-term financial returns through an investment strategy focused on long-term value creation and that ADIA does not seek active management of the companies in which it invests..³⁷

ADIA has a very sophisticated and 'good on paper' organizational structure, yet the management; including Chairman, Managing Director, together with other Board members, are appointed by a decree of the Ruler of the Emirate. Furthermore it is no surprises that the top level management comprises of the names either royals, sheiks or people very close to the royal family.,

The Board holds primary responsibility for the implementation of ADIA's strategy in accordance with Law (5) of 1981 of the Emirate of Abu Dhabi. It also oversees ADIA's financial performance and the activities of management. The Board does not involve itself in ADIA's investment and operational decisions, for which the Managing Director is responsible under the law..³⁸ ADIA seemed to have adopted the notion of "independent CEO" which puts it beyond modern corporations as they are still arguing whether appointing an independent CEO although recent corporate governance literature is insisting on its efficiency and necessity.

It also comprises five different committees vested with different authorizations, maybe the most important one amongst them is the Investment Committee, with its role of assisting the Managing Director by reviewing and making recommendations on investment proposals originated by ADIA's investment

³⁶ <http://www.adia.ae/En/About/Mission.aspx>

³⁷ http://www.adia.ae/En/About/Guiding_Principles.aspx

³⁸ <http://www.adia.ae/En/Governance/Governance.aspx>

departments. The Investment Committee comprises the Managing Director as its Chairman, in addition to senior executives from across ADIA's investment and support departments.

A number of advisory committees and departments support the Investment Committee, including:

The Strategy Committee advises on ADIA's overall investment strategy; whereas The Guidelines Committee formulates and advises on investment guidelines for individual investment departments; The Evaluation & Follow Up Department provides independent analysis and advice on investment proposals received from the investing departments, and evaluates the performance of ADIA's internally and externally managed assets.³⁹ As seen, ADIA does not merely hold specialists advising it on project basis but legally established persistent committees each intervening at a different level of the investment. This feature is the proof of a very professional investment process, whether democratic or not.

Although good on paper, ADIA has recently become involved in assertive investments as proving it thinks big, acts as the investment vehicle of the government and get involved in infrastructure and energy deals. In March 2011, Abu Dhabi Investment Authority (ADIA) formed a partnership with South Korea for joint investments. The partnership signifies closer relations between South Korea and the UAE, and reflects opportunities for South Korea's state-run funds such as the National Pension Service (NPS) –the world's fifth largest pension fund and the Korea Investment Corp (KIC) to exert greater influence in the global financial market. "Both nations agreed to step up efforts to support each other's state-run funds to make better investments. For example, if the UAE wants to invest in East Asia and yet lacks information, Korea's sovereign fund could help or jointly invest," said an official at the Presidential Council for Future & Vision.⁴⁰

³⁹ http://www.adia.ae/En/Governance/Investment_Committee.aspx

⁴⁰ South Korea and ADIA Form Strategic Partnership, Asset International, Tuesday, March 29, 2011 4:17:52 PM),

Furthermore in June 2011, Solveig Gas Norway, a holding company 25 per cent owned by the Abu Dhabi Investment Authority (Adia), has agreed to buy 24.1 per cent of the Gassled joint venture from Statoil, Norway's largest oil company..
“The deal is one of the largest of late for Adia in energy infrastructure, and comes as sovereign funds shift away from investments in financial services companies and increasingly towards infrastructure and commodities” concludes Asa Fitch from *The National*..⁴¹

V. Background of Investment Strategies and Fear of China

Main concerns relating SWF investment are market inefficiency –common belief that private firms allocate capital more efficiently than governments, national security, unfair competitive advantages relative to the private sector, summarizes Kimmitt..⁴²

Naturally, SWFs enjoy more political power comparing to an average private company and they may be willing to make most of it when “convincing” a company in which they have invested to act in a certain way, for example to make it open a plant in its country which is not in the works of the company during that period. Epstein explains it by using carrot and stick metaphors: (...) *First the SWF might offer the firm some carrot (like tax breaks) to induce the firm to open the plant. But the sovereign need not be an investor in the firm to pursue this strategy, and the plant opening under this scenario would be profit maximizing for the firm in any event (the firm would not take the carrot unless it is more than offset the anticipated losses from the plant opening.) Second, the SWF might threaten the firm with some stick (like blocking the firm’s access to its product markets) to induce it to open the plant (...) The SWF might also threaten to dump its shares in the firm or refuse to invest in it in the future. But this is a stick that any large investor could wave; it is in no way attributable to the SWF’s sovereign status.*⁴³

[http://www.ai-cio.com/channel/DEALS/South Korea and ADIA Form Strategic Partnership.html](http://www.ai-cio.com/channel/DEALS/South_Korea_and_ADIA_Form_Strategic_Partnership.html), accessed on 11 August 2011.

⁴¹ Adia buys stake in Norway gas, Jun 7, 2011 <http://www.thenational.ae/business/energy/adia-buys-stake-in-norway-gas> accessed on 1 August 2011

⁴² Kimmitt, 4.

⁴³ *Ibid*, 126.

It may be alleged that SWFs are less efficient and less valued in the market considering the public enterprises serve also to the interests of politicians and become inefficient. Accordingly, companies invested by SWFs may potentially be forced to choose locations and technologies that favor the SWF region of origin instead of making independent investment favoring the company itself as in the example of Abu Dhabi based fund Mubadala which holds a significant share in computer chip maker AMD is obliged to deliver social value to Abu Dhabi.⁴⁴ Taking a different point of view in the same case can end up in presumption that SWFs may also bring with them advantages that no other investor directly hold, as they can influence the government decisions in favor of the companies they invested in. According to Nuno Fernandes, these benefits may constitute of government-related contracts, open doors for invested firms to enter new markets or helping them market their products in the home markets.⁴⁵

Some authors claim that East Asian SWFs' real objective is *resource nationalism* which is characterized by the government attempt to take control of raw material sources outside their borders in order to prevent monopoly or collusion.⁴⁶

Blackburn also reminds that in some SWF countries the returns that individuals can earn on their savings are limited either by internal barriers to abroad investment or by cultural factors. In China for example, investments in Hong Kong and London markets have recently become available to Chinese citizens. In Russia on the other hand, there is a lack of trust in financial sector due to the 1990s' crisis and corruption leading one third of the population to keep their savings in cash. Thus Blackburn assigns a positive value to SWFs in such countries, as they can obtain higher returns than individual investment of citizens as long as higher investment barriers exist.⁴⁷ At that point one must lend an ear to Francis Fukuyama's sayings. He argues that political power generates economic resources which in turn generates greater political power. The sore point here is that the economic growth that took place is largely extensive rather than intensive meaning that total population and resources increased over time, but not on a per

⁴⁴ Mubadala Annual Report, cited in Fernandes.

