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GENERAL INTRODUCTION

The aim of the present research is to study the applicability of the provisions of relevant branches of international economic law and of European Union law (EU law) to Sovereign Wealth Funds (SWFs), i. e. to those special purpose investment vehicles which are created, owned and managed by governments or by other sovereign entities in order to pursue macroeconomic purposes and which invest all or a part of their assets overseas.

SWFs are relatively new actors in international economic and policy. This explains why today provisions of international economic law and of EU law explicitly and exclusively dealing with them are scarce. In fact, most existing rules of international and EU law have developed in an economic and political context in which SWFs did not exist yet or in which they were irrelevant. It is therefore necessary to understand whether today international and EU law are well equipped to deal with the new challenges and opportunities posed by the rise of SWFs in the international economic landscape. This is one of the objectives of the present research which will review the relevant branches of international economic law and of EU law in an attempt to investigate whether their provisions could be properly used also to govern the investments of SWFs.

In particular, two distinct aspects of such relation will be the object of the analysis developed in this work.

The first one is the impact that relevant provisions of international and European Union law have had and still have on the *creation* of SWFs. This will also imply a discussion as to whether the current international legal regime may provide States with incentives or disincentives for the creation of SWFs, without prejudice to the fact that the ultimate decision of a State to establish a SWF depends first of all on its domestic economic and political conditions and needs.

The second aspect is related to the study of the applicability of international and EU law to the *investments* undertaken by SWFs. Although the focus will be on the investments SWFs undertake abroad, some references will be made also to the impact of international law on the domestic investments of SWFs, i. e. on the investments SWFs make in the same State which owns them. The study of the applicability of international and EU law to the investments of SWFs will imply a careful analysis of the way such provisions may impact on the ability of recipient countries to adopt domestic policies, laws and regulations directly and indirectly targeting the operations of SWFs in their territory.

The present research means to be interdisciplinary in character. In fact, although it mainly focuses on the legal aspects concerning the creation and the investments of SWFs, nevertheless it attempts to explain, in qualitative and descriptive terms, the main economic and political aspects of the creation and of the investments of SWFs. This approach is necessary because it is my convincement that a proper discussion on the regulation of SWFs cannot be made without a decent understanding of the economic mechanisms which underlie their establishment and their investment choices. This is even more important since the notion of SWF includes a very broad and heterogeneous ensemble of State-owned investment vehicles, which, notwithstanding some important common features, may significantly differ *inter alia* as to their macroeconomic objectives, their source of financing and their investment strategies. The understanding of the economics of SWFs could therefore allow to elaborate a legal analysis on the way they could be regulated which is not developed in abstract terms, but taking into consideration the reality of this new category of investors. The only chapter which exclusively adopts an economic approach is chapter 1. However, some economic analysis will be developed also in other chapters, for instance in chapters 3, 4 and 6 in order to ensure a proper understanding of the legal reasoning which will be provided.

Each of the chapters in which the present research is articulated will start with a detailed introduction, presenting the reasoning that will be developed in all the paragraphs in which it is divided and explaining the order in which all the relevant issues will be addressed. Therefore, the present general introduction will provide a very brief overview of the content of the chapters.

Chapter 1 will provide a concise description of Sovereign Wealth Funds (SWFs). It will review some of definitions of SWFs which have been recently provided and it will attempt to analyse and compare them. It will study the similarities and the differences between SWFs on one hand and, on the other hand, other entities like mutual funds, pension funds, State-owned enterprises, Central Banks. It will provide basic information and data as to the issues of the legal framework, the origins, the source of financing, the size, the localization of SWFs. A distinction shall be drawn in particular between commodity funds, which are financed by the proceeds from the exploitation and the sale of domestic natural resources and forex funds which are financed by transfers of foreign currency reserves in excess. Chapter 1 will also explore the investment strategies of SWFs and it will provide a brief discussion of the transactions they have carried out so far. Finally, it will discuss the main concerns the investments undertaken by SWFs rise in recipient countries and it will review all the elements and the options which should be taken into account when trying to regulate them.

Chapter 2 will explore certain aspects concerning the creation of commodity SWFs. More in detail, it will study the role they may have in ensuring a proper management of the revenues from the exploitation of natural resources. The focus will be on countries which are rich in natural resources and, at the same time, which are scarcely industrialised and which are characterised by an underdeveloped and undiversified economy. It will link this discussion to the principle of permanent sovereignty over natural resources which has been developed in international law. More in detail, it will develop an analysis of such principle, and in particular of the instruments which declared it, of their content, their evolution, the legal effects they were expected to produce and the political and economic effects they have produced in practise. Then, it will be studied whether, and under which conditions, the creation of SWFs may enhance the respect of the principle of permanent sovereignty over natural resources in a way to contribute to the development of the States which own SWFs and to ensure that SWFs may be managed in order to really benefit the peoples of the States owners.

Chapter 3 will explore the applicability of international monetary law and international trade law (with a focus on WTO law) to both the creation and the investments of SWFs. The choice made in the present work to analyse all these issues in a single chapter is supported by the existence of a strong relation between international monetary cooperation, balance of payments and exchange rates on one side and, on the other side, international trade. When studying the relation between international monetary law and SWFs, the focus will be mainly (although not exclusively) on forex SWFs i. e. on those funds which are established as a result of the accumulation of a large amount of foreign exchange reserves.

Chapter 3 will first of all study whether the current international monetary system, as it has been shaped by the law and the practise of the international Monetary Fund (IMF), has been conducive to the creation of forex SWFs. Then, it will focus on the relation between monetary unbalances, disequilibria of the balance of payments, excessive accumulation of foreign exchange reserves and the creation of SWFs. It will discuss in particular whether certain economic practises which lead to the accumulation of foreign exchange reserves in excess and then to the creation of SWFs, as well as the establishment and the operations of SWFs themselves, may be regarded as inconsistent with international monetary law and with WTO law provisions concerning the balance of payment and the relation between monetary issues and international trade law. The impact this may have on SWFs will be also explored. Finally, chapter 3 will study whether certain monetary practises conducive to the creations of SWFs may be regarded as a form of prohibited State aid or as a form of monetary dumping (and then it will be studied whether monetary dumping is governed by WTO law).

In the last part of the chapter it will be questioned the applicability of WTO law provisions concerning State subsidies to domestic investments of SWFs and the applicability of the provisions contained in other multilateral agreements concluded within the framework of the WTO (i. e. the GATS and the TRIM) to foreign investments of SWFs.

Chapter 4 will study the applicability of international investment law to SWFs. The focus will be on International Investment Agreements (IIAs) and in particular on Bilateral Investment Treaties (BITs), which are concluded between two States and which exclusively contain provisions on foreign investments. Due attention will be paid, of course, to the relevant arbitral decisions which interpreted and applied such international instruments. The chapter will study whether SWFs may be regarded as covered investors, and whether their operations may be regarded as covered investments, under the BITs and under the ICSID Convention. Then, an analysis will be made of the applicability to SWFs of provisions of substantive law contained in BITs and especially of those concerning: admission of foreign investments, most favoured nation treatment, national treatment and fair and equitable treatment clauses, expropriation, transfer of capitals. Finally it will be undertaken a broader discussion of the issue of national security of the host State and of the means to protect it, also in case of investments of SWFs, that are available under international investment law.

Chapter 5 will discuss whether SWFs, when they carry out their investments into the territory of a foreign State, should be entitled to State immunity from the jurisdiction to adjudicate, to adopt measures of constraint and to tax of that other State. To this end, the sources and the basic principles of the law of State immunity shall be reviewed. It will be studied the distinction which is commonly made between *acta jure imperii* and *acta jure gestionis* and it will be discussed in which of these two notions the operations of SWFs should be included. It will be investigated whether the law of State immunity may preclude the possibility to adopt measures of constraint against the assets under the management of a SWF which are held overseas, in order to enforce an award or another judicial decision which has been issued against the State which owns that SWF. Finally, when the issue of the immunity from taxation will be studied more in depth, it will be discussed whether tax exemptions to income earned by SWFs on their investments overseas may be conceived as a form of aid to development, at least when the owner of the SWF is a developing country and the recipient country is a developed one.

Chapter 6 and 7 will study the investments of SWFs in the European Union (EU) as well as the EU law and policies which may affect the operations of these State-owned investment vehicles.

Chapter 6 will provide a brief overview of the operations of SWFs in the EU and of the relation between SWFs' investments and the competitiveness of EU economy. It will discuss the content of a Communication of the Commission providing for an EU approach to SWFs. It will turn to analyse the legally binding provisions of EU law which are applicable in general to the investments in the EU and then it will study how they can apply in particular to the investments undertaken in the EU by SWFs. The provisions which are more relevant to govern these matters and therefore which will be studied more in depth will be those concerning free movement of capitals. However, a discussion will be developed also concerning the applicability of provisions on freedom of establishment.

Finally, the chapter will study whether the ability of EU members to decide which domestic assets cannot be owned by foreign SWFs, may be preserved by art. 345 TFEU, which provides that EU law does not prejudice "the rules in Member States governing the system of property ownership." To this purpose, it will be reviewed the interpretation made by the ECJ of art. 345 in different cases, especially those concerning so-called golden shares legislation. The notion of golden shares will be discussed and it will be explored the extent to which the case law of the European Court of Justice on golden shares have limited the ability of EU members to protect certain strategic sectors from the investments of foreign SWFs.

Chapter 7 will study the impact the interaction between EU law and BITs may have on the possibility to regulate investments of SWFs in the EU. This is a particularly relevant question since EU members are contracting parties to more than 1100 BITs not to mention many other IIAs. Since the majority of investments in the EU are carried out by SWFs owned by non-EU countries, the focus needs to be on so called extra-EU BITs, i. e. on BITs concluded between an EU member and a third country. Nevertheless, in order to clarify some important concepts, a discussion will also be undertaken on the relation between EU law, on one side, and, on the other side, intra-EU BITs, which are concluded between two EU member States. Chapter 7 will take due account of the changes introduced by the Lisbon Treaty to the competences of the EU in entering into extra-EU BITs and it will study the impact this may have on the regulation of the investments in the EU of SWFs owned by third countries. It will also discuss whether the EU should adopt a screening mechanism for foreign investments similar to the one already in force in some of its members or in other important recipients of in the capitals of SWFs, like the USA.

Finally, chapter 7 will also explore how the EU has participated in the activity undertaken by international organisation or by other international fora in order to adopt a mutually agreed set of principles and rules applicable to the operations of SWFs and to the policies that recipient States may adopt in relation to them. Such principles and policies are laid down in some instruments of soft law which have been adopted since 2008, especially on the impulse of the IMF or within the framework of the OECD.

Chapter 8 will be entirely devoted to the analysis of such instruments. It will focus first of all on a document titled "General Accepted Principles and Practices" (GAPP), also known as Santiago Principles, which has been adopted in 2008 by a forum of SWFs called International Working Group of Sovereign Wealth Funds (IWG). The content and the implementation of this document will be carefully analysed, together with the evolution of the IWG into the International Forum on Sovereign Wealth Funds (IFSWF). Chapter 8 will also explore other instruments of soft law which have been adopted within the framework of the Organization for Economic Cooperation and Development (OECD). The focus will be not only on the “declaration on SWFs and Recipient Country Policies”, adopted during the Ministerial Council Meeting on 4-5 June 2008 in Paris, but also on other important OECD instruments which have been quoted in such declaration: the Declaration on International Investment and Multinational Enterprises; the Guidelines on Corporate Governance of State-owned Enterprises and the Code of Liberalisation of Capital Movements (the latter being legally binding and therefore not constituting an instrument of soft law).

Since the majority of instruments explicitly addressing SWFs are instruments of soft law, the last part of chapter 8 will develop a more in depth discussion of what soft law actually is as well as of the subjects which can adopt soft law, its addresses, its legal effects, its relations with "hard law", i. e. with international and domestic legally binding provisions. It will be discussed the extent to which the instruments of soft law concerning SWFs may interact with provisions of hard law discussed in chapters 2 to 7 of the present thesis and the effects this may have on the international regulation of SWFs.

As a conclusion of this general introduction I attempt to anticipate some possible criticisms to my research.

First of all, some readers may argue that many topics are dealt with superficially. For instance, it could be remarked that in chapter 5, when I discuss the issue of the applicability of the principle of State immunity to SWFs, I do not develop an autonomous and systematic analysis of all the relevant domestic laws and of the relevant judgments issued by domestic tribunals, but, on the contrary, I simply build on the findings of a few doctrinal studies which in turn attempt to investigate general trends in the practice of some States in relation to the issue of State immunity. Likewise, it can be submitted that in chapter 6, when I review the exceptions to the principle of the free movement of capitals which have been laid down by the European Court of Justice, I only refer to a very few judgments, while I quickly mention doctrinal studies to provide an overview of the current interpretation of the much more abundant and complex jurisprudence of the European Court of Justice. Very similarly, it can be pointed out that when in chapter 7 I discuss the issue of the relation between EU law and BITs I do not develop a broader discussion on the issue of the external relations of EU law and of the relation between the European legal system and international law.

Such criticism can be dismissed in the following way. As the present research tries to demonstrate, the issues of the creation and of the investments of SWFs, as well as of the policies States may adopt to govern these phenomena, may be affected by a large number of provisions which pertain to a plurality of branches of international law and of European Union Law. Developing an exhaustive analysis of all the aspects of international and European law which may interact with the issue of the creation and the operations of SWFs would fall outside the scope of the present research. In fact, the objective of this research is to study the applicability to SWFs of certain provisions of international and EU law and not to develop an analysis of the content of such provisions. Therefore, the present thesis will provide only a very brief (and sometimes partial) overview of all the issues which allow to better understand the applicability of international and EU law to SWFs but which are not directly related to SWFs. In this way, it will be possible to focus on the legal acts, official documents and on the arbitral or judicial decisions which directly deal with SWFs or which in any case contain important principles and rules which may apply to SWFs.