⁴⁵ Fernandes, 3.

⁴⁶ Gerald Lyons, "State Capitalism: The Rise of Sovereign Wealth Funds.", Standard Chartered Bank publication (19 Oct 2007): 9

⁴⁷ Blackburn et al., 9.

capita basis...⁴⁸ If not projected to per capita wealth, it may be the very reason itself of discontentedness amongst people as it is subject to be seen as their own money kept away from them. Accordingly, one should keep in mind the sensitivities of targets' stock prices to changes in oil - as most of the active investor SWFs come from oil exporter countries. These SWFs funded by oil revenues might prefer stocks with negative oil price sensitivity to help them diversify their countries asset base...⁴⁹ In this direction, it would not be wrong to say that oil exporter, Middle Eastern funds hold a particular responsibility towards their citizens. As oil is non-renewable, a non-sustainable, these states must find an alternative to it to generate wealth for future. Their dilemma lies on whether extracting the oil and selling it at current market prices or keeping it under soil to sell at future prices.

As of 2011, United Kingdom attracts most of the SWF investment, followed by Singapore, Hong Kong and United States...⁵⁰ Ugur Lel and Jason Kotter compare institutional investors preference for target characteristics with SWFs' and conclude they're both similar in choosing financially-distressed, cash-constrained, large and multinational firms with poor performance and those located in financially developed countries...⁵¹

Likewise, Blackburn et al. make a distinction between SWFs regarding their investment strategies. They claim that future generation funds tend to be diversified and hold small stakes in their investment as it is in the example of Norwegian fund which holds shares approximately in 3.500 companies with less than 1% stakes whereas stabilization funds seek to deliver low risk returns. More broadly, less transparent funds are aimed for substantial but non-controlling shares to avoid disclosure requirements as in the case of Middle Eastern and Chinese SWFs...⁵²

China is probably the sole SWF country that is posing the biggest threat to Western economies. On the contrary of the belief that dependence creates co-

⁴⁸ Ibid, 467.

⁴⁹ Ibid, 366.

⁵⁰ Deutsche Bank Research, 363.

⁵¹ Jason Kotter and Ugur Lel, *Friends or Foes? Target Selection Decisions of Sovereign Wealth Funds and Their Consequences*, (Journal of Financial Economics, Volume 101, Issue 2, August 2011, Pages 360-381), 364.

⁵² Blackburn et al. 14

operation in international trade seems to have a dent. China as an export-driven country is heavily dependent on free-trade policies yet has a substantial political power which it can use as much as a US president can. It should however be kept in mind that as a rapidly modernizing and institutionalizing state, China is growing much more fast than western nations ever did and thus the central government may be justified in maintaining control of certain sectors of the economy..⁵³

Accordingly, In 2005 Chinese state-owned oil company CNOOC's attempt of acquiring U.S. oil company Unacol was stroke by Washington's national security and strategic interests concern..⁵⁴

Monk too brings the attention too on China Investment Corporation (CIC) as this particular fund might constitute danger for U.S. taken together into consideration with above mentioned facts, as it adds \$500 billion to its foreign assets every year and it reports directly to China's State Council putting the fund under direct supervision of Chinese leadership as well as comprising in its board member coming from Ministry of Finance, People's Bank of China, National Department and Reform Commission, National Pension Fund and Ministry of Commerce; thus it involves all parts of China's bureaucracy on its board..⁵⁵

VI. Corporate Governance Principles and SWFs

f.Can SWFs considered to be companies?

⁵³ *ibid.*

⁵⁴ China's CNOOC drops bid for Unocal, http://www.msnbc.msn.com/id/8795682/ns/business-oil_and_energy/t/chinas-cnooc-drops-bid-unocal/ (visited July 19, 2011). In 1987 Kuwait Investment fund first acquired %20 of the stakes in the recently privatized British Petroleum and had to sell half its stakes when struck by Margaret Thatcher's discontent. Likewise, the following year, Dubai Ports World owned by the UAE state bid to purchase the British firm Peninsular and Oriental Steam Navigation Company (P & O) who had the controlling right of main U.S. ports. After facing strong controversy, DPW eventually agreed to sell P&O's American operations to American International Group

⁵⁵ Ashby H. B. Monk, *Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy and Governance*, (2008-05-01), online: <<http://ssrn.com/abstract=1134862>> 19.

“If it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck.”

In order to answer this question one must first examine whether SWFs can be interpreted as corporations and whether a fund whatsoever comprises that entity.

Berle and Means purported in 1932 that what characterizes the modern corporations were separation of ownership and control, that the shareholders exercised no control over day to day operations nor long-term policy, that instead it was vested in the board of directors and the professional managers.⁵⁶ Today it can be alleged that there is a consensus on the professional management amongst scholars and that this is the end of history for company law doctrine.

Next generation, Hansmann and Kraakman define ownership as basically comprising two key elements: (i) the right to control the firm, (ii) the right to receive the firm’s net earnings proportional to the amount of capital contributed.⁵⁷ They further bring together five features characterizing the corporate form in its modern sense today. These are: (1) full legal personality with a well-defined authority to bind the firm to contracts and to bond those contracts with assets that are the property of the firm as distinct from the firm’s owners, (2) limited liability of owners and managers, (3) shared ownership by investors of capital, (4) delegated management under a board structure, and finally (5) transferable shares.⁵⁸ The authors argue that the corporate form is the standard model today, that there are three essential factors driving consensus on it which are the competitive pressures of global commerce; the failure of alternative models – the manager-oriented model, the labor-oriented model, the state-oriented model and the stakeholder models ; and the shift of interest group influence in favor of an emerging shareholder class. ⁵⁹

⁵⁶ Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, (Transaction Publishers, 1932)

⁵⁷ Henry Hansmann and Reiner Kraakman, *The Anatomy of Corporate Law: A Comparative and Functional Approach, What is Corporate Law?*, (Oxford University Press, pp. 1-19, 2004.)
, p.13.

⁵⁸ Henry Hansmann and Reiner Kraakman, *The End of History for Corporate Law*, the Yale International Center for Finance Working Paper, No.00-09 (January 2000), p. 1.

⁵⁹ *Ibid*, 3.

Hansmann and Kraakman indicate that the firm creates a legal person – a contracting party distinct from the various individuals who own or manage the firm, or are suppliers or customers of the firm- as it is the case in other organizational laws and that it also shields the assets of entity from the creditors of the entity’s managers and owners..⁶⁰

As a matter of fact SWFs are rhetorically closer to the definition of corporation made by Alchian and Demsetz. The prominent scholars of Chicago School assert that “All firms must initially acquire command over some resources. The corporation does so primarily by selling promises of future returns to those who (as creditors or owners) provide financial capital. In some situations resources can be acquired in advance from consumers by promises of future delivery.”⁶¹ On the other hand SWFs also are similar to mutual and nonprofit firms in its character that the future consequences of improved management are not capitalized into present wealth of stockholder..⁶²

Alchian and Demsetz allege that firms do not have power of fiat, no disciplinary action nor authority, that an employer’s control over its employees is no different than a consumer’s over the grocer..⁶³ This is not true, not the case especially for giant corporations which have enormous lobbying powers, a great influence on capital markets, manipulation. Stephen Bainbridge as well claims that what distinguishes firms from markets is the power of fiat that the nexus wields to..⁶⁴ He solidifies his argument with Ronald Coase’s theory that firms emerge when it is efficient to substitute entrepreneurial fiat for the price mechanisms of the market..⁶⁵ Bainbridge further argues that by creating a central decision maker – a nexus- with the power of fiat, the firm substitutes ex post governance for ex ante contract..⁶⁶

⁶⁰ Ibid, 7.

⁶¹ Armen A. Alchian and Harold Demsetz, *Production, Information Costs, and Economic Organization*, (The American Economic Review, Vol. 62, No.5 (Dec. 1972). Pp. 777-795.) 779

⁶² Ibid, 789.

⁶³ Ibid, 777.

⁶⁴ Stephen Bainbridge, *Shareholder Activism and Institutional Investors*, (UCLA School of Law, Law-Econ Research Paper No. 05-20)

⁶⁵ Ronald Coase, *The Nature of the Firm*, (4 *Economica* (N.S. 386 (1937)) cited in Bainbridge,5.

⁶⁶ Bainbridge, 6.

SWFs are a bizarre form of capitalistic society as the resources are this time owned and allocated by government, by state funds and nongovernmental organizations and by markets in the same time. Also, this time the company is not formed by a concrete adhesion contract or a nexus of contracts – The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals⁶⁷, but by the most ancient and fundamental one finds its roots, the social contract of Hobbes, Rousseau and Locke.

State in that case is like a guardian acting on behalf of a person under legal disability by managing its funds and by saving and collecting the fruits for their future usage usually on an unknown time, until he gains full legal capacity again.

g. Similarities with Institutional Investors

It is difficult to assess the outcome of institutional shareholder activism. Moreover, it is related to the local legal system within the target country as for example in some European countries there is “share blocking” system which requires shareholders to hold their shares and show up at the annual meeting if they are willing to vote.⁶⁸ This underlines the co-relation between liquidity and control as it effectively prohibits the investor from trading prior to the annual general meeting.⁶⁹ Furthermore, the costs of intervention, the limited number of other institutions helping with an intervention can be counted as impediments that institutional investors face as soon as they take a step in. Nonetheless, Bainbridge does not underestimate the power that corporations holding large share blocks. He claims that they might reunite ownership of the residual claim and ultimate

⁶⁷ Michael Jensen and William Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, (3 Journal of Financial Economics 305 (1976)) .9.

⁶⁸ Gillian, S. L. and Starks, L.T, p. 23.

⁶⁹ Ibid. La Porta, See Lopez –de-Silanes, Shleifer and Vishny, *Legal Determinants of External Finance*, Journal of Finance, 52, 1131-1150. The authors argue that investor protection is at a higher level in common law countries., which may be not the principal but a secondary factor effecting SWFs choice of target countries /companies.

control of the enterprise which may lead to a reduction in shirking and a reduction in agency costs.⁷⁰

Therefore maybe it wouldn't be such a bad decision to let SWFs act as active institutional investors and take part in the management of the corporation that they invest in if one considers them as another passenger on a board going to same direction with the boat. Yet some conspiracy theorists might go further and claim that they have ulterior motives and they are not another passenger on board but rats eating into the ship. That is yet to see.

h. Shareholders of SWFs

(i) Who are the shareholders of SWFs?

The answer is as simple as that: Citizens –the tax payers and sole contributors. This brings the question of dividend. If citizens of the state that owes the SWF are to be counted as shareholders, can they also claim dividends as residual claimants?

An average shareholder's main concern is to get either short-term benefit by selling out the shares at a higher price than they've bought or medium-term benefit by getting dividend payment. As for the citizens of the SWF country they are the shareholders compulsorily participating in the SWF's capital. The content of the dividend is indistinct even unknown. One can assume that there is general, indirect, mass benefit to shareholders/citizens once the company gets more prosper with their passive contribution. Although this may not be the case where there are inequalities between different social-economic classes in income distribution. Furthermore, if considered for a moment that there really is an SWF paying dividend to its citizens/shareholders, how is this ratio to be determined? Can one assume that the wealthier citizens paying luxury tax or the businessmen paying high corporate taxes get to be paid of higher dividends in accordance with their participation in the countries' budget? Answering this question affirmatively can result in chaos.

⁷⁰ Bainbridge, 10.

(ii) Do SWFs become shareholders themselves once they invest in corporations?

If so as shareholders themselves, they do not have to be transparent towards the company more than a hedge-fund is. Yet the Santiago Principles seem to be asking for the opposite.

i. Shareholder benefit

It can be further argued that since markets need norms, the state's regulatory provisions is crucial to achieve a maximisation of freedom.⁷¹ Yet one must be careful with interventionist policies as there is not only the possibility of market-failures but also of politics-failures, not every well-meant piece of legislation is acceptable, and therefore, one should not assume *a priori* that there has to be shareholder or stakeholder supremacy, argues Siems.⁷²

The argument that the companies should operate to serve the interest of society as a whole has gained significant importance, especially after the Enron crisis. The scholars did event take it a step further by bringing to table the Corporate Social Responsibility doctrine.

Within the body of an SWF, no other group but the political majority is given representation on the board as it is mostly constituted of the bureaucrats appointed by the government. Yet it can be argued that the political majority's average financial interests are the same with the minorities' as the countries with SWF prefer investing in foreign markets and increasing their capital and allegedly their worldwide political influence which is probable to result in prosperity in the country itself as it is tiding knots in the business world and joining "the gentlemen's club". The counter-argument to it would be that the countries with SWFs have ulterior motives, that they invest in specific countries, in specific industries and develop ideological infrastructure projects or funnel money to certain interest groups.