This last argument allows to introduce a second possible criticism I expect to receive, that in my analysis I mostly discuss hypothetical situations. For instance, in chapter 4 I study the applicability of art. 25 of the Washington Convention of 1965 by an ICSID Tribunal in case of a hypothetical dispute between a foreign SWF and the host State. Moreover, in the same chapter I study whether and how certain substantive provisions of BITs could apply in case of similar hypothetical disputes, taking into consideration the peculiar features of SWFs. This is due to the fact, as it was explained above and as it will be showed in the following chapters, that so far international instruments (especially legally binding instruments) which explicitly mention SWFs are scarce and so are judgments or awards which are rendered to settle disputes concerning SWFs. More in general, the practice of the international community concerning SWFs is extremely scarce. This makes it necessary to study judgments, awards, treaties and other official documents which do not deal with SWFs and then to investigate which of the principles they contain could be applicable, *mutatis mutandis* to the creation and to the investments of SWFs.

When in the future more arbitral awards, international or domestic judgments, acts of international or municipal law are adopted, concerning issues related to the investments of SWFs, it will be possible to assess whether many of the concepts I develop in the present research will be confirmed or whether the practice of the international community will privilege other approaches and solutions.

A third possible criticism can be related to the fact that differently from many researches which have been recently published on SWFs and which focus on the issue of SWFs, I devote a relatively little number of pages to the analysis of the instruments directly and exclusively targeting the operations of SWFs, like, in particular, the GAPP (better known as Santiago Principles). This choice is due to the fact that such instruments are not binding and, as it will be clear in chapter 8, their content is very vague. Therefore, on their own they would hardly be able to establish a decently clear, sound and predictable legal framework governing the transnational operations of SWFs. Their relevance depends on whether they can interact with the existing instruments of hard law which are studied in chapter 2 to 7. Therefore only a full understanding of the applicability of legally binding instruments of international and European Union law and of their applicability to SWFs may allow a discussion on whether the principles of soft law explicitly addressing SWFs and which have been adopted in recent years, may have a practical impact on the operations of SWFs.

Unless otherwise specified, the present research relies on information updated to September 2011.

CHAPTER 1

AN OVERVIEW OF SOVEREIGN WEALTH FUNDS.

Introduction

The purpose of the present chapter is to provide a concise description of Sovereign Wealth Funds (SWFs). It will study economic and policy issues related, *inter alia*, to their origins, source of financing, size, localization, organization, investment strategies and implications of their operations. This chapter will adopt an economic approach and mainly a qualitative one. Its aim is not to provide an overarching and exhaustive analysis of macroeconomic and financial issues concerning SWFs, also because in the last four years several books, articles and working papers on these topics have already been published, and it would be difficult to add something really new in these fields. On the contrary, the aim of the present chapter is to provide just the basic information on SWFs and on the economic framework in which they develop, in order to facilitate a better understanding of the legal issues related to their creation and regulation which will constitute the argument of the present thesis and which will be studied in detail in the next chapters. This choice is motivated by the convincement that a proper discussion on the regulation of economic issues is favoured by a good understanding of the economic aspects and implications of the object of regulation.

Therefore, in the present chapter the focus will be on the explanation, from an economic perspective, of the aspects of the SWFs whose regulation will make the object of in depth analysis in the following chapters.

The present chapter will be organised as follows. Paragraph 1 will attempt to define SWFs. It will emphasise the protean nature of such State-owned investment vehicles and it will try to identify the basic features shared by all of them. It will also review the legal framework governing the creation of SWFs in the States owning them. In addition, it will discuss the similarities and the differences between SWFs, other institutional investors and other State entities which engage in transnational investments. Paragraph 2 will study how and why SWFs are created. It will distinguish between commodity funds and foreign exchange funds and it will explain the role they play in the economy of the State which establishes them. Paragraph 3 will describe the main features of SWFs in relation to their size and localization. Moreover, it will study their investments, analysing in particular which are the countries and the industries which so far have been the main recipients. It will also study whether SWFs mainly undertake direct or portfolio investments. Finally, it will explain why even low income countries have found it possible and convenient to use SWFs to invest abroad, in spite of the widespread poverty which still affect them. Paragraph 4 will discuss the main concerns the investments undertaken by SWFs rise in recipient countries. It will then review all the elements and the options which should be taken into account when trying to regulate them.

1. The problem of the definition of SWFs

The issue of the definition of SWFs rises some difficulties. In fact, as it will be clearer in the following paragraphs, SWFs present very different features as to their source of financing, their legal organization and their role. Finding a list of features which are shared by all of them is not easy. Likewise, it is not always easy to distinguish them from other entities, which are not SWFs but with which they share several features or with which they can be related in several different ways. Therefore, it can be sometimes difficult to draw a clear line between SWFs, on one side, and, on the other side, State-owned enterprises, State-owned pension Funds, Central Banks and other monetary authorities in charge of the management of reserves of foreign currency.

It would be impossible, and probably useless for the purposes of the present research, to review in this chapter all the definitions of SWFs which have been provided in literature.[1] In any case, it must be underlined that they are quite similar; therefore in the present paragraph a mention will be made to some of them and the focus will be on those definitions provided for in official documents adopted within the framework of international summits and especially on those contained in documents which, although not legally binding, form part of the so called soft law.

One of the first attempts to elaborate a definition of SWFs has been made on June 21, 2007 by Mr Clay Lowery – then Acting Under Secretary for International Affairs. In his view, a SWF is “a government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from official reserves".[2] The American economist Edwin Truman has argued that: "the broadest definition of a sovereign wealth fund (SWF) is a collection of government-owned or government-controlled assets." However he also points out that "narrower definitions may exclude such assets as government financial or nonfinancial corporations, purely domestic assets, foreign exchange reserves, assets owned or controlled by sub national governmental units, or some or all government pension funds."[3]

The Sovereign Wealth Fund Institute, which is the main think tank dealing with SWFs explains that "a Sovereign Wealth Fund (SWF) is a state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets." It further specifies that "these assets can include: balance of payments surpluses, official foreign currency operations, the proceeds from privatizations, fiscal surpluses, and/or receipts resulting from commodity exports" and that "Sovereign Wealth Funds can be

[1] For an attempt to review the definitions of SWF and to classify them see, for instance: F. BASSAN; *The law of Sovereign Wealth Funds*; Cheltenham; Edward Elgar Publishing; 2011; p. 17-35; S. CHIARLONE; *I fondi Sovrani*; in M. LOSSANI, F. BERTONI, S. CHIARLONE, ed; *Fondi sovrani: economie emergenti e squilibri global*; Milano: Francesco Brioschi Editore; 2010; p. 55-80.

[2] See, also for a comment of this definition: S. JEN; *The definition of a Sovereign Wealth Fund*; Morgan Stanley; 2007; available online at: http://www.morganstanley.com/views/gef/archive/2007/20071026-Fri.html#anchor17065580-419f-11de-a1b3-c771ef8db296 page visited on 09-02-2011; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; in *European Business Law Review*; 2010; p. 170-171.

[3] E. M. TRUMAN; *Sovereign Wealth Funds: New Challenges from a Changing Landscape; Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee*; US House of Representatives September 10, 2008.

structured as a fund, pool, or corporation." Such a definition clearly shows the variety of SWFs in relation to their origins and organization. In addition, according to the Sovereign Wealth Fund Institute "the definition of sovereign wealth fund exclude, among other things, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises (SOEs) in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals [...]"[4]

What could be regarded as an official definition of SWFs has been provided in October 2008 by the International Working group on SWFs (IWG) in occasion of the adoption of the “Santiago Principles[5]”. It reads as follows: “SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets.”

Some elements of this definition needs to be stressed.

First of all, SWFs are owned by a General government, which means both central and sub national governments. Therefore, there are SWFs owned, for instance, by China and Norway, but also by "sub national government" like Alaska (USA) Alberta (Canada) Abu Dhabi (United Arab Emirates). In this case, it could be argued that the term sovereign might be inappropriate, since sovereignty is a feature which does not pertain to sub-national governments. However, the element which deserves more attention is the following one. The declaration that a SWF must be owned by a general government allows to distinguish it from other institutional investors which operate in financial markets like mutual funds, hedge funds, non-State pension funds,

[4] Sovereign Wealth Fund Institute http://www.swfinstitute.org/what-is-a-swf/ page visited on 09-02-2011

[5] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - “Santiago Principles*”; IMF; 2008; available online at: http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf page visited on 27/7/2011. The content of this document will be analysed in detail see, *infra*, chapter 8. On the definition provided for in the "Santiago Principles" see also:

since the owner of the SWFs and of the assets under their management is always a State or one of its agencies, and never a non-State actor.[6]

The second element of the IWG definition which deserves to be underlined is that SWFs investment strategy includes (but it is not limited to) investments in foreign financial assets. For this reason Funds or other entities which invest in domestic assets only, are excluded from the IWG definition of SWFs. Therefore, the statements of some European medias and politicians that the Italian “Cassa Depositi e Prestiti” and the French “Caisse des Dépôts et Consignation” are SWFs would not be correct, since these two entities, although they are State-controlled long-term investors, actually invest essentially in domestic assets.[7]

The third element which according to the wording of the Santiago Principle defines SWFs is that they are created “for macroeconomic purposes.”[8] This concept will be defined more in depth in the following paragraphs, when it will be clarified the reason why SWFs are created and the task they fulfil. It can be anticipated that the profitability of the investments of SWFs, i.e. their ability to generate financial returns, can be regarded as one of the objectives of the investment strategies they pursue,

[6] Since the end of 2009 some SWFs have started to rise capitals from the market, e. g. by means of issuance of bonds (or even of shares in case of SWFs structured as companies). For instance Singapore’s Temasek Holdings has been issuing bonds since 2005, but it accelerated its bond program from Q3 2009. Between October 2009 and February 2010, it raised $4 billion through debt issues. Another example is constituted by the Mubadala Development Company which in April 2009 offered $1.25 billion in five-year bonds and $500 million in ten-year bonds to international investors. Nevertheless the fact that in this way SWFs manage also relatively small capitals owned by private investors and not exclusively by the State is deemed to be not sufficient to hinders the sovereign nature of SWFs. See: V. BARBARY, B. BORTOLOTTI, V. FOTAK, W. MIRACKY; *Sovereign Wealth Fund Investment Behavior; Semi Annual Report; January- June 2010*; FEEM and Monitor Group; 2010; p. 20-25.

[7] A. GOLDSTEIN, P. SUBACCHI; *I fondi sovrani e gli investimenti internazionali - Salvatori o sovvertitori?*; in VVAA; *L’Italia nell’economia internazionale. Rapporto ICE 2007-2008*; ICE; 2008; p. 59; A. DEMAROLLE; *Rapport sur les fonds souverains*; available online at: http://www.minefe.gouv.fr/presse/dossiers_de_presse/080522_rapdemarolle/rap_demarolle.pdf. Page visited on 10-10-2009; p. 28-29. Therefore it seems unconvincing the stance of other authors who considers as SWF all State entities investing State-owned wealth, irrespective of whether they invest only domestically or also overseas. For an example of this position see: X. YI-CHONG; *The political economy of Sovereign Wealth Funds*; in X. YI-CHONG, G. BAHGAT; ed.; *The political economy of Sovereign Wealth Funds*; Basingstoke; Palgrave Macmillian; 2010; p. 1-24

[8] On the macroeconomic function performed by SWFs and on the way they contribute to change the relation between the private and public spheres see, for instance: L. C. BACKER; *Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience*; in *Transnational law and contemporary problems*; 2010-2011; p. 141-144

but not as the reason underlying their creation. In fact, SWFs are created for macroeconomic purposes, which include the management of the revenues obtained from the exploitation of natural resources, the management of foreign exchange reserves, the management of the proceeds from privatizations, the conduct of industrial policy, the search of safe and stable sources of supply of commodities and other inputs for the companies based in the State which owns the SWFs at issues.

The same Santiago Principles stress the protean nature of SWFs. In fact it is acknowledged that they "have diverse legal, institutional, and governance structures. They are a heterogeneous group, comprising fiscal stabilization funds, savings funds, reserve investment corporations, development funds, and pension reserve funds without explicit pension liabilities."

Strictly speaking, the term "SWFs" should only refer to the "funds", regarded as mere pools of assets and foreign currencies owned or controlled by the States or by their agencies and instrumentalities. It would not refer to the authorities or to the State-owned enterprises which actually manage them, and decide how to invest the wealth hoarded in SWFs [9]. In practice, when the fund is not directly run by the government or the central Bank but by a legally independent authority or by a State-owned or State-controlled enterprise, the term SWF applies to both the fund and the company or the authority managing it.

As it has been pointed out by In the Santiago Principles, the legal framework governing the creation of SWFs can vary greatly. SWFs can be established as separate legal entities of public law, with full capacity to act and governed by a specific constitutive law. This is the case of the SWFs established by Kuwait, Korea, Qatar, and United Arab Emirates (Abu Dhabi Investment Authority, ADIA). Other SWFs take the form of state-owned corporations, which are created in accordance to the corporate law of the State owning them. They are different from other institutional investors, like for instance mutual funds and hedge funds, because the assets under their management is owned by the State. This solution has been adopted, *inter alia*,

[9] A. GOLDSTEIN, P. SUBACCHI; cit.; p. 55-57; INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Sovereign Wealth Funds - current institutional and operational practices*; IMF; 2008

by the Singapore's Temasek Fund, by the Government of Singapore Investment Corporation (GIC) and by China Investment Corporation (CIC). Finally, SWFs can consist in pools of assets without a separate legal identity, owned and managed directly by the central bank or the ministry of economic affairs. This occurs, for instance, in Botswana, Canada (Alberta), Chile, and Norway [10] . Their legal organization, and in particular the issue as to whether they have independent legal personality, is not decisive in determining the degree of independence of their management and staff from the political organs of States which own them. In fact, the control of the political organs on the activities of SWFs can be assured by other means: for instance in China the role of the Communist Party in determining and influencing the management of the China Investment Corporation ensures a certain degree of consistency of the operations of the SWF with the strategies and the priorities of the government.[11]

To define SWFs it can also be useful to study their relations with other State entities which performs also economic and investment activities or which are constituted as pools of assets or which own or manage them.[12] First of all, the distinction between SWFs and other State-owned enterprises should be assessed. In principle, SWFs are to be distinguished from any other State-owned enterprise as they do not carry out any commercial or industrial activity, but they only invest sovereign wealth. More in detail, it has been argued that while SWFs would mainly undertake portfolio investments and while they would mainly pursue public welfare functions, on the contrary SOEs would mainly undertake industrial investments and they would pursue

[10] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 11; INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Sovereign Wealth Funds - current institutional and operational practices*; cit.

[11] A. ARDUINO; *Il fondo sovrano cinese*; Milano; Barra Edizioni, 2009; L. C. BACKER; *The Chinese Communist Party and the Governance Structures of SWFs and SOEs: "Unswervingly Upholding the Party's Core Political Status in SOEs*", in Law at the End of the Day, 2009; available at http://lcbackerblog.blogspot.com/2009/09/chinese-communist-party-and-governance.html; page visited on 3/9/2010

[12] On this issue, see, for instance: R. M. KIMMIT; *Public footprints in private markets. Sovereign wealth funds and the world economy*; in: *Foreign Affairs*; 2008; p. 120

a company interest.[13] However, such distinction can become more blurred when SWF are also used (as it often occurs especially in countries like China and Singapore) as holdings which own and manage participations in other State owned enterprises. In addition, when SWFs do not undertake exclusively portfolio investments, but when they purchase controlling shares in companies, their involvement in economic activities other than asset management makes them more similar to other State owned enterprises.[14]

SWFs should also be distinguished from Central Banks and from foreign exchange reserves managed by Central Banks. However such distinction is often difficult to make in practise, since in some cases SWFs are owned and/or controlled by the Central Bank itself. Alternatively, it can occur that assets under the management of SWFs actually are foreign exchange reserves previously pertaining to the Central Bank and later transferred to SWFs in order to perform tasks which, although not identical to those traditionally performed by Central Banks or monetary authorities, are however complementary to them.[15]

As to the relation between pension funds and SWFs, it could be argued that if a pension fund is owned by a State and if it carries out investments overseas, it fulfils the first two conditions of the definition of SWF provided for in the Santiago Principle. As to the third element, i. e. the need to be established for macroeconomic purposes, it must be concluded that it is satisfied, as a fund created for the management of the pension system and the payment of pensions clearly performs macroeconomic functions. Only the source of financing of such funds can give rise to some doubts. In fact, in the Santiago Principles it is stated that the notion of SWF includes "pension reserve funds *without explicit pension liabilities*" (emphasis added). The definition proposed by the Sovereign Wealth Fund institute excludes from the notion of SWFs "government-employee pension funds".

[13] F. BASSAN; *The law of Sovereign Wealth Funds*; cit.; p. 21-23.

[14] On the interdependencies between SWFs and SOEs and on the role they play especially in non-market economies see: L. C. BACKER; *Sovereign Investing in Times of Crisis*; cit.; p 60-67 and p. 129-130. See also *infra* chapter 8 paragraph 4.

[15] See also: ECB; *Foreign asset accumulation by authorities in emerging markets*; ECB monthly Bulletin; January 2009

It seems it could be concluded that State pension funds, when they are financed through fiscal transfers or contribution (mandatory of voluntary) of employers or employees, should not be regarded as SWFs.[16] On the contrary, when they are created and financed as other SWFs, the fact that they are in turn used to finance the pension system would not prevent them from falling into the notion of SWFs. Therefore the Norway Government Pension Fund Global and the National Wealth Fund of Russia, since they are State owned fund, they invest their resources overseas, are financed through the sale of oil and gas and are used to finance the pension system can be regarded both as SWFs and as pension funds.

2. The creation of SWFs and the distinction between commodity and foreign exchange funds.

Broadly speaking, SWFs are created when States own big amounts of wealth and when they find it economically convenient to use a part of it to undertake investments abroad. In this way, a SWF is a special investment vehicle, to which an excess of resources is transferred in order to invest in domestic and foreign assets both. According to the source of financing of SWFs it is possible to distinguish between commodity funds, financed by the proceeds from the sale of commodities, and non-commodity funds. The latter can be divided in “forex” funds, financed by big trade balance surpluses, and fiscal funds, fed by surpluses deriving from privatization or structural surpluses of the State budget.

Commodity SWFs[17] are financed by the proceeds from the exploitation of natural resources (in particular oil, gas and minerals). Most SWFs of this kind are localized in the Middle East[18], in Russia[19], Central Asia, Africa and Latin America. Proceeds are

[16] A. BLUNDELL-WIGNALL, Y. HU, J. YERMO; *Sovereign Wealth and pension Funds issues*; in *Financial Market Trends*; 2008; p. 1-17; S. KERN; *Sovereign Wealth funds; State investments on the rise*; Deutsche Bank Research; 2007; p. 2.

[17] Further explanation of commodity SWFs will be also provided *infra* in chapter 2.

[18] For a discussion of SWFs and in general of commodity funds in the Gulf Region: J. NUGÉE, P. SUBACCHI; ed; *The Gulf region: a new hub of global financial power*; London; Chatham House; 2008. See also: G. BAHGAT; *Kuwait Investment Authority - an assessment*; in X. YI-CHONG, G. BAHGAT; ed.;

collected in different ways: through the direct sale of commodities in international markets (when their extraction is managed directly by State-owned companies) or through the royalties, export duties or taxes paid by foreign firms involved in the exploitation of natural resources in the State owner of SWFs.[20] Commodity funds may serve the purposes of saving funds, i. e. funds which should ensure intergenerational savings, and/or of stabilization funds, when they are used to stabilise the revenues from the sale of commodities. However, the two categories of commodity funds should not be considered as completely separate. In fact, a stabilization fund can also perform the function of a saving fund, especially when it grows sufficiently large to allow a part of the resources under its management to be used not only to insulate State budget from external shocks of world commodity prices but also to ensure inter-generational saving with even longer macroeconomic horizons.[21]

The functioning and the rationale underlying the creation of commodity SWFs can be explained as follows.

When a country is rich in natural resources, several policies are possible, depending on its needs, on its current economic situation and on how much of its natural resources it is able and willing to use for the wealth of the current or of the future generations. Many natural resources as oil, minerals, etc. are exhaustible and their exploitation in the present brings them to depletion into the future. This means that future generations will be prevented from enjoying the same level of wealth of current generations, at least if wealth only depends on the proceeds from the use of natural resources.

The political economy of Sovereign Wealth Funds; Basingstoke; Palgrave Macmillian; 2010; p. 72-87; J. A. KÉCHICHIAN; *Sovereign Wealth Funds in the United Arab Emirates*; in X. YI-CHONG, G. BAHGAT; ed.; *The political economy of Sovereign Wealth Funds*; Basingstoke; Palgrave Macmillian; 2010; p. 88-112; J. SEZNEC; *The Gulf Sovereign Wealth Funds: Myths and reality*; in *Middle East Policy*; 2008; p. 97-110.

[19] S. FORTESCUE; *Russia's SWFs: controlled by a domestic agenda*; X. YI-CHONG, G. BAHGAT; ed.; *The political economy of Sovereign Wealth Funds*; Basingstoke; Palgrave Macmillian; 2010; p. 113-132.

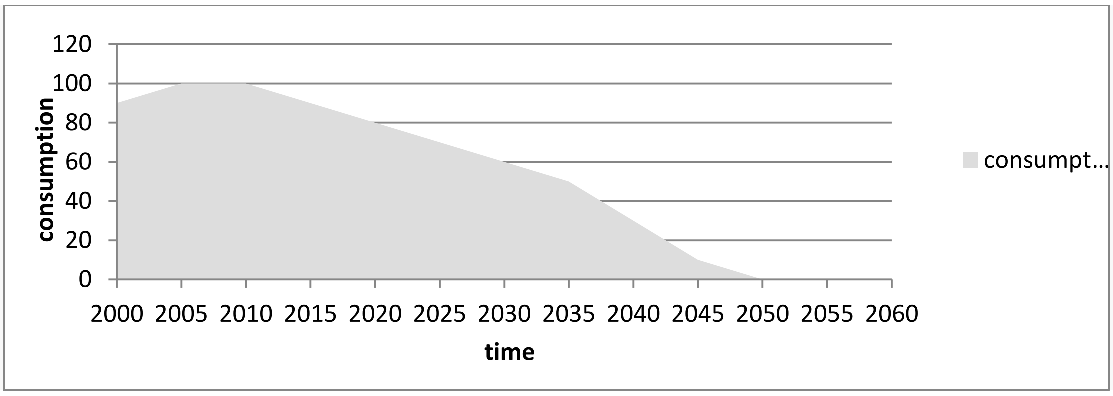
[20] E. M. TRUMAN; *Sovereign wealth funds: threat or salvation*; Washington, DC; Peterson Institute for International Economics; 2010; p. 21-22.

[21] E. M. TRUMAN; *Sovereign wealth funds: threat or salvation*; cit.; p. 10-11; Z. FENG; *How Should Sovereign Wealth Funds Be Regulated*?; in *Brook. J. Corp. Fin. & Com*; 2009; p. 488.

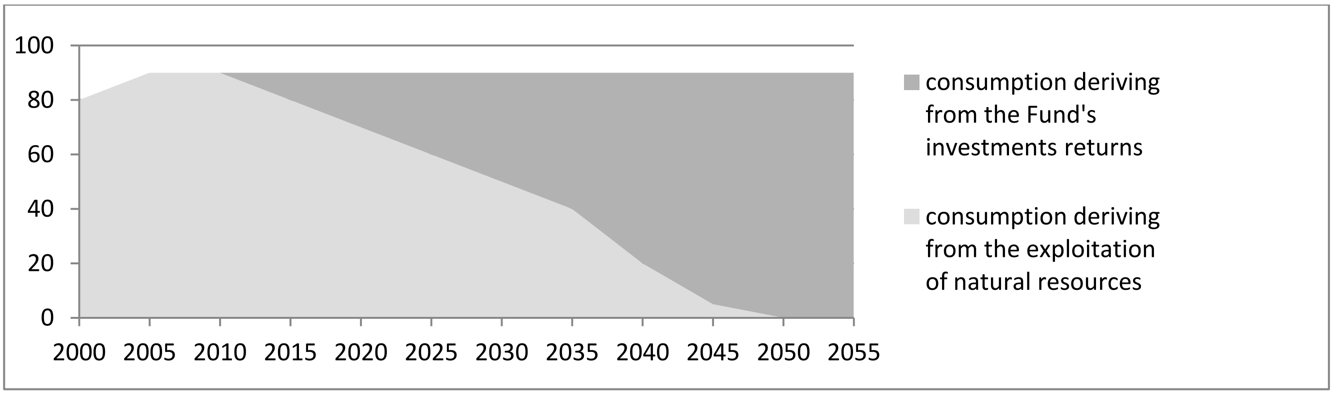
For this reason a State should chose to exploit its natural resources only in part, in order to leave them for future generations. Therefore, a government may decide not to extract all the oil which is technically possible to extract from its territory, and to leave a part of it in the subsoil. However, this strategy is not optimal. In fact, it is possible that in the future there will be no more demand for those natural resources which today are so much requested. For instance in the 20th century some economists warned that too much coal was extracted and consumed, bringing world reserves to depletion and prejudicing future opportunities of development. Today in the World there are still relevant coal reserves, but the demand for them is not as high as expected. For this reason, it could be ineffective a strategy which consists in refraining from exploiting today natural resources which are currently used in the productive processes and which can be profitably sold, while there is no certainty that in the future the world demand and the price of the same resources will be as high than it is at present. In other words it cannot be excluded that oil and gas, in the future, could have the same fate of carbon in the last century. For the reasons stated above, the best solution can consist in exploiting the natural resources at present and, at the same time, in setting aside a part of the proceeds in a fund. The fund shall carry out investments and it will ensure that, when natural resources are exhausted, the proceeds from its investments will equal the proceeds from the exploitation of natural resources. The fund shall carry out investments in the domestic market or abroad, in sectors others than those related to the exploitation of natural resources. The returns from such investments will ensure that future generations will enjoy the same level of wealth of current generations even when natural resources are exhausted. Moreover such a strategy makes it possible to turn an economy dependent on a few natural resources into an economy with several profitable sectors. These concepts can be better explained in the following graphs.[22]

[22] The following graphs are based on hypothetical data: they aim at clarify a general concept, not at portraying the situation of a specific country. They are based on the analysis developed in: J. JOHNSON-CALARI; *Managing commodity revenues and windfall profits: investment income funds*; in J. JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 47- 70 and especially p. 53-54

In graph 1 all proceeds are consumed; as a result, when natural resources get exhausted no consumption will be possible anymore



In graph 2 a part of proceeds is used to finance a fund. The returns of the investments of the fund (or a quota of them) will be devoted to consumption. As the graph shows, when natural resources are finished, future generation will be assured the same level of wealth. Future consumption will no more depend on the proceeds from the exploitation of natural resources but on the returns of the investments of the fund.



Commodity funds are also used to stabilise the revenues related to the exploitation of natural resources, allowing to set aside a part of the wealth in periods in which commodity prices are high and eventually to withdraw it and make it available when commodity prices are lower.

To better understand their role, it must be remarked that commodities are one of the most volatile assets and therefore revenues related to their exploitation and sale can change dramatically as a result of an increase or a decrease of their price on the international markets. In fact it has been calculated that the average commodity volatility (expressed by the standard deviation of price return) is about 20%-25% annually. This depends not only on the changes of supply and demand for commodities for industrial uses, but also on international speculations. Without stabilization funds, revenues related to the exploitation of natural resources can vary dramatically and one of the negative consequences is that governments of countries rich in natural resources and heavily relying on them will be prevented from effectively planning their investments and expenses in the long run. This would have disruptive effects on their possibility to implement programs aiming at the development of the domestic economy.

In conclusion, if a State is rich in natural resources which are demanded by the international markets it should exploit them; however the revenues thus obtained should not be entirely and immediately used for consumption. On the contrary, they should be used in order to improve the domestic macroeconomic and social situation in a durable and sustainable way.

More in detail, the following uses are possible. First of all, proceeds from the exploitation of natural resources could be used in order to reduce public debt, especially when it has reached levels which can affect the stability of public finances. To this extent, it should be reminded that many countries which have traditionally experienced persistent deficits and problems with their public finances, thanks to the proceeds from the exploitation of their natural resources have been able to reduce their debts and to run big surpluses, which have allowed them to hoard enough wealth to invest abroad.