⁷¹ Mathias, M. Siems, *Shareholders, Stakeholders and the "Ordoliberalism"*, (European Business Law Review, Vol. 13, pp. 147-159, 2002)

⁷² *Ibid.*, 14.

What is more, as Hill points out, there is a tension between the two main perceptions regarding the role and the nature of the board. First one is that the board requires collegiality to perform well and the second is as it is expressed by Warren Buffett, that “dissent is needed in the boardroom.”⁷³ But there aren’t any different stakeholder groups within an SWF. No minority shareholders, no workers, no investors with or without voting rights, no nothing. There are just the citizens who constitute the closest constituency to shareholders but in a very vague, implicit and theoretical way and the bureaucrats appointed by the government, thus the political majority. Therefore there is no dissent in the opinions nor consensus in its classical sense.

However the recent research results show that the short-run market reaction is positive to announcements of SWF investments, that the price impact remains high for 20 days following the announcement and go back to its pre-purchase levels without much delay.^{74 75} This does not come as a surprise as it is common knowledge that the market usually and reasonably accepts the new cash flow arising from M&As.⁷⁶

Furthermore, it is also examined that SWFs tend to be passive shareholders, as target firms’ performance and governance do not change significantly in the long-run relative to a control sample, state Kotter and Lel.⁷⁷ Yet regarding the transparency and proficiency, the authors indicate that the investors react more favorably to acquisitions of SWFs that have a greater percentage of private director representation on their board of directors.⁷⁸ They also bring forward that another factor promoting the increase in stock price is the financial distress that

⁷³ See Hill, p. 30, n. 155.

⁷⁴ Kotter et al. See Jason, Kotter ; Ugur Lel, *Friends or Foes? The Stock Price Impact of Sovereign Wealth Fund Investments and the Price of Keeping Secret*, International Finance Discussion Papers Number 940, August 2008

⁷⁵ See B. Bortolotti, V. Fotak, w. Megginson and W. Miracky, *Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm*, (Unpublished working paper, University of Oklohoma, 2010) for the opposing-view.

⁷⁶ Marina, Martynova; Luc, Renneboog, *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?* (previous title: *The History of M&A Activity Around the World: A Survey of Literature*), (ECGI - Finance Working Paper No. 97/2005 *Journal of Banking and Finance*, 2008);

⁷⁷ Kotter, . 375.

⁷⁸ *Ibid*, 370.

the target firms are in and the greater degree of information available about the acquiring SWF.⁷⁹

j. Applying corporate governance principles to SWFs

It has been argued if public finance was cheaper than private finance. As in corporate finance the risk of the project is key to determining its cost, public finance appears to be cheap because the risk is borne by future taxpayers e.g. if a government project takes a loss, then they can increase taxes or dip into the SWF.⁸⁰ Ken Arrow and R.C. Lind allege that government projects bear less risk for two main reasons: risk pooling and risk spreading. Risk bearing by the government results in a truly risk-free discount rate reflecting the risk-neutrality of government and as for risk spreading, the government can spread it out among the entire deduct that SWFs are in the best interests of citizens.

Blackburn brings in three different alternatives to SWFs: “Voluntary” SWF where a private citizen decides whether he/she wants to invest in a fund; a lump sum remitted to citizens- similar to a tax rebate program in the United States and a paying fixed percentage to every generation.⁸¹

Even if one admits SWFs are pseudo-companies should they still undergo corporate governance intervention as a matter of efficiency? To begin with one should ask the question “What is corporate law?”. Black defines it includes laws that primarily govern the relationship between a company’s managers and investors excluding the laws that regulate corporate action to benefit others, such as employees.⁸²; whereas corporate governance is defined as “the system of laws, rules and factors that control operations at a company, setting structures that provide boundaries for the firm’s operations.”⁸³ On the other hand Shleifer and Vishny takes the investor’s side and claim that it constitutes of the ways in which

⁷⁹ Ibid, 368.

⁸⁰ K. Arrow and R. Lind, “The Uncertainty and the Evaluation of Public Investment Decisions”, American Economic Review, 1970., cited in Blackburn.

⁸¹ Ibid, 21.

⁸² Ibid, 547.

⁸³ Gillian, S. L. and Starks, L.T. , *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, Contemporary Finance Digest, 2, 3, 10-34.

suppliers of finance to corporations assure themselves of getting a return on their investment..⁸⁴

Black studies the triviality of corporate law in four subcategories: Market mimicking rules, avoidable rules, changeable rules and unimportant rules..⁸⁵ As for the first category, Black indicates that some mandatory rules may survive because they mimic the market under two conditions; first if they are “*fully efficient*” for all companies and second if managers and shareholders make efficient choices..⁸⁶ Yet he adds that one cannot prove that a rule is market mimicking, that it will depend on analogies and that the closer the focus, the greater the chance that the doctrine will be unimportant or avoidable..⁸⁷ Regarding the second category, avoidable rules, Black underlines that there are avoidance costs, that the default rules can be avoided at little cost but may have significance importance for small companies..⁸⁸ He also cites three factors that limit the importance of default rules. Similar to the arguments raised by pro-self-regulation scholars, Black points out that even unsophisticated decision makers invariably consult experts that these experts are familiar with similar issues and develop standard solutions and as a result, the cost of using a privately developed standard form instead of the government’s form is small..⁸⁹ Furthermore the author brings up that the process of trivialization is dynamic and that rules may change any time. However, the companies can even pressure legislatures to overturn judicial decisions by courts which interpret statues in new ways..⁹⁰ In addition to this Black emphasizes that changeable rules overlap with avoidable rules as one way to avoid a rule is to get it changed..⁹¹

The Hon. Justice Neville Owen seemed to have very well predicted the future course of corporate governance when raising his concerns that the phrase “corporate governance” itself has been so widely used that it might become

⁸⁴ Shleifer, A. and Vishny, R. , *A Survey of Corporate Governance*, *Journal of Finance*, 52., 737-775.

⁸⁵ Bernard S. Black, *Is Corporate Law Trivial? A political and economic analysis*, *Northwestern University Law Review*, Vol. 84,- No. 2, Winter 1990, p. 576.

⁸⁶ *Ibid*, 532.

⁸⁷ *Ibid.*, 555.

⁸⁸ *Ibid.*, 557.

⁸⁹ *Ibid*.

⁹⁰ *Ibid*, 559.