Secondly, the proceeds from the sale of natural resources could be used in order to carry out productive investments in the domestic economy, in order to enhance its diversification and modernization. However, it is possible that the domestic economy, given its small size and its limited level of current development, might be unable to absorb in productive investments all the capitals which are obtained from the exploitation of natural resources. In this case it makes sense to create saving funds, which could ensure that resources which cannot be profitably invested in the present in the domestic economy might be "set aside" for future domestic investments or consumption.

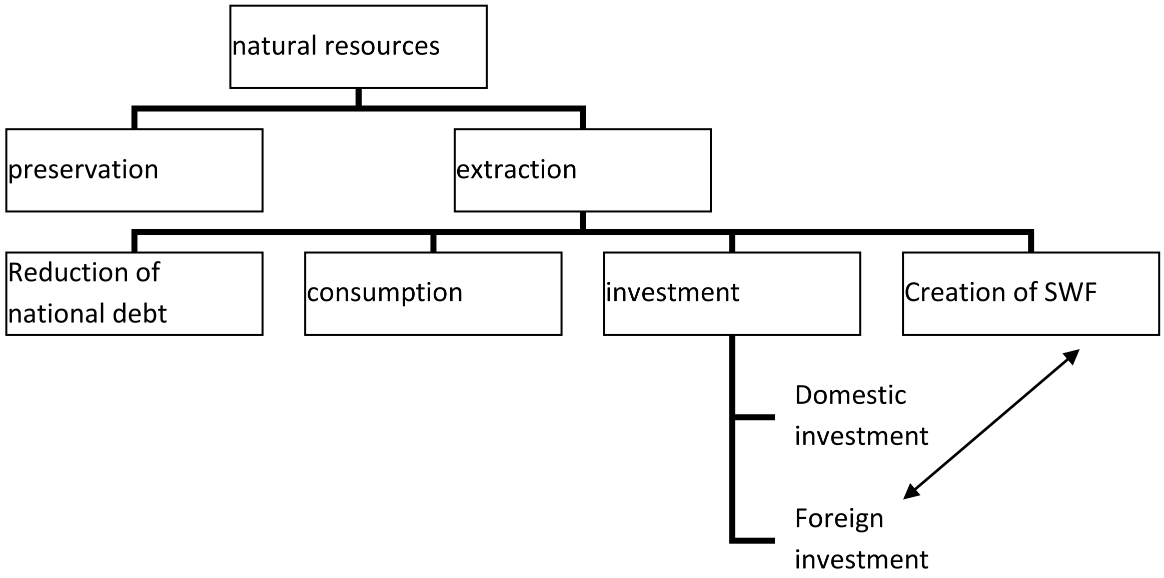
Finally, a part of the proceeds from the exploitation of natural resources should be used in order to stabilise revenues from the exploitation of natural resources, according to the mechanism of stabilization funds showed above.[23]

Saving funds and stabilization funds by themselves are not SWFs according to the definitions provided above, and especially according to the definition provided for in the Santiago principles. They become SWFs when they undertake investments (also) overseas. However, in practise, this often occurs: in fact, as explained above, revenues from the exploitation of natural resources often cannot be entirely invested immediately in the domestic economy and therefore commodity funds, and especially

[23] On the functions of commodity SWFs and on the rationale underlying their creation see: L. H. SUMMERS; *Opportunities in an era of large and growing official wealth*; in J. JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 15 -28; J. JOHNSON-CALARI *Managing commodity revenues and windfall profits;* cit.; p. 47- 70; K. N. KJAER; *Turning oil wealth into financial assets: the case of Norway*; in JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 189-202; L. MOHOHLO; *Traditional reserves and the management of commodity revenues: the case of Botswana*; in JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 203-218; S. COWPER; *A word to the wise: managing Alaska's oil wealth*; in JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 219- 230; M. SARTBAYEV, A. IZBASAROV; *Managing oil wealth in a transition economy: Kazakhstan's oil fund*; in JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 247- 256; R. PARRADO; *Sovereign funds; the Chilean experience*; in M. RIETVELD; ed.; *New perspectives in sovereign asset management*; Central Banking Publication; 2008; p. 161-172. M. BARBIERI; *Developing Countries and their Natural Resources. From the Elaboration of the Principle of Permanent Sovereignty over Natural Resources to the Creation of Sovereign Wealth Funds*; UNCTAD- Virtual Institute Digital Library; 2009; p. 22-28; J. SANTISO; *Sovereign Development Funds: Key financial actors of the shifting wealth of nations*; OECD Emerging Markets Network Working Paper; 2008; p. 6.; T.WÄLDE; *Natural resources and sustainable development: from "good intentions" to "good consequences*" in N. SCHRIJVER, F. WEISS ed.; *International law and sustainable development – principles and practice*; Leiden; Martinus Nijhoff Publishers; 2004; p. 130- 150; R.VAN DER PLOEG, A. VENABLES; *Harnessing windfall revenues in developing economies*; VOX; 2008; available online at http://www.voxeu.org/index.php?q=node/1725; page visited on 30/1/2009; S. KERN, H. REISEN; cit.; p. 6-9; S. GRIFFITH-JONES, J. A. OCAMPO; *Sovereign Wealth funds: a developing country perspective*; Columbia University; 2008; available online at: http://policydialogue.org/files/events/Griffith-JonesSovereign_Wealth_Funds.pdf webpage visited on 07/05/2011; p. 8-10; E. BARBIER; *Natural resources and economic development*; Cambridge; Cambridge University press 2005; p. 1-184 and p. 344-372.

saving funds, *de facto* need to invest abroad a part of the assets under their management.

All the possible governmental choices mentioned so far, can be summarized in the following scheme.


natural resources
preservation
extraction
Reduction of national debt
consumption
investment
Creation of SWF
Domestic investment
Foreign investment

A discussion on commodity SWFs should also mention their role in preventing the so called Dutch Disease, which occurs when an economy excessively relies on the exportation of its natural resources. As the demand of foreigners for commodities rises, the real exchange rate of the exporting country tends to rise. As a result, competitiveness of goods other than commodities is reduced and dependency on the export of commodities becomes even more entrenched, enhancing the country's vulnerability to shocks of commodity prices. Moreover, in such a situation, investments in other sectors which might provide high returns in the future are not encouraged. Using the proceeds from the use of natural resources to promote investments in other fields than the exploitation of these resources is a way to avoid the Dutch Disease and the creation of a SWF can be particularly suitable.[24]

Another important category of SWFs is constituted by forex SWFs[25], which are financed by the transfer of part of the reserves of foreign currency owned by a State, which in turn are the result of big trade balance surpluses not obtained by the sale of commodities. SWFs belonging to this category are localized in particular in East Asia, where increasing exportations (mainly of low-cost manufactured products) and high saving rates have permitted hoarding a big amount of foreign reserves. The process which has brought to the creation of SWFs in these countries can be summarized as follows.

East Asia countries like China have in the last years experienced persistent surpluses of the current account balance. This brings them to own a large amount of foreign currency. This *should* have two main consequences.

The first is that in the international money market, the increased demand for the goods produced by a country, which results into an increased demand for the currency of that country, would bring to a revaluation of such currency. As a result, there would be an increase of prices denominated in the currency of the importing countries of the goods exported whose competitiveness would be trimmed down.

The second consequence is that in the domestic market an increase of supply of money would occur, and this would raise the level of prices, affecting real exchange rates and making exported goods less competitive in world markets[26].

[24] C EBRAHIM-ZADEH; *Dutch Disease: too much wealth managed unwisely*; Finance and development; 2003; available online at: http://www.imf.org/external/pubs/ft/fandd/2003/03/ebra.htm page visited on 3/9/2011; P. STEVENS, E. DIETSCHE; *Resource curse: An analysis of causes, experiences and possible ways forward*; in *Energy Policy*; 2008; p. 56 seq.; E. BARBIER; cit.; p. 108-154.; E. DURUIGBO; *The World Bank, multinational oil corporations and the resource curse in Africa*; in *University of Pennsylvania Journal of International Economic Law*; 2005; p. 2-67.

[25] The term "forex", which is adopted in the present thesis, is an abbreviation of foreign exchange and is used, for instance, in A. GOLDSTEIN, P. SUBACCHI; cit.; p. 56. Some aspects concerning the functioning of forex funds as well as the way States create them will be the object of more in depth analysis *infra* in chapter 3.

[26] For a more detailed explanation on the role of foreign exchange reserves see: R. CARBAUGH; *International Economics*, 10th ed., Cincinnati; Thomson South Western; 2005; p. 491-492. On the mechanism through which current account surpluses lead to the increase of the reserves of foreign currency see: P. KRUGMAN, M. OBSTFELD; *International Economics - Theory and Policy*; 8th ed.;

Actually, in many East Asia economies we are considering in this chapter, these two mechanisms, which automatically would bring the current account back to equilibrium, are prevented from working. The main reason for this situation is that the countries we are considering, pursue an export-based model of economic growth, which makes them interested in keeping their currency undervalued. Also because of the scarce autonomy of their central banks, it is possible for them to implement monetary policies allowing governments to pursue this kind of objectives.

Broadly speaking, a Central bank of these countries may act as follows. It may maintain big foreign currency reserves[27], in order to reduce the supply of these currencies in international markets and in order to keep them over-valued vis-à-vis its own currency. At the same time, when sterilizing official reserves, it may reduce the supply of money in the domestic markets, in an attempt to tackle inflation and its effects on real exchange rates.

The main consequence of all the above mentioned policies is an increase in foreign reserves. Sound foreign reserves are useful, as they ensure the maintenance of a fixed exchange rate or, in case of floating exchange rates, they hinder excessive fluctuations. In any case they help to prevent speculative attacks or massive and disruptive outflows of capitals. It is not fortuitous that many Eastern Asia economies have started policies aiming at hoarding large foreign reserves after 1997 in order to avoid repeating the problems experienced during the currency crisis occurred that year.[28] Nevertheless, when reserves exceed a certain level, problems may rise. They cause inflation (because they determine an increase of money supply) or, if sterilized, the monetary authorities need to pay interests for securities they had issued to mop up excess liquidity. Moreover, large foreign reserves holdings can lead to a risk for the central bank's balance sheet (in particular exchange rate and, in part, interest rate risk) without providing relevant returns. All these reasons encourage states to seek for an alternative use of the part in excess of their official reserves. A valid

Boston; Pearson International Edition; 2009; p. 307-312; M. D. LEVI; *International Finance*; 5th ed.London, New York; Routledge; 2009; p. 151-155; R. CARBAUGH; cit.; p. 320-321.

[27] Foreign currency reserves, foreign exchange reserves, official reserves are used as synonyms.

[28] See, *infra*, chapter 3 par. 2 and par. 3

alternative is to have them transferred to a Fund using them to invest abroad. It is in this way, and according to this rationale, that forex SWFs are created.[29]

A quick mention, at the end of the present paragraph, should be made to other kind of non-commodity SWFs, which are created with the purpose of effectively investing the proceeds which are obtained, from partial or total privatizations of the economy. Since privatizations can be made only once, (it is clearly not possible to privatize again an asset which has already made the object of previous privatization) proceeds from privatization are obtained *una tantum*. This makes it clear that they can give rise to stable and durable income only if they are properly invested in a way which can generate returns. SWFs can properly serve this purpose.

3. Localization, size and investments of SWFs

After having defined what a SWF is and how it is created, it is finally possible to provide a list of existing SWFs which specifies, for each of them, basic information as to the geographical origin, the size, the year of inception, the source of financing, and the degree of transparency. There are many lists available: the one reported in this chapter is prepared by the Sovereign Wealth Fund Institute. It must be remarked that it includes certain entities like the French Strategic Investment Fund, which, for the

[29] On the economics of the creation of forex SWFs see: L. H. SUMMERS; cit.*;* p. 15 -28; P. M. HILDEBRAND; *Four tough questions on foreign reserve management*; in J. JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 29- 45; C. RHEE; *The creation of the Korea Investment Corporation*; in J. JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 257-272; S. KERN; *Sovereign Wealth funds; State investments on the rise*; cit.; p. 2; S. KERN, H. REISEN; *Commodity and non-commodity Sovereign Wealth funds*; Deutsche Bank Research; 2008; p. 3; H. REISEN; *Fonds souverains et économie du développement*; *La Vie économique- Revue de politique économique*; 2008; p. 26-28, P. SUBACCHI; *Capital flows and emerging market economies: a larger playing field?*; Chatham House; 2007; R. BECK, M. FIDORA; *The impact of Sovereign Wealth Funds on global financial markets*; Occasional Chapter series No 91 / July 2008; European Central Bank; S. BUTT, A. SHIVDASANI, C. STENDEVAD, A. WYMAN; *Sovereign Wealth Funds: A Growing Global Force in Corporate Finance*; in *Journal of applied corporate finance*; 2008; p. 73-83; T. GOMES; *The Impact of Sovereign Wealth Funds on International Financial Stability*- Discussion paper 2008-14; Bank of Canada; 2008; p. 1 and p. 6; S. CHIARLONE; *Squilibri globali e accumulazione di riserve*; in M. LOSSANI, F. BERTONI, S. CHIARLONE, ed; *Fondi sovrani: economie emergenti e squilibri globali*; Milano: Francesco Brioschi Editore; 2010; p. 35- 54

reasons stated above, can hardly fit into the notion of SWF which is adopted in the present research and which essentially relies on the one provided for in the Santiago Principles.