⁹¹ *Ibid*, 560.

meaningless.⁹² Likewise, Sir Adrian Cadbury recognized that there is an interrelation between government regulation and corporate governance that the inadequate enforcement of good governance practices could lead to the renewal of onerous government regulation.⁹³

The prophecy that Karmin made in 2000 did not seem to take. He had predicted that unless the companies start paying more attention to corporate governance, emerging markets could remain stuck in the backwards of global finance.⁹⁴ Turns out, the opposite is happening. The emerging markets found a way to get ahead of the global finance by concretizing their investment policies within SWFs and stalling the financial crisis with the cash they flow into the markets.

VII. Regulating SWFs

a. SWF Regulation under classical regulatory governance theories

To begin with, one must extrapolate what regulation means. Baldwin defines regulation as the promulgation of rules by government accompanied by mechanisms for monitoring and enforcement, mostly assumed to be performed through a specialist public agency or the direct intervention of the state in the economy in any form or again all of the mechanisms of social control or influence affecting all aspects of behavior from whatever source, whether they are intentional or not;⁹⁵ whereas Selznick indicates that regulation is the sustained and focused control exercised by a public agency over activities that are valued by a community.⁹⁶

⁹² HIH Royal Commission, *The Failure of HIH Insurance: Volume 1: A Corporate Collapse and Its Lessons*, (Commonwealth of Australia, April 2003) cited in Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, Vanderbilt University Research Paper No. 06-04.

⁹³ Holland, *Self Regulation and the Financial Aspects of Corporate Governance*, [1996], *J Bus L* 127, 131, n.12

⁹⁴ Karmin, C. *Corporate Governance Issues Hamper Emerging Markets ---Stalled Changes Push Some Shareholders to Abandon the Field*, Wall Street Journal, Nov. 8. P. C1.

⁹⁵ Baldwin, R, Scott,C and Hood,C (1998) *A Reader on Regulation*, Oxford: Oxford University Press; note 29, in J, Black '*Critical reflections on regulation*. Australian journal of legal philosophy, 27 pp

⁹⁶ P. Selznick, 'Focusing Organisational Research on Regulation' in R. Baldwin, M.Cave, 'Understanding Regulation' (Oxford, 2010), 2.

Aside from the definition of regulation, what is more important is to single out good governance features. Baldwin and Cave designate five different criteria to be used as key tests to evaluate whether a regulatory act can be counted as 'good'. They suggest that good regulation must be legitimate thus worthy of support in their words where it is supported by the legislative authority, where there is an appropriate scheme of accountability, fair and accessible procedures, where the regulator is acting with sufficient expertise and finally where the action is efficient overall.⁹⁷ Apart from their definition, it can be asserted that good governance exists only where legitimacy already comprises all of the above-mentioned properties. Legitimacy in its simplest form is the credentials given to a person - public or private, legal or natural- by the one(s) who bound themselves by that particular person's virtual authority for practical reasons.⁹⁸ Furthermore it is the satisfaction of the subjects which have the power to remove an authority - a legal or natural person- from its office.

Its roots lie in the social contract theory but one can briefly say that it stems from the fear of chaos and the belief as Suchman points out⁹⁹ that the entity that takes its power from the people in its broadest sense is more eager to respond the needs of that people on their behalf if and that is accountable to them. That is exactly why it can be alleged that legitimacy already covers efficiency and accountability. As in the example of a government losing its legitimacy once economy starts falling down although it is elected with the majority of the votes of the people. As long as a country has surplus or keeps growing even a dictator does not lose its seat though he or she is corrupted in all the ways which is the case in rich Middle East countries.¹⁰⁰ For the very reason accountability is literally accountability as a finance term; In brief, legitimacy is economy.¹⁰¹

Monk pledges that legitimacy is a subjective quality synonymous with gaining access to operate and invest in a given country or market in the eyes of the society

⁹⁷ R. Baldwin, M. Cave, 77.

⁹⁸ Hazal Ugan, *Can self-regulation be legitimate and effective without substantial state involvement?*, (UCD Regulatory Governance Class Assignment, 2011.)

⁹⁹ Suchman ,M.C., *Managing Legitimacy: strategic and Institutional Approaches*, *Academy of management review* 20:571-610,

¹⁰⁰ Ugan, 3. Kuwaiti citizens each received a grant of 1,000 Kuwaiti dinars and free food staples for 13 months to mark three major anniversaries at the wake of recent unrest in Middle-East. Coincidence? No.

¹⁰¹ *Ibid.*

in which it seeks the legitimacy...¹⁰² Following the above-mentioned arguments and Monk's reasoning, SWFs are to be legitimate in the eyes of target country citizens as they bring in money, especially in desperate straits as it postpones or diminishes the effects of a financial crisis.

On the other hand, the studies on the relationship between development and democracy show that transitions from autocracy to democracy can occur at any level of development but are less likely to be reversed at higher levels of per capita GDP...¹⁰³ It can be taken as another proof backing up our argument that legitimacy is obtained where the people who grant it are satisfied with their financial situation. Accordingly states are aware of it and become more jealous of their sovereignty and their autocratic regime as far as the financial balance is positive.

The problem of finding balance between efficient decision mechanisms and democracy becomes more significant in SWF case. It is way more complicated than a listed company's business as it involves state investment, public interest, legitimacy problems and the assessment of taxes for further strategies.

As for the accountability concerns, SWF management should be held accountable to the citizens, the people- tax-payers and future generations as it is in any case of social contract, basically. The remuneration schemes also relates to the position of the board. Do the board members get bonuses? If not, then the directors are ordinary shareholders and residual claimants just like the citizens and thus have little interest in using their control to increase their own wealth, given the human nature as Bainbridge concludes...¹⁰⁴ Regarding the accountability process itself, the question of by whom or through which mechanisms can SWFs be held accountable stands out. In accordance with Westphalian system, SWFs are to be held accountable by their own national courts, probably the High Courts or through internal, political, non-legal mechanisms unless reciprocity is provided to form an international judiciary or disciplinary instrument. Still accountability is a very delicate issue as it might cause a shift in the locus of authority from A to B if

¹⁰² Ibid,15.

¹⁰³ Adam Przewoski et al. , *Democracy and Development: Political Institutions and Material Well-Being in the World, 1950-1990*, (Cambridge: Cambridge University Press, 2000) cited in Francis Fukuyama, *The Origins of Political Order*, (New York, 2011) 471.

¹⁰⁴ Bainbridge, 7.

*every decision of A is to be reviewed by B, thus to a denial of authority as Kenneth Arrow puts it nicely.*¹⁰⁵

State regulation is although providing de facto legitimacy in the eyes of the citizens may cause counter-productive effects which Cass Sunstein calls paradoxes.¹⁰⁶ The author alleges that there are six paradoxes : First one stemming from state imposing stringent regulatory controls taking the regulation beyond the point of feasibility thus causing under-regulation by over-regulating.¹⁰⁷ The second one occurs when state requires the best technology but in fact causes a retard in technological development as it eliminates the incentive to innovate.¹⁰⁸ There is also old risk-new risk paradox which comes to life when states impose severe limitations on new sources but exempt old ones.¹⁰⁹ Also, the redistributive regulation as well harms those at the bottom of socioeconomic ladder as it is in the case of regulation relating the minimum wage which ends up decreasing the importance of work.¹¹⁰ Furthermore the disclosure requirements make actually people less informed as in the example of perfect accuracy requirements leading producers to furnish no information whatsoever.¹¹¹

On the other hand although rhetorically, self-regulation may appear to lack any state involvement but in reality it may constitute a response to threats by government that if nothing is done state action will follow.¹¹² Therefore it is not possible to completely separate self and state initiatives since the actions and reactions are cyclical.

The academia classifies self-regulations pros and cons-mostly in the same way. While expertise and efficiency are the main arguments in favor of self-regulation, lack of mandate, unaccountability and unfair procedures are considered to be its weakest points.

¹⁰⁵ Kenneth J. Arrow, *The Limits Of Organization 68-69 (1974)*, cited in Bainbridge, 8-9.

¹⁰⁶ Sunstein, C, *Paradoxes of the Regulatory State*, (University of Chicago Law Review, 57: 407-441. 1990),

¹⁰⁷ *Ibid*, 410

¹⁰⁸ *Ibid*.

¹⁰⁹ *Ibid.*, 412

¹¹⁰ *Ibid*.

¹¹¹ *Ibid*.

¹¹² Black,J. 'Constitutionalising Self-Regulation' (1996, 59 MLR) 24 in Baldwin.

At the end, SWFs have still some escapeways from protectionist policies indicates Monk; avoidance, lobbying and adaptation. ¹¹³

b. SWF-Specific Regulation : Santiago Principles

The International Working Group of Sovereign Wealth Funds (IWG) was established in May 2008 at a conference gathering up the countries with SWFs and IMF. The IWG's 26 members are Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, The United Arab Emirates and The United States. Permanent Observers are The OECD, Oman, Saudi Arabia, Vietnam and the World Bank while the Chairman is the Chairman of Australia's Future Fund Board of Guardians, David Murray. The Deputy chairs are Jin Liqun, the Chairman of the Board of Supervisors of China Investment Corporation and Bader Mohammad Al-Sa'ad the Managing Director of the Kuwait Investment Authority. Although elected by the IWG member states, it is not a coincidence that the chairman is of one of the Commonwealth countries which also has a particularity as it is a recipient country in the same time, Australia while the deputies come from notorious China and Kuwait holding the oldest SWF. The IWG group just like Santiago Principles is formed to ease the concerns of Western capital relating the Eastern capital as well as giving a larger elbowroom to the latter in the same time. So it wouldn't be too pessimistic to say that both are projections of a sham fight- same as any other international public law regulation without a proper legal sanction- going on in international financial relations.

¹¹³ - Monk, 29.

The group met three times to draft generally accepted principles and practices for SWFs and finally came to an understanding at the third meeting in Santiago. In addition to the member countries, some of the recipient countries namely Brazil, Canada, Japan, France, South Africa, Spain, United Kingdom, Italy and Israel contributed to the drafting process as well as the European Commission, the OECD and the World Bank. The former two also hold permanent observer position together with Saudi Arabia and Vietnam.

Santiago Principles are designed primarily to establish trust between recipient countries and SWFs. They constitute a set of a voluntary principles supported by the members of the IWG to be implemented as they are believed to be achievable by countries at all levels of economic development. The GAPP sets out standards in three principal areas: Legal framework, objectives and coordination with macroeconomic policies; institutional framework and governance structure; and investment and risk management framework.¹¹⁴ More broadly, it aims at reducing protectionist pressures, contributing the stability of the global financial system and helping to maintain an open and stable investment climate.

As the subject of this dissertation is not solely the Santiago Principles themselves, they will not be examined in detail but some of the principles will be extracted and commented in order to better illustrate the case and show inefficiencies of disclosure requirements.

“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*

¹¹⁴ Santiago Principles, Objective and Purpose.

well as the legal relationship between the SWF and other state bodies, should be publicly disclosed. “

In the commentary to the above-mentioned article, it is concluded that there are three different legal framework establishing SWFs.¹¹⁵ The *first* type of SWFs is established as a separate legal identity under public law with full capacity to act and governed by a specific constitutive law as it is mostly the case for Middle Eastern funds e.g. Kuwait, Qatar, and United Arab Emirates (ADIA). As for the East Asian funds they often fall under the *second* category the form of a state-owned corporation e.g., Singapore’s Temasek and Government of Singapore Investment Corporation (GIC) or China’s China Investment Corporation (CIC)). As state-owned corporations they are subject to be governed by general company law, although other SWF-specific laws may also apply. Finally, the *third* category of SWFs is constituted by a pool of assets owned by the state or the central bank without a separate legal identity e.g., Botswana, Canada (Alberta), Chile, and Norway). In these cases, legislation typically sets out specific rules governing the asset pool.

GAPP requires that the establishment, mandate of manages and beneficial and legal owners of the SWFs should be clearly defined under domestic law.

Obviously the first principle does not ask too much to be accomplished in order to be satisfied. Any kind of SWF, with ulterior motives or not, governed fairly or poorly can comply with this principle as all of them are established through a legal text of different nature and as the GAPP does not give out a restrictive definition for legality, this principle is maybe one of the most easy-to-comply-with principles of GAPP.

GAPP 2. Principle

The policy purpose of the SWF should be clearly defined and publicly disclosed.

¹¹⁵ Discussion of the GAPP- Santiago Principles, 11.

This principle does not seem to appear to be drafted to get realistic results as the policy purpose of a SWF is the reason why all these conflict and concern have been going on. SWFs naturally do not want to export their policies as these policies are of a mixed nature gathering together both trade and state secrets. Even so, if they were to disclose a policy to comply with the GAPP there is a little chance that this would be the real one. Yet in order to ease the concerns of the receiving countries the GAPP conceptualized the correlation between asset management and investment policies of SWFs. *“For instance, stabilization funds, which serve short- to medium-term objectives, usually have shorter investment horizons. By contrast, savings funds, which have longer-term objectives, typically aim at generating higher returns over a long time horizon. SWFs whose objective is to hedge against country-specific risks may hold assets with negative correlation to the country’s major exports to offset terms-of-trade shocks.”*¹¹⁶

GAPP 15. Principle

SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.