Country	**Fund Name**	**Assets $Billion**	**Inception**	**Origin**	***Linaburg-Maduell Transparency Index***
UAE – Abu Dhabi	Abu Dhabi Investment Authority	$627	1976	Oil	3
Norway	Government Pension Fund – Global	$571.5	1990	Oil	10
China	SAFE Investment Company	$567.9**	1997	Non-Commodity	2
Saudi Arabia	SAMA Foreign Holdings	$472.5	n/a	Oil	2
China	China Investment Corporation	$409.6	2007	Non-Commodity	7
Kuwait	Kuwait Investment Authority	$296	1953	Oil	6
China – Hong Kong	Hong Kong Monetary Authority Investment Portfolio	$292.3	1993	Non-Commodity	8
Singapore	Government of Singapore Investment Corporation	$247.5	1981	Non-Commodity	6
Singapore	Temasek Holdings	$157.2	1974	Non-Commodity	10

China	National Social Security Fund	$146.5	2000	Non-Commodity	5
Russia	National Welfare Fund	$142.5*	2008	Oil	5
Qatar	Qatar Investment Authority	$85	2005	Oil	5
Australia	Australian Future Fund	$72.9	2004	Non-Commodity	10
Libya	Libyan Investment Authority	$70	2006	Oil	2
UAE – Abu Dhabi	International Petroleum Investment Company	$58	1984	Oil	n/a
Algeria	Revenue Regulation Fund	$56.7	2000	Oil	1
US – Alaska	Alaska Permanent Fund	$40.3	1976	Oil	10
Kazakhstan	Kazakhstan National Fund	$38.6	2000	Oil	6
South Korea	Korea Investment Corporation	$37	2005	Non-Commodity	9
Malaysia	Khazanah Nasional	$36.8	1993	Non-Commodity	4
Azerbaijan	State Oil Fund	$30.2	1999	Oil	10
Ireland	National Pensions Reserve Fund	$30	2001	Non-Commodity	10
Brunei	Brunei Investment Agency	$30	1983	Oil	1
France	Strategic Investment Fund	$28	2008	Non-Commodity	n/a

Iran	Oil Stabilisation Fund	$23	1999	Oil	1
Chile	Social and Economic Stabilization Fund	$21.8	1985	Copper	10
UAE – Dubai	Investment Corporation of Dubai	$19.6	2006	Oil	4
Canada	Alberta’s Heritage Fund	$14.4	1976	Oil	9
US – New Mexico	New Mexico State Investment Council	$13.8	1958	Non-Commodity	9
UAE – Abu Dhabi	Mubadala Development Company	$13.3	2002	Oil	10
New Zealand	New Zealand Superannuation Fund	$12.1	2003	Non-Commodity	10
Brazil	Sovereign Fund of Brazil	$11.3	2008	Non-Commodity	TBA
Bahrain	Mumtalakat Holding Company	$9.1	2006	Oil	8
Oman	State General Reserve Fund	$8.2	1980	Oil & Gas	1
Botswana	Pula Fund	$6.9	1994	Diamonds & Minerals	6
East Timor	Timor-Leste Petroleum Fund	$6.3	2005	Oil & Gas	6
Mexico	Oil Revenues Stabilization Fund of Mexico	$6.0	2000	Oil	n/a
Saudi	Public Investment	$5.3	2008	Oil	3

Arabia	Fund				
China	China-Africa Development Fund	$5.0	2007	Non-Commodity	4
US – Wyoming	Permanent Wyoming Mineral Trust Fund	$4.7	1974	Minerals	9
Trinidad & Tobago	Heritage and Stabilization Fund	$2.9	2000	Oil	8
UAE – Ras Al Khaimah	RAK Investment Authority	$1.2	2005	Oil	3
Venezuela	FEM	$0.8	1998	Oil	1
Vietnam	State Capital Investment Corporation	$0.5	2006	Non-Commodity	4
Kiribati	Revenue Equalization Reserve Fund	$0.4	1956	Phosphates	1
Indonesia	Government Investment Unit	$0.3	2006	Non-Commodity	TBA
Mauritania	National Fund for Hydrocarbon Reserves	$0.3	2006	Oil & Gas	1
UAE – Federal	Emirates Investment Authority	n/a	2007	Oil	2
Oman	Oman Investment Fund	n/a	2006	Oil	TBA
UAE – Abu Dhabi	Abu Dhabi Investment Council	n/a	2007	Oil	TBA
Nigeria	Nigerian Sovereign Investment Authority	n/a	2011	Oil	n/a
	Total Oil & Gas Related	$2,628.7			

	Total Other	$2,102.5			
	TOTAL	**$4,731.2**			

*This includes the oil stabilization fund of Russia.

**This number is a best guess estimation.

***All figures quoted are from official sources, or, where the institutions concerned do not issue statistics of their assets, from other publicly available sources. Some of these figures are best estimates as market values change day to day

Table 1. Source: website of the Sovereign Wealth Fund institute, page: http://www.swfinstitute.org/fund-rankings/ visited on 12/08/2011

In paragraph 2, it was explained that sources of financing of most SWFs are the foreign exchange reserves in excess (in case of forex funds) or the proceeds from the exploitation of natural resources (in case of commodity funds). For these reasons, forex SWFs and commodity SWFs are owned, respectively, by countries which experience current account surpluses or which have and exploit important natural resources.[30] Forex funds are owned in particular by Asian countries, especially China, which in recent years have hoarded large amounts of foreign exchange reserves thanks to the increase of their exports which has not been matched by an equally big increase of imports.

Commodity funds, which in most cases are oil and gas funds, in the sense that their source of financing is related to the sale of oil and natural gas in the international markets, are owned especially by the States of the Gulf Region. Nevertheless, important oil funds are owned also by Asian countries (like Kazakhstan) and European countries (Russian and Norway). The creation of many SWFs belonging to this category occurred in the first years of the XXI century and it is clearly related to the increase of oil and gas prices, which have brought to oil-rich countries an

[30] It is important to note that it is not enough that a State has big natural resources. It is important that it can actually control them and enjoy the proceeds from their exploitation. Countries like Congo, which is far from being able to use and enjoy its natural resources is not able to set a SWF.

unexpected wealth. Commodity SWFs which are not financed by oil proceeds, can be created in order to manage the wealth for the exploitation of the country's endowments of other natural resources: copper (in case of the Chilean SWF) diamonds (Botswana) phosphates (Kiribati).

Table 2 shows the relation between the existence of rich oil reserves with the establishment of a SWF. It is clear that countries benefiting from the proceeds from oil have been capable to finance large SWFs.

Country	Barrels in Billions	World Share	Main Oil Commodity SWFs
Saudi Arabia	264.3	21.9%	SAMA Foreign Holdings
Iran	137.5	11.4%	Oil Stabilisation Fund
Iraq	115.0	9.5%	
Kuwait	101.5	8.4%	Kuwait Investment Authority
United Arab Emirates	97.8	8.1%	Abu Dhabi Investment Authority
Venezuela	80.0	6.6%	FIEM
Russia	79.5	6.6%	Oil Stabilization Fund
Libya	41.5	3.4%	Libyan Arab Foreign Investment Company
Kazakhstan	39.8	3.3%	Kazakhstan National Fund
Nigeria	36.2	3.0%	Excess Crude Account
United States	29.9	2.5%	Alaska Permanent Fund
Canada	17.1	1.4%	Alberta's Heritage Fund
China	16.3	1.3%	
Qatar	15.2	1.3%	Qatar Investment Authority
Mexico	12.9	1.1%	

Algeria	12.3	1.0%	Revenue Regulation Fund
Brazil	12.2	1.0%	
Angola	9.0	0.7%	Reserve Fund for Oil
Norway	8.5	0.7%	Government Pension Fund – Global
Azerbaijan	7.0	0.6%	State Oil Fund
Sudan	6.4	0.5%	
India	5.7	0.5%	
Oman	5.6	0.5%	State General Reserve Fund
Other	57.1	4.7%	
TOTAL	1208.2	100.0%	

Table 2. Sources: BP Statistical Review of World Energy June 2007, Sovereign Wealth Fund Institute

SWFs manage assets estimated to be worth 4,731 billion of USD. It is important to keep in mind that there exist other researches according to which the size of SWFs is very different, and it would be about 2,000 or 2,900 billion of USD[31] or even 5,000 billion of USD.[32] It is quite pointless to make a survey of all different estimates provided by international institutions and research centres, in particular as these estimates diverge significantly, because of different methods used to compute assets held by SWFs as well as a result of lack of transparency of many SWFs and the impossibility to know how much wealth some of them actually manage. When analysing the size of SWFs and the size of the investments they can make abroad, it can be more useful to consider other aspects.

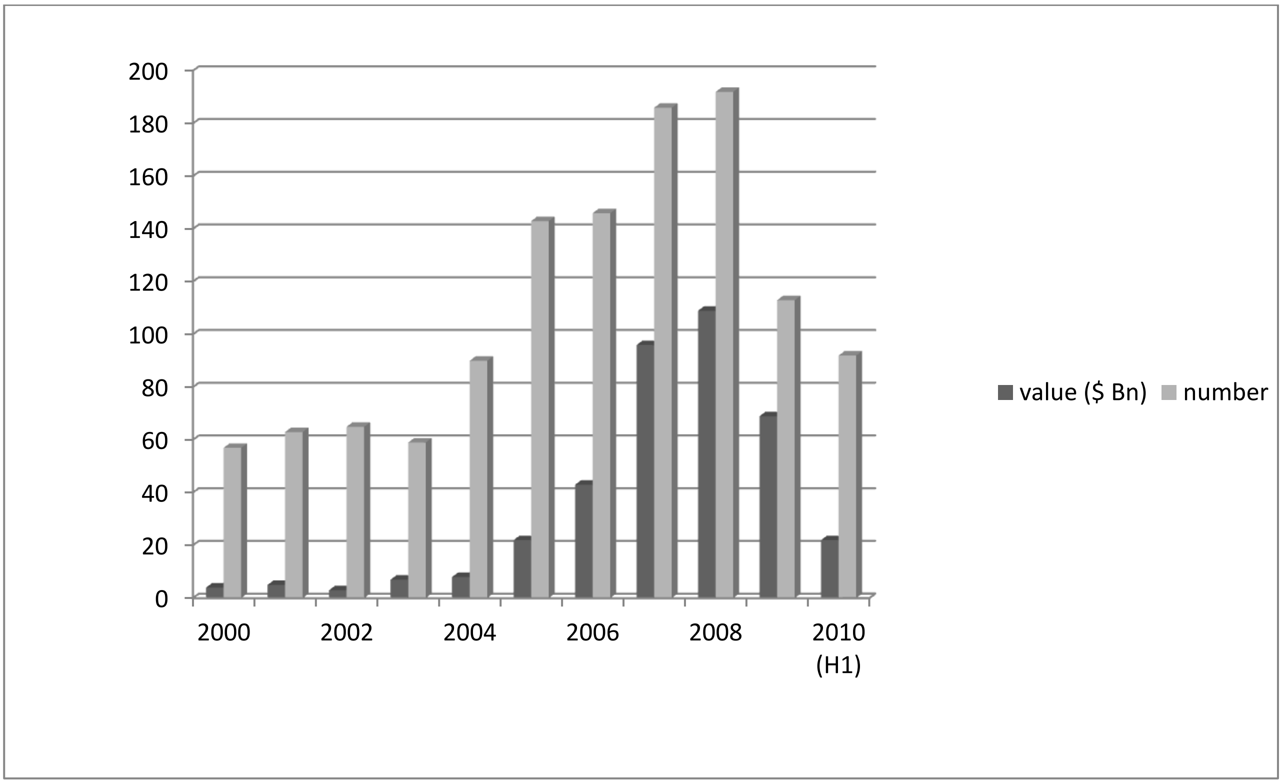
First, in many cases data available are provided spontaneously by the SWFs themselves and, when they decide not to disclose such information, data are based on estimates. Second, the value of assets held by SWFs can change, in particular in the current period of high volatility of financial markets. Third, it is important to note

[31] E. M. TRUMAN; *Sovereign Wealth Funds: New Challenges from a Changing Landscape*; cit..

[32] For further information on the size of SWFs see, for instance: UNCTAD; *World Investment Report 2008 - Transnational Corporations and the Infrastructure Challenge*; Geneva; UNCTAD; 2008; p. 20.

that only a part of the wealth SWFs manage is actually used to buy foreign assets. For these reasons, when we are talking about the foreign investments of SWFs, we should remind that they actually invest abroad much less than 4,731 billion USD. On the other side, as State owned pension funds (those which are different from SWFs, otherwise they would fall under the category of SWFs, as explained in paragraph 1), State-owned enterprises and, according to certain aspects, Central Banks, can make invests abroad, the amount of sovereign-owned foreign assets will be clearly higher than the amount of foreign assets owned by SWFs alone. In conclusion, the amount of the resources under the management of SWFs may not correspond to the amount of all the State owned wealth invested overseas.

As it is impossible to know precisely the current size of SWFs, it is very difficult to forecast their size in the future. There is only one certainty on this issue: SWFs' total size worldwide has increased dramatically over the past 10–15 years. In 1990, SWFs probably held, at most, $500 billion and in 2006 they still were relevantly smaller than today. Moreover, in recent years the involvement of SWFs in the world economy has increased. This is clearly shown in graph 3, which reports the increase of SWFs transactions both in relation to their number and to their size.



Graph 3. SWF equity transactions by value and number. source: Victoria Barbary Bernardo Bortolotti Veljko Fotak William Miracky; Sovereign Wealth Fund Investment Behavior; Semi Annual Report; January- June 2010; FEEM and Monitor Group; 2010

Until 2007, when the growth of SWFs seemed unstoppable and when the international economic context providing the conditions for a further development of SWFs seemed to be unquestionable, some estimates forecast that assets under the management of SWFs could have reached $10 trillion by 2012.[33] According to other studies, SWFs could have reached $ 4.7 trillion by 2010 and $ 10 trillion by 2015.[34]
However, all these estimates relied on the fact that SWFs would have grown in the future as fast as they have done in the first 8 years of the 21st century. The international economic events occurred since 2007 have prevented this from

[33] S. JOHNSON; *The Rise of Sovereign Wealth Funds*; in Finance and development; 2007; available online at: http://www.imf.org/external/pubs/ft/fandd/2007/09/pdf/straight.pdf page visited on 3/9/2011

[34] For a more in-depth discussion of the growth scenarios of SWFs see: S. KERN; *SWF's and foreign investment policies - an update*; Deutsche Bank Research; 2008; p. 6-7.

occurring. In fact, the economic crisis started in 2007 has brought to a recession of the world economy and currently recovery is extremely slow, especially in western countries. World demand for manufactured goods and for commodities has therefore been severely hit. Oil and other commodity prices have fallen and in spite of a partial recovery they are still down from their tops of 2007. Official reserves owned by Central Banks in certain emerging economies, especially in Russia, have diminished sharply and re-constituting them requires much more time than spending them. In such a situation, the main sources of financing of SWFs, as they have been explained in paragraph 2, have been reduced. Moreover, the economic crisis and the threat of recessions of the domestic economy of some States owning SWFs have brought governments to use a larger quota of the assets under the management of their SWFs to help domestic troubled firms, instead of continuing to invest overseas. Finally, we should remind that as a result of the current financial crisis many assets hold by SWFs have lost in part their value, given the fall of stock prices.[35]

Irrespective of possible estimates on the future growth of SWFs, as a matter of fact they have increased in size in the last decade and so have done their investments abroad. It is important to stress that in the past many developing countries used to invest their official reserves in excess or their wealth deriving from current account surpluses mainly in low risk (but also low-yielding) assets, in particular in US Treasury bond or in other liquid assets. The creation of SWFs is consistent with a change in strategy, according to which SWFs seek to achieve a higher degree of diversification, both from the point of view of the sectoral and geographical distribution of their operations and from the point of view of asset classes in which they envisage to invest.[36]

[35] S. KERN; *SWF's and foreign investment policies - an update*; cit; 11; V. ROSSI; *Learning to live with SWFs*; in W. MIRACKY, B. BORTOLOTTI; ed.; *Back on course. Sovereign wealth und activity in 2009*; Monitor Group and FEEM; 2010; p. 54-57.