Asking SWFs to comply with all applicable regulatory and disclosure requirements is another reflection of *ask maximum to get minimum* approach of the GAPP. First non of the national investors comply with all applicable rules and second, foreign investors should face less strict measures than nationals as the benefit they bring to the target State is greater. They increase liquidity levels, credibility of that state in international markets and in return the last thing they would like to come across is a stringent and protectionist system instead of incentives and tax reliefs.

GAPP 16. Principle

¹¹⁶ Ibid.

The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.

The authors of the GAPP envisage that it would promote a clear understanding of what the SWF seeks to achieve and of the division of responsibilities to provide assurance that investment decisions are made on an independent basis without political interference. One should ask itself the question whether it is possible to make a decision that procreates macro-economic effects without political interference.

GAPP 17. Principle

Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.

The above-mentioned principle seems to be an umbrella clause covering what is left of disclosure requirements. What SWFs would do to abide by this rule is to disclose dummy financial tables of little importance as the content of the term relevance is relative and not defined in the GAPP. Regulatory authorities should avoid juxtaposing vague and broad requirements as they decrease the level of persuasiveness and seen as overwhelming inefficient red-tape that one must comply with without believing in it.

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.

If investment decisions were to be subject to considerations other than economic and financial ones they wouldn't be disclosed; if forced to be, they would be disguised under false pretenses.

Accordingly, the OECD acquis – OECD Code of Liberalisation of Capital Movements of 1961 and the OECD Declaration on International Investment and Multinational Enterprises of 1976, designates the following principles: Non discrimination, transparency, progressive liberalization, standstill and unilateral liberalization.¹¹⁷ Non-discrimination policy not only comprises OECD members but it also extends to non-OECD members. As for the transparency, the OECD acquis provides that information on restrictions on foreign investment should be comprehensive and accessible to everyone whereas for progressive liberalization it requires that members gradually eliminate restrictions on capital movements across their countries. Standstill indicates not introducing any additional restrictions. Finally unilateral liberalization stands for avoidance of reciprocity as the OECD instruments are based on the philosophy that liberalization is beneficial to all especially to the country which undertakes it. Therefore it is not surprising that OECD set out in its “SWF and Recipient Country Policies” report a similar approach. It requires that OECD member countries that receive SWF investment should express a common understanding of fair treatment of foreign investors, commit adhering governments to build this fair treatment into their investment policies and provide for “peer review” of adhering governments’ observance of these commitments. ¹¹⁸ Ideally, SWFs too should follow some principles for their part in order to ease recipient countries concerns and avoid causing systemic risk with their long-term, opaque positions. They should base their investment decisions solely on economic, commercial grounds, not political ones. They should also be transparent about their investment policies, have solid risk management, government and internal control systems. Furthermore they should

¹¹⁷ Sovereign Wealth Funds and Recipient Country Policies, OECD Investment Committee Report, 4 April 2008.

¹¹⁸ Ibid.

compete fairly with private sector, avoiding financing acquisitions below-market rates...¹¹⁹

On the other hand, some scholars argue that more conservative measures should be taken considering the SWFs belong to states that are at best delicate relations with NATO member countries and *to some potential adversaries with a long history of extensive and effective espionage that they are not the best vehicle for information gathering* and for various economic and commercial mischief national security related reviews cover all foreign investments and the concern about national security should not be underestimated. ¹²⁰ Yet the same scholars declare that paradoxically, SWFs are least important with regards to foreign direct investment (FDI)...¹²¹ Why would they be required to be more transparent than the other actors in market anyway?...¹²²

The major reason causing inefficiency of Santiago Principles lay in its soft law character. Chinkin alleges that : *“Soft law instruments are concluded by States to combine collective regulation and restraint in economic dealings with a flexibility and freedom to manoeuvre where events or changing circumstances so require. They are however, frequently not only regulatory but are also intended to construct and program the development towards a new international economic structure.”* ¹²³ On the other hand, soft law’s advantage lies in its *informative* and *educative* role which is well suited to non-judicial means of dispute settlement and to self-regulation between interested participants...¹²⁴

VIII. Investment protectionism:

¹¹⁹ Ibid.

¹²⁰ Charles Kovacs, *Sovereign wealth funds: much ado about some money*, (Columbia FDI Perspectives Perspectives on topical foreign direct investment issues by the Vale Columbia Center on Sustainable International Investment ,No. 14, October 1, 2009)

¹²¹ Annual FDI flows in the past 10 years have ranged between US\$600 billion to a record US\$2 trillion in 2007. Meanwhile, the FDI from SWFs amounted to only US\$10 billion in 2007: 0.2% of their total assets, and 0.6% of the FDI flows that year. See Kovacs.

¹²² Fotak, Megginson; Epstein of the same opinion.

¹²³ C. M. Chinkin, *The Challenge of Soft Law: Development and Change in International Law*, (The International and Comparative Law Quarterly, Vol. 38, NO.4 (Oct., 1989). Pp. 850-866)

¹²⁴ Ibid, 862.

As there are no legal sanctions in their classical for SWFs, the deterrent foreign investment protectionist mechanisms in internal laws of the target countries can be seen as the closest thing to it.

U.S. as one of the most invested countries by SWFs decided for its part, not to accumulate SWF investment, based on the belief that private investment is likely to result in greater returns and greater national prosperity.¹²⁵ U.S. legal framework for foreign investment requires SWFs to abide by the same rules as private-equity funds and hedge funds including the disclosure requirements if they acquire a 5 percent or greater equity stakes in a public company.¹²⁶ Moreover, there exists the Committee on Foreign Investment in the United States (CFIUS) defined as *an inter-agency committee authorized to review transactions that could result in control of a U.S. business by a foreign person ("covered transactions"), in order to determine the effect of such transactions on the national security of the United States* by U.S. Department of Treasury. - ¹²⁷that reviews foreign investments in national companies and study their effects on national security and other statutory regimes relating the foreign control in certain delicate areas like infrastructure or national defense. ¹²⁸ Very suspicious about SWFs' real intentions, U.S. seems to take a rather investor protectionist behavior, yet under its current tax law it exempts SWFs from paying taxes on portfolio investments in the US, while foreign citizens and corporations pay respectively high taxes.¹²⁹

Not only most of the Western countries or pseudo-western countries but also prominent developing economies too have foreign investment review committees. These state committees are using common criteria in evaluating whether a foreign investment can do harm to national interests. Some of these criteria are adverse implications for national security and defense, impact on economic development,

¹²⁵ Epstein, Richard, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, (University of Chicago Law Review, Forthcoming U of Chicago Law & Economics, Olin Working Paper No. 469) 125.