[36] D. SINISCALCO; *Governi alle porte. Crisi del credito e fondi sovrani*; in *Mercato, Concorrenza Regole*; 2008; p. 75-86; P. SUBACCHI; cit.; R. J. GILSON, C. J. MILHAUPT; *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*; in *Stanford Law Review*; 2008; p.1347-1348.

In principle SWFs are able to invest in virtually any kind of assets: equity and debt instruments, units of funds as well as in any other financial asset. SWF can also invest in non financial assets, like real estates, etc.. Possible limitation on the eligible asset classes may be imposed by the legal framework governing the operations of the SWF which is laid down in the legislation of the owner State.

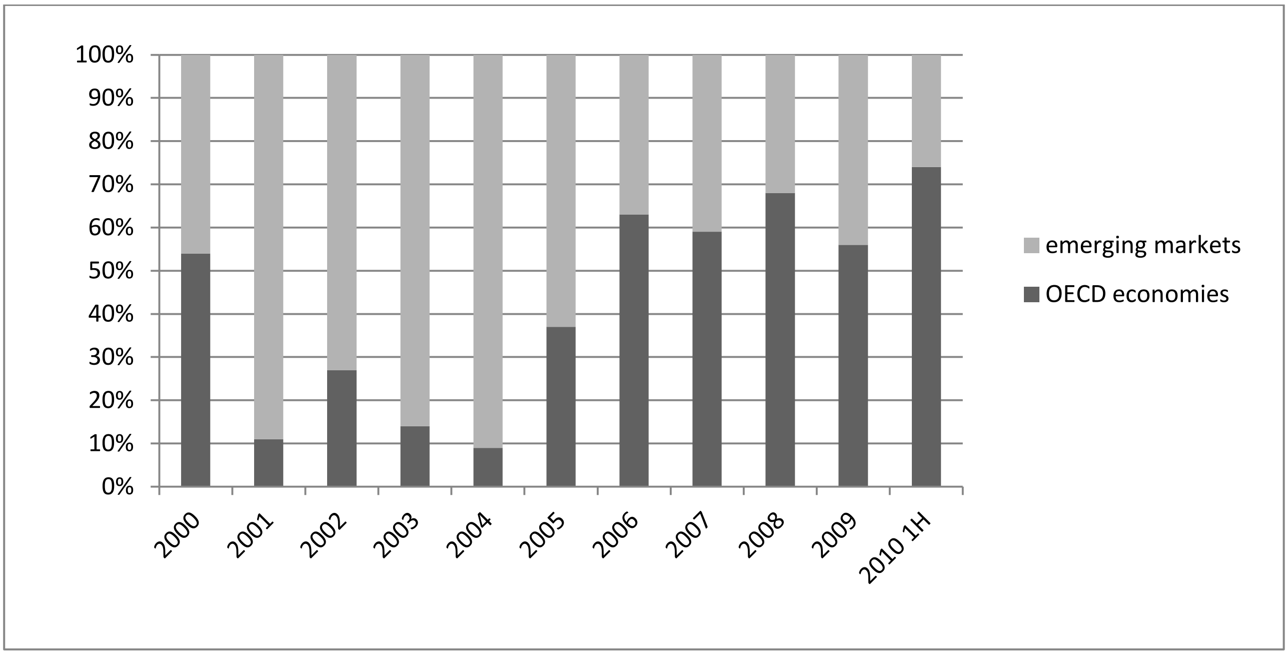
As to the issue of which countries are the main recipients of the investments of SWFs and which are the most targeted sectors, it is necessary to develop a more articulated discussion.

With respect to the first aspect, North American and European countries have become the main recipient of SWFs investment, and this trend has increased in the first decade of the XXI century. However, as graph 4 shows, since 2009 SWFs have progressively increased the quota of their investments towards emerging non-OECD countries, which seemed to provide better business opportunities also because of their good macroeconomic fundamentals and the encouraging prospective of economic growth.[37] Moreover, it must be remarked that also before the inception of the crisis many Asian SWFs undertook to significantly invest in other Asian countries, and some authors think that in some cases they do so because of the existence of a regional bias. In other words, certain SWFs would tend to invest in countries with the same religion or similar culture, partially disregarding financial aspects meant in a narrow sense.[38] Finally, other authors have stressed that the increased amount of SWFs' investments in developing countries of Africa and Asia, may allow to consider SWFs as new tools for the promotion of economic development in these countries.[39]

[37] V. BARBARY, B. BORTOLOTTI, V. FOTAK, W. MIRACKY; *Sovereign Wealth Fund Investment Behavior; cit.;* p. 12-15

[38] V. CHHAOCHHARIA, L. LAEVEN; *Sovereign Wealth Funds: their investment strategies and performance*; CEPR discussion chapter series No. 6959; 2008.

[39] J. SANTISO; *Sovereign Development Funds*; in *The Globalist*; 2008; available online at: http://www.theglobalist.com/storyid.aspx?StoryId=6866 page visited on 3/9/2011; P. J. KEENAN; *The human rights potential of sovereign wealth funds*; in *Georgetown Journal of International Law*; 2009; p. 1151-1180. See also, *infra*, chapter 8 paragraph 2 and paragraph 4.

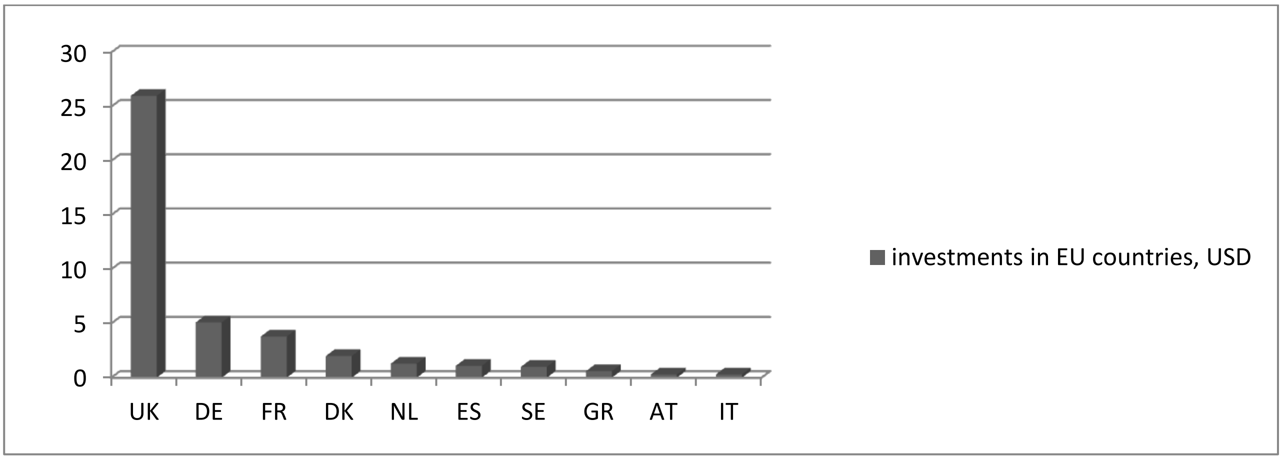


Graph 4. Value of SWF deals by location of target: OECD vs. Emerging Markets. Source: Victoria Barbary Bernardo Bortolotti Veljko Fotak William Miracky; Sovereign Wealth Fund Investment Behavior; Semi Annual Report; January- June 2010; FEEM and Monitor Group; 2010

Looking at SWFs acquisition of participations in foreign firms from 1995 to 2007, 37% of the total transaction volume has been related to North American enterprises and 32% to Europe-based firms.[40] This choice is explained by the fact that European and American capital markets traditionally offer the widest selection of investments and a high level of liquidity, and are thus able to absorb the large volumes institutional investors typically seek to allocate. Graph 5, which focuses on Europe, shows that the main recipient of SWFs investments is by far the UK, probably because of its economic openness and its efficient and dynamic financial market. France and Germany too have received huge amounts of capitals. Italy, maybe because of the predominance in its economy of small and unlisted firms, in the beginning has been less attractive, but the recent acquisition *inter alia* of relevant stakes in Unicredit Eni

[40] S. KERN; *SWF's and foreign investment policies - an update*; cit; p. 7. On the investments of SWFs in western economies see also J. COOKE; *Finding the right balance for Sovereign Wealth Fund regulation: open investment vs. national security*; in *Columbia Business Law Review*; 2009; p. 732-734; R. PASCA DI MAGLIANO; *Fondi di ricchezza sovrana*; Milano: LED; 2009; p. 70-73.

and Finmeccanica by Libyan SWFs might suggest an increased interest in Italian companies too.[41]



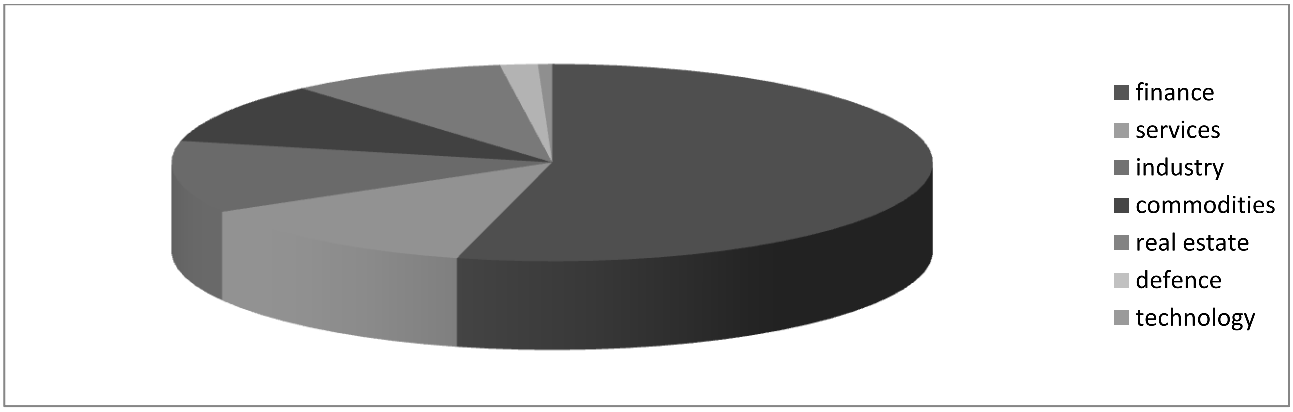
Graph 5. Investments in EU countries in USD Billion. Source. Deutsche bank research

As regard the sectors which are the target of SWFs' investments, financial firms are undeniably the main recipients of SWFs' capitals. In the US other sectors are practically neglected, while in Europe investments have been more diversified, involving services, retail, industry, commodities energy, and real estate as well. Investments in the defence sectors, which are likely to raise particular concerns, have played an insignificant role. Graph 6 and7 shows the distribution by sector of SWFs investments in Europe and in the US.

The predominance of the banking and financial sectors can be given several explanations. Until the end of 2007, State owning SWFs were attracted by the higher returns banks used to offer, as well as by the possibility to establish strong relations between their firms and banks on one side and foreign financial institutions on the other. Later, when US and European banks share prices fell, SWFs thought it was time to buy even bigger stakes at low prices. In the meanwhile, as they were

[41] Many Libyan sovereign investments are not carried out though its official SWFs, but by its Central Bank. However, it is difficult to distinguish from a Central Bank which is acting as a SWFs and other entities which are officially given the status of SWFs. The lack of transparency of the Libyan funds makes this distinction even more difficult to make.

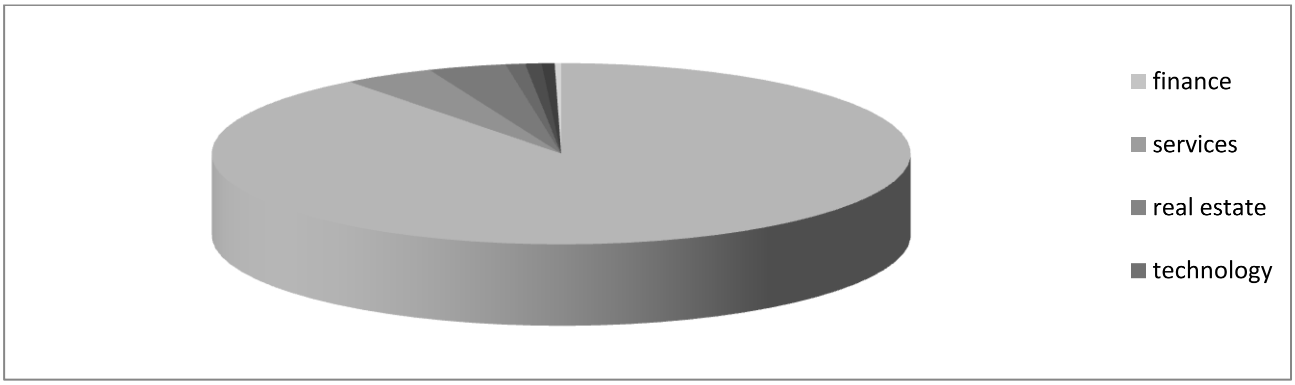
providing fresh capitals to firms which were desperately needing liquidity because of the credit crunch[42], they profited by the situation to improve their reputation as reliable and useful economic actors. In any case, it is unlikely that SWFs will continue investing such a disproportionate quota of their resources in the financial sector, first of all because especially in 2008 and 2009 this strategy has caused relevant reductions of the value of their assets and, more generally, because this would be contrary to the basic principles of portfolio diversification.[43]



Graph 8 Investments with SWF participation in EU by sector of recipient companies; reported and completed transactions, 1995-Jul 2008 USD Bn. Source Deutsche Bank research; 2008

[42] F. MOSHIRIAN; *Sovereign Wealth Funds and Sub-Prime Credit Problems*; working paper; 2008; available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1275226 page visited on 11/08/2011

[43] For a description of the investments of SWFs see, for instance: UNCTAD; *World Investment Report 2008*; cit.; p. 23-24; D. SINISCALCO; cit.; p. 75-86; S. KERN; *SWF's and foreign investment policies - an update*; cit; p. 9-12; J. SEGRELLES; *Fondos Soberanos y sector energético: problema o solución*?; Real Instituto Elcano; 2008. For more information of the importance of diversification in asset management see: F. WEINBERGER, B. GOLUB; *Asset allocation and risk management for sovereign wealth funds*; in J. JOHNSON-CALARI, M. RIETVELD, ed.; *Sovereign wealth management*; Central Banking publications; 2007; p. 71-116; R. BREALY, S. MYERS, S. SANDRI; *Principi di finanza aziendale*; Milano; McGraw-Hill; 2003; p. 155-162.