¹²⁶ Securities Exchange Act of 1934. Exchange Act

¹²⁷ Committee on Foreign Investment in U.S. (CFIUS), U.S. Department of Treasury <http://www.treasury.gov/resource-center/faqs/CFIUS/Pages/default.aspx>

¹²⁸ Federal Aviation Act of 1958; Atomic Energy Act of 1954; The Foreign Investment and National Security Act of 2007. See Epstein for regulatory status quo

¹²⁹ Fleischer, Victor, "Taxing Sovereign Wealth Funds", *Conglomerate* 4 March 2008; <http://www.theconglomerate.org/2008/03/taxing-sovereig.html>

competitiveness on world markets, public security, public order, cultural concerns, protection of critical industries, famous trademarks and traditional brands, control of classified and sensitive technology, potential national security-related effects on critical infrastructure including major energy assets...¹³⁰

Regarding investment protectionist policies, one should remember charter-mongering example New Jersey / Delaware for a moment. If a state or a country is liberal and another is restrictive in its company law rules, the companies naturally will flee the latter...¹³¹

IX. Conclusion

The pioneer of the concept *open society*, the well-known speculator George Soros agrees with market fundamentalists on their concerns relating the government's hand in economy. He gives market fundamentalists some credit by arguing that governments are ill-suited to run the economy which he claims to be more true in the international area than in the domestic one...¹³² He further argues that it is the shortcomings of governments themselves which has led to the rise of market fundamentalism. Yet he concludes that both government regulations and markets have their strength and weaknesses that it is not a question of either/or and that the fact that one is imperfect does not render the other perfect...¹³³ On the other hand he claims that globalization is a market fundamentalist project and thus the government regulations seems to lose its fair ground to markets that the markets should be let alone do what they do best: allocate resources...¹³⁴ Ironically, if we apply Soros' and pro-market fundamentalist argument to SWFs, there comes forward a catch-22 situation, in which a government controlled fund is to be set free in market as the latter would find the best way on its own, in order to get rid of the government intervention in finance itself.

¹³⁰ See Kaiser, Annex, for a detailed comparative investment regimes.

¹³¹ See Roberta Romano, *The genius of American corporate law*, (AEI Studies in Regulation and Federalism, 1993.)

¹³² George Soros, *The Age of Fallibility – The Consequences of The War on Terror*, (Public Affairs, 2006)

¹³³ Ibid, 145.

¹³⁴ Ibid.

At the end, there is no consensus on the concept good governance. While economist Jeffrey Sachs maintains that good governance is the product of economic growth rather than a cause of it.¹³⁵ it is also sensible to defend the contrary, that the good governance is responsible for the economic growth in the existence of comparative cases such as between Nigeria and South Korea, where the former took in more than \$300 billion oil revenues between 1975 and 1995 yet was in decline in its per capita income during the exact period whereas the latter grew at rates ranging from 7 to 9 percent per year over the same period, to the point that it became the world's twelfth largest economy by the time of the Asian financial crisis in 1997..¹³⁶

Roubini claims that eventually they will ask for more and claim voting rights and get active like hedge funds do as an exception to the lethargy of institutional investors by exercising the limited control rights granted shareholders..¹³⁷ Would that be so bad? They are either shareholders or institutional investors or state owned enterprises, they are at the end profit maximizers and they will not get involved in any activity whose costs exceed its benefits..¹³⁸

Governments should realize that SWFs are a heterogeneous group varying in respect to size, funding, objectives, investment style and sophistication and that therefore regulation should, a priori, treat all SWFs equally, but any ad-hoc response.¹³⁹ should affect the offending fund, rather than the entire category and IMF should keep its regulator position together with World Trade Organization as multilateral action is more effective than bilateral agreements..¹⁴⁰ Burden of proof accordingly should fall on those who ask for more restriction in the market entrance and more regulation..¹⁴¹

Increasing the entry barriers for SWFs will push them away towards other markets, maybe not the prime class ones as US or UK but to the emerging markets

¹³⁵ Jeffrey Sachs, *The End of Poverty : Economic Possibilities for Our Time*, (New York, 2005) cited in Fukuyama, 470.

¹³⁶ Ibid.

¹³⁷ Ibid, 11.

¹³⁸ Ibid.

¹³⁹ Veljko Fotak and William Megginson, *Are SWFs Welcome Now?*, Columbia FDI Perspectives Perspectives on topical foreign direct investment issues by the Vale Columbia Center on Sustainable International Investment No. 9, July 21, 2009

¹⁴⁰ Ibid.

¹⁴¹ See Fotak, Megginson; Epstein of the same opinion.

with several procedural and financial advantages such as less strict M&A rules and higher level of interest rates. This may even cause the creation of regional forces that West would never agree upon. Furthermore disinvestment in US, then their nations may switch their reserve currency, which would negatively impact the dollar. Moreover Epstein seems to be right in his reasoning that it would be very difficult to ask nations to support US on a variety of international military or security issues if US were to make it impossible for them to sell their goods in its market.¹⁴² Obviously, even an overconfident superpower needs to keep good relations with other countries as it cannot set them straight by military force all the time. At this point forming financial relations might be more efficient and subtle in manipulating them in a Sorossian way as there is no guarantee SWFs will 100% comply with the strategic and financial requirements of the Western world even if they adopt Santiago Principles or any other good governance regulatory framework.

Yet as every nation is an enemy for one another unless they get to make business in its broadest sense together, Western World's reaction towards Asian and Middle-Eastern SWFs is very sensible and comprehensible. What West should realize is that if they want to make more business and less enemies, they should tie the knot with these "gung ho" new rich which cannot be done in the presence of exclusionary and overwhelming regulation.

In the wake of a new financial crisis or more correctly put the second wave of 2007 mortgage crisis, SWFs appear to get the upper-hand with the high level of liquidity they provide to Western markets. Soon as foreseen by Roubini, they will ask for more rights in exchange of their investment which will be taken by the markets as a contribution and by that time we all shall see whether they have an ulterior motive. What one can be certain of is that in short to medium term, the subject of SWF legitimacy will shift towards SWF efficiency as West will start reevaluating pros and cons of the huge amount of incoming SWF investment: but this time will be too busy to fill the gap it will not have time to discuss *de lege feranda*.

¹⁴² Ibid, 131.

In consideration of all these legal, financial and political arguments, the current regulatory attempts appear to be a masquerade for investor protectionist policies: thus the answer to the question is no.

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