Graph 9. Investments with SWF participation in US by sector of recipient companies; reported and completed transactions, 1995-Jul 2008 USD Bn. Source Deutsche Bank research; 2008

SWFs investments are generally portfolio investments. FDIs, which involve SWFs taking the control of foreign firms[44], were $10 billion in 2007, accounting for a mere 0.2% of their total assets and only 0.6% of total FDIs carried out in the World in the same period. Private Equity funds, for instance, have been much more involved in FDI, which have been carried out in particular trough mergers and acquisitions.[45] Nevertheless this might change: in fact, in the last few years there has been a rise of FDI by SWFs, with a particular activism of SWFs from the United Arab Emirates and Libya.[46]

SWFs invest in domestic and foreign assets both. This could rise some perplexities, as one could wonder why SWFs of developing countries should export capitals abroad instead of using all resources available to alleviate domestic situations of extreme poverty. According to some popular explanations, which especially apply to SWFs which are regarded by recipient countries as owned by hostile and undemocratic regimes, investments undertaken overseas by SWFs are not economically but politically motivated. In other words, SWFs would try to invest

[44] Municipal law of recipient States establishes when acquiring a stake of a firm involves controlling it. According to the IMF, owning more than 10% of the equity involves the control of the firm. As a result, according to statistics by international organizations, a FDI occurs when more than 10% of the capital of a firm is acquired.

[45] UNCTAD; *World Investment Report 2008*; cit.; p. 23; R. PASCA DI MAGLIANO; cit.; p. 69-77.

[46] On the ongoing change of investment strategies of SWFs towards a greater involvement in FDIs see: F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 166-167.

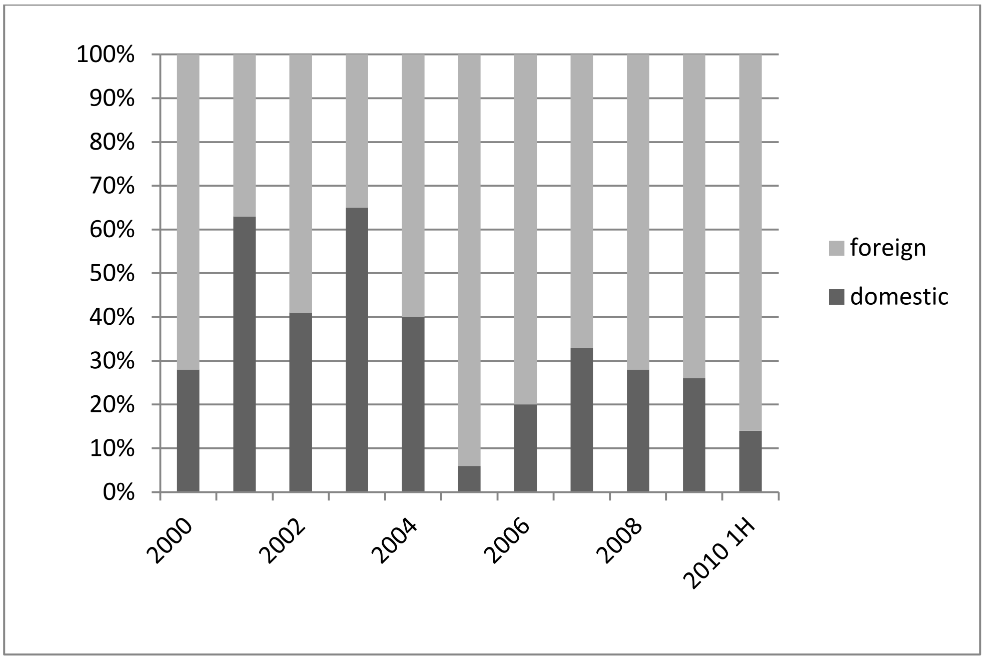
overseas in order to take control of strategic sectors of other States with the aim to influence their political decisions or with a view to disrupt their financial markets prompting speculations or other similar plots. These issues will be analysed later; now it is sufficient to argue that there is evidence that nothing similar has occurred so far; hence such explanations are not very useful.[47] Otherwise, it can be suggested that undemocratic governments of some developing countries simply prefer to invest where they can maximize the returns of the resources they dispose of for the exclusive interests of the elites having the monopoly of governmental offices, rather than investing the same resources immediately in the domestic market for the wellbeing of their peoples.

A more convincing answer is that the domestic market, the society and the institutions of a State, and in particular of a developing State, may be unable to absorb immediately all those windfall revenues deriving from a sudden increase of proceeds from natural resources (which is the consequence of a sharp rise of international prices of commodities). Sudden and massive injections of capitals, caused by the decision to invest or spend immediately the revenues in the domestic economy, could even have disruptive effects, distorting prices and boosting inflation. So, in order to avoid macroeconomic unbalances and waste of capitals which can't be entirely allocated in the domestic market immediately and efficiently, it might be better to invest a part of State wealth in foreign assets and to invest in the domestic market the returns from these investments only in a second moment, when the domestic market will be larger and capable of absorbing greater injections of capitals.[48]

[47] E. TRUMAN; *Four Myths about Sovereign Wealth Funds*; cit.; E. M. TRUMAN; *Sovereign Wealth Funds: New Challenges from a Changing Landscape*; cit.; J. BIARD; *Fonds souverains; Revue de Droit bancaire et financier*; juillet 2008; comm. 124. G. BAHGAT; *Sovereign Wealth Funds: dangers and opportunities*; in *International Affairs*; 2008 ; p. 1201- 1204.

[48] J. SANTISO; *Sovereign Development Funds: Key financial actors of the shifting wealth of nations*; cit.; p. 6. For a more in depth discussion on the decision to invest overseas part of State wealth instead of using it immediately for domestic development see: I. M. FOX, P. DELVECCHIO, O. KHAYUM, C. GATENIO, J. BLACKBURN, D. WOLFSON; *Do Sovereign wealth Funds best serve the interests of their respective citizens*? 2008; available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1309285 page visited on 11/08/2011; P. J. KEENAN; *Sovereign Wealth Funds and Social Arrears: Should Debts to*

Graph 10 shows how the proportion of foreign and domestic investments of SWFs have evolved over time. It can be remarked that while in the years 2003 to 2006, which correspond to the period of greatest development of such funds, there was a clear trend towards the increase of the share of foreign investments, with the inception of the economic crisis in 2007 a limited increase of domestic investments too has occurred.



Graph 10: value of SWFs deals by location of target: domestic v. foreign. Source: Victoria Barbary Bernardo Bortolotti Veljko Fotak William Miracky; Sovereign Wealth Fund Investment Behavior; Semi Annual Report; January- June 2010; FEEM and Monitor Group; 2010

4. Economic and policy issues related to the regulation of SWFs

The rise of SWFs is associated to a historical change in the structure of world capital flows. First of all, it must be stressed that, while in the past capitals used to flow from developed to developing countries, now many emerging economies have become the home countries of the investors and western countries the recipients of their

Citizens be Treated Differently than Debts to Other Creditors?; in *Virginia Journal of International Law*; 2009; p. 432-472 investments. Secondly, while in the past most investments were undertaken by privately owned companies, today the rise of SWFs have increase the share of investments undertaken by State entities.[49] Thirdly, while in the past most capital exporters were western liberal democracies, today capital exporters are also States which have adopted different economic and political models and which are often regarded by the new recipients of their investments as undemocratic regimes or as economical or political adversaries, or both. For these reasons the rise of investments of SWFs have prompted several concerns in recipient countries; especially in North America and in Europe.

The most common fears are related to the fact that SWFs might invest in the defence or in other dual-use- technology sectors, in order to have access to foreign military technology and perhaps to secret information related to national security, in order to pursue strategic and military advantages. Other fears concern the possibilities that SWFs might control strategic sectors, being capable in such a way to influence policies and the economies of recipient States. According to this views, SWFs' strategies, would not be commercially-driven, but rather dominated by political and strategic aims. In addition, someone thinks that the investments of SWFs are mainly speculative in character and are expected to destabilize financial markets.

The political dimension of SWFs could also emerge when their foreign investments are used in order to indirectly influence foreign invested company to adopt strategies which might benefit the State owner of the SWFs at issue. For instance, a SWF might agree to invest in a company subject to the condition that the company at issue commits to build factories in the country owner of the SWF in order to provide jobs, diversify the economy, and strengthen the country's tax base.

[49] M. LOSSANI; *Economie Emergenti, squilibri globali e fondi sovrani*; in M. LOSSANI, F. BERTONI, F. CHIARLONE, ed.; *Fondi sovrani: economie emergenti e squilibri globali*; Milano: Francesco Brioschi Editore, 2010; p. 7-34; P. SUBACCHI; cit.; P. SAVONA, P. REGOLA; *Il ritorno dello Stato padrone: i fondi sovrani e il grande negoziato globale*; Soveria Mannelli: Rubbettino; 2009; p. 1-32; L. HSU; *SWFs, recent US legislative changes and Treaty obligations*; in *Journal of World Trade*; 2009; p. 451; SOUTH CENTRE; *Capital flows from south to north: a new dynamic in global economic relations*; South Centre Analytical Note SC/GGDP/AN/GEG/8; July 2008 32.

In the light of the discussion carried out in the previous paragraphs, these worries need to be partially reconsidered. It is false that all SWFs are owned by undemocratic regimes and non-western States (or even States hostile to western countries): there are SWFs created by Norway, New Zealand, Australia, Alberta (Canada) and Alaska. Investments in the military sector are always very small and, in any case, the defence sector is already very protected from foreign investors, irrespective of whether they are State or non-State actors.

With respect to the fears that strategic firms might fall under the control of foreign governments ready to use them to pursue undue political advantages, a preliminary objection can be made: up to now SWFs have done mainly portfolio investment, which implies that they are not interested in acquiring direct control over developed countries firms.

With respect to the worries of disruptive speculations, it should be noted that SWFs are in general long-term and counter-cyclical investors and that, in the current economic crises, they seem to be more the victims of stock markets fluctuations rather them responsible for them, at least if we look at the recent depreciation of the foreign assets they have previously purchased.

In the last year there has been a change in the attitude towards SWFs, which has lead to dismiss the grossest criticism against them. The current economic crises has helped this change. The subprime mortgage turmoil which started in the US in mid 2007 and which has turned into a broader financial crises affecting in the beginning developed economies and later the world economy as a whole, has provoked, amongst other effects, a sudden credit crunch and shortage of liquidity. Firms, and in particular banks, which so far had relied on abundant and cheap money from the wholesale market, find themselves in a situation in which financing has suddenly become very difficult and costly. SWFs, providing liquidity without demanding in exchange controlling stakes, were perceived as indispensable economic partner or even as savers.[50]

The real and undeniable political dimension of SWFs, which cannot be abolished because it is determined by the same reasons underlying the creation of SWFs, resides in the fact that SWFs are created by States with the task of performing governmental functions within their own domestic economy.

As it was explained above, the functions of SWFs mainly consist in the conduct of the monetary policy of the home State of the SWF and in the management of its foreign

[50] The literature on the possible threats posed by SWFs and on the benefits their capitals may entail or have already brought, is extremely abundant. See, for instance, the following.
F. BERTONI; "*Stepping stones" o "stumbling blocks"*; in M. LOSSANI, F. BERTONI, S. CHIARLONE, ed; *Fondi sovrani: economie emergenti e squilibri globali*; Milano: Francesco Brioschi Editore; 2010; p. 81-96; D. W DREZNER; *Il potere economico nella politica mondiale*; in M. LOSSANI, F. BERTONI, S. CHIARLONE, ed; cit.; p. 97-116; P. SAVONA, P. REGOLA; CIT.; p. 1 -100; E. M. TRUMAN; *Sovereign wealth funds: threat or salvation*; cit.; p. 35-56.; E. TRUMAN; *Four Myths about Sovereign Wealth Funds*; Peterson Institute for international economics; 2008; E. M. TRUMAN; *Sovereign Wealth Funds: New Challenges from a Changing Landscape*; D. SINISCALCO; cit.; p. 75-86; G. LYONS; *State Capitalism: The rise of sovereign wealth funds*; in *Law and Business Review of the Americas*; 2008; p. 4-62; E. C. ANDER; *Take the money and run: sovereign wealth funds and the demise of American prosperity*; Westport, London; Praeger Security International, 2009; L. C. BACKER*; The Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law;* in *Tulane Law review;* 2007-2008; p. 1801-1868; G. BAHGAT; *Sovereign wealth funds: dangers and opportunities*; in *International Affairs*; 2008; p 1189-1204; M. BARBIERI*; A new challenge for the European Union: Regulating the investments of Sovereign Wealth Funds while preserving the Competitiveness of the European Market; in* VV AA; *Совершенствование архитектуры внешнеэкономических связей и повышение международной конкурентоспособности России: материалы международной научно-практической конференции (Москва, 22 апреля 2009 г.)*; Moscow; 2010; p. 272-274; F. Bassan; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 165-201; J. BIARD; cit.; T. GOMES; cit.; p. 9-18; S. KERN; *Sovereign Wealth funds; State investments on the rise*; cit.; S. KERN; *SWF's and foreign investment policies - an update*; cit.; p. 11-17; J. SEZNEC; cit.; p. 97-110; D. K. DAS; *Sovereign-Wealth Funds: Assuaging the Exaggerated Anguish about the New Global Financial Players*; in *Global Economy Journal*; 2008; p. 1-15; P. ROSE; *Sovereigns as shareholders*; in *North Carolina Law Review*; 2008-2009; p. 94; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 165-201; Z. FENG; cit.; p. 490-501; R. M. KIMMIT; cit.; p. 123-126; A. WONG; *Sovereign Wealth Funds and the problem of asymmetric information: the Santiago principles and international regulation*; in *Brook. J. Int'l L.*; 2009; p. 1090-1098; F. WU, A. SEAH; *Would China's Sovereign Wealth Fund Be a Menace to the USA*?;in *China &World Economy*; 2008; p. 33-47; T. A. HEMPHILL; *Sovereign Wealth Funds: National Security Risks in a Global Free Trade Environment*; in *Thunderbird International Business Review*; 2009; p. 551-556; R. MASON; *Sovereign Wealth Funds and the Efficient Management of the Wealth of Nations*; in *Tax Notes*; 2008; available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1242447 page visited on 4/9/2011; p. 1321-1322; J. BHAGWATI; *Sovereign wealth funds: implications for policy*; in M. RIETVELD; ed.; *New perspectives in sovereign asset management*; Central Banking Publication; 2008; p. 25-32; R. PASCA DI MAGLIANO; cit.; p. 79-90.

exchange reserves. Moreover, it may consist in ensuring an effective management of the revenues obtained from the exploitation of natural resources of the home State. The achievement of such objectives represent a political priority for the States owners.

In principle, the pursuit of a sustainable strategy which might allow to maximize returns from the investments undertaken by SWFs should be consistent with these political objectives and, at the same time, it should ensure that the investment strategies of SWFs are the same as those of any other private investor. In fact, if a SWF undertakes investments overseas which are not consistent with the objectives of financial returns maximization, then the assets under its management will lose value, thus hindering the ability of the State owner to use them, when necessary, for the purposes of its monetary and budgetary policies.

In limited cases it seems that, in order to pursue the political objectives mentioned above, SWFs might be forced to act in a very different way from a private investor. What occurred during the recent economic crisis provides an example. Some SWFs, like the Russian ones, were used by governmental and monetary authorities to stabilize the State budget and to tackle the sharp fall of the domestic currency. This implied massive sales of foreign assets in a moment when their market price was much lower than it was at the time in which they were purchased. An investor which was commercially driven would have avoided to sell assets in such a moment and to report relevant losses. However, since such SWFs were required to pursue the political objectives of stabilization of governmental revenues and of the domestic currency, in these circumstances they ended up acting in a way different from an investor which was exclusively commercially driven.

This argument should not be overestimated. In fact, it could occur to any investor that it may need liquidity in a period in which the market prices of the assets it owns are lower than the prices at which it previously purchased these assets. In this case the reasons underlying the choice to divest can differ from those of a SWF, but the divestment and the losses due to sales at unfavourable prices are the same.

Other cases of politically driven investments can be related to the use of a SWF to promote certain values abroad. This occurs, for instance, in the adoption of an investment strategies which deliberately exclude from the eligible assets all securities which are related to companies whose conduct or whose productions is inconsistent with the values that the owner of the SWF declares to be committed to respect. For instance SWFs owned by muslin countries could be expected to exclude from their investments all financial assets issued by companies operating in sectors like pornography and alcohol. Likewise, some SWFs of western countries may avoid to invest in companies producing certain weapons or which fail to respect basic standards of protection of the environment or of labour rights.[51]

In the present paragraph, after having clarified the real features of the political dimension of SWFs and after having assuaged some fears related to their investments overseas, it has been concluded that a prejudicial opposition to any investment by any SWFs is clearly a self-defeating strategy.[52] Nevertheless, also uncritical acceptance of all of them does not constitute a fully satisfactory option. In fact, on one side excessive protectionism on behalf of recipient countries would prevent them from receiving the liquidity they need and at the same time it would prevent States owner of SWFs from allocating their surpluses in an efficient way. On the other side, measures should be taken in order to avoid that SWFs, because of their particular nature (and particular features of States owning them), might threaten strategic interests of recipient States. Any proposal about regulating SWFs should aim at finding a balance between these two needs.[53]

[51] On the relation between Islamic finance and SWFs see: A. DELL'ATTI, F. MIGLIETTA; ed. *Fondi sovrani arabi e finanza islamica*; Milano; EGEA; 2009. See also the discussion developed in chapter 8 paragraph 2 of the present research.

[52] J. COOKE; cit.; p. 167-170

[53] E. TRUMAN; *Four Myths about Sovereign Wealth Funds*; cit.; E. M. TRUMAN; *Sovereign Wealth Funds: New Challenges from a Changing Landscape*; UNCTAD; *Trade and Development Report 2008*; UNCTAD; 2008; available at http://www.unctad.org/Templates/Page.asp?intItemID=4580&lang=1; p. 8; D. SINISCALCO; cit.; p. 75-86; S. KERN; *Sovereign Wealth funds; State investments on the rise*; cit.; A. DEMAROLLE; cit.; p. 21-33; A. GOLDSTEIN, P. SUBACCHI; cit.; 62-65; J. BIARD; cit.; G. BAHGAT; *Sovereign wealth funds: dangers and opportunities*; cit.; p. 1189-1204.

Against this background, several options are in principle available to recipient States, when they decide which attitude they should adopt in relation to the investments undertaken by SWFs in their territory.

In abstracto, a State can decide to prevent any investment undertaken in its territory by any foreign SWF, since it believes that all SWFs are political entities, that they are all political motivated and therefore that they represent a threat to national security and national sovereignty. Alternatively, a State might decide to admit foreign investments of SWFs on a selective base and to subject them to further requirements and controls. This approach seems to be less extreme and more reasonable, and it is the one adopted in practise by most States. Several elements should nonetheless be considered in the debate concerning the attitude of host States towards SWFs; such elements are important when it is studied the way SWFs should be regulated.

In this case, first of all, a State should decide if there are countries whose SWFs shall be prevented or restricted to invest because of particular characteristics of the State owner of the SWF; for instance because it is undemocratic or it is an enemy. In this case, it should be clear that the motivations of the recipient State are exclusively political ones. The State preventing a SWF’s investments should know that it is acting in order to pursue a non-economic aim, irrespective of the consequences its own economy might suffer. In other words, measures hampering SWFs in such a way are tantamount to economic sanctions. For instance, according to this approach, the US would prevent any investment from SWFs of countries like Iran, with the only aim to prevent Iranian government from profiting from the possibility to invest in the US market.

Secondly, a State should decide which sectors shall be off-limits to SWFs and which sectors shall be open to SWFs’ investments but only under particular restrictions. This is quite a difficult task, because it requires deciding which sectors are to be regarded as strategic. While it is clear that defence and dual use sectors should be off-limits for SWFs, other sectors can raise more difficulties. For instance: can telecommunications, medias or infrastructures or even agriculture be regarded as strategic? In particular, once a sector is regarded as strategic, will SWFs be applied the same rules already applicable to foreign private investors or other special, more restrictive provisions? In general, the answer to these questions largely depend on what each State, according to its values and needs, regards as strategic. Moreover, additional restrictions can be motivated by the fact that the investing SWF belongs to a State which is a competitor or an enemy. It is important to remind that the choice to define a sector "strategic" can actually be an excuse to protect some firms from global competition and from the risks of hostile take-over. In such a way the real need would consist in helping domestic lobbies to maintain the control on some national firms, irrespective of the general interests of the State.

Thirdly, it is necessary to note that, beyond differences of national origin, SWFs are not all the same. They have very different degree of transparency and their investment strategies, as well as their governance and their management, differ significantly. A host State should decide the requirements an investor needs to fulfil in order to be admitted: if a SWFs (at least if it is not owned by an enemy State) meets certain standards, especially of transparency, it should find no obstacles.

Fourthly, regulation of SWFs should not take place exclusively at the national level. In fact, there is the risk that States whose firms are needing SWFs liquidity might start a competition to obtain SWFs resources and the result would be promoting a regulation too favourable to SWFs and which would not consider adequately the essential security interests of the recipient State. It is possible that companies or, rectius, their management, might consider the investments of SWFs in a favourable way. Such an attitude could be explained by the fact that SWFs often provide liquidity and behave as passive investors, who are not very interested in seizing the control of invested companies and in appointing its management. In this case, domestic (target) companies might lobby so that the host State might accept the investments of SWFs even neglecting its own national security.[54] Alternatively, there is the risk that a government might be too much prone to the interests of domestic protectionist lobbies or to irrational fears of the public opinion and it will be prompted to enact a

[54] T. A. HEMPHILL; cit.; p. 551-552.

legislation which is too protectionist and which would prevent domestic firms to take advantage from the capitals SWFs can provide. In any case, establishing at least some broad principle at the international level, can improve coordination and efficiency. Another important aspect that must be considered when studying how SWFs should be regulated is that SWFs themselves should be consulted on this issue. In fact, it would be rather difficult to enforce any rule applicable to SWFs without their consent, or, at least, without the consent of a relevant part of them. In particular, instead of formulating abstract norms about how SWFs should act and trying to impose them, it would be more useful to start from the analysis of the actual best practices of some SWFs which could be implemented by all the other SWFs, not only in the interest of recipient countries, but also in their own interests.

Fifthly, some authors and policymakers underline the importance of reciprocity. In principle, submitting the acceptance of SWFs to the promise of an equally open attitude to foreign investments on behalf of the States of origin of the SWFs could be a good idea. Nevertheless, a State should first of all look at its actual needs. When receiving foreign capital is more important than having the possibility to export one's own capital, then reciprocity becomes less relevant.

Sixthly, it is necessary to dismiss the idea that establishing some internationally-agreed rules or, at least, guidelines for SWFs will imply benefits for recipient States only and harmful limitation for SWFs. On the contrary, some rules can contribute to improve the governance of SWFs and the management of official reserves and of sovereign wealth in countries setting SWFs. As a result, SWFs will be able to carry out investments more effectively and with a higher degree of transparency and the benefits of their activities will be distributed in an equitable way in the State which has created them. Moreover, if SWFs agree to fulfil certain requirements about transparency, governance and investment strategies, recipient countries will be less worried about their investments, and they will accept them to a greater extent: as a result SWFs should find less obstacles to their investments. This issue is particularly important. In the present chapter it has been argued that *so far* SWFs have undertaken portfolio and not direct investments, that they have not acquired stakes in the defence sector, that they seem not to be speculative funds and that their investment are commercially and not politically motivated. Nevertheless this is the result of their own strategic choices in this specific historical moment and it is not the consequence of an international legal framework prohibiting or at least discouraging them from doing so. Nothing assure that they will keep on behaving in such a way. In other words, if at the international level SWFs are completely free to decide their governance and strategies and if they are allowed not to disclose them properly to recipient countries, there will be nothing preventing them, as soon as they find it consistent with their interests, from trying to acquire controlling stakes even in strategic sectors, from pursuing political aims through their investments, or from turning into speculators and using financial devices, for instance leverage and derivatives, in a way which might have disruptive rather than stabilizing effects on the financial system of the recipient countries.

If recipient countries think this might happen, they will find it appropriate to obstacle SWFs investments, by enacting protectionist national legislation, even though SWFs' practices have not involved dangers *so far*, and they will do so because there is no certainty that *future* practices and activities of SWFs will continue to be harmless. On the contrary, an *international* (legal) framework for SWFs investments, would provide recipient States and SWFs with the certainties they need to create an environment favourable to transnational investments.

Seventhly, consistently with what was explained before, international rules applicable to SWFs should be accompanied and integrated by rules applicable to recipient countries. [55]

[55] For a general discussion on the regulation of the operations of SWFs, also at the domestic level, see: J. TAYLOR; *Sovereign Wealth Funds and their regulation*; in M. GIOVANOLI and D. DEVOS; *International monetary and financial law - the global crisis*; Oxford University Press; 2010; p. 262- 289; M. AUDIT; *Is the erecting of barriers against foreign sovereign wealth funds compatible with international investment law?*; Society of international economic law; Working Paper No. 29/08; 2008; available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1154601 page visited on 4/9/2011; R. A. EPSTEIN, A. M. ROSE; *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*; in *The University of Chicago Law Review*; 2009; p. 111-134; E. M. TRUMAN; *Sovereign wealth funds: threat or salvation*; cit.; p. 57-67; E. M. TRUMAN; *A Blueprint for Sovereign Wealth Fund Best Practices;* Peterson institute for international economics; 2008. E. M. TRUMAN; *The Rise of Sovereign*

When trying to regulate SWFs, several approaches are available. They can be schematically summarized by the following possibilities.

- domestic legislation vs. international rules.
- special rules (or *ad hoc* rules, which would be devised exclusively for SWFs and which would explicitly apply to them only) vs. general rules, which are applicable to all foreign investors.
- Binding vs. non-binding rules.

These possibilities do not exclude one another. Broadly speaking, in the last years the following choices have been made. At the national level (and here we mainly focus on western countries) domestic legislations contain binding provisions which apply to foreign investments in general (or even to investments irrespective of their nationality). Nevertheless, proposals for enacting special legislation about SWFs are at study in some countries.

At the international level or, *rectius*, at the level of public international law, several legally binding rules exist, which govern investments, trade and monetary issues in general and which in principle may apply to SWFs too. In the following chapters it will be studied in detail whether and to what extent such rules apply to the creation and to the investments of SWFs as well as to the policies of the recipient States adopted to govern the activities of SWFs undertaken on their territory.

Together with binding (but also non-bind or soft-law) rules applicable to foreign investments in general, since 2008 some non-binding instruments specifically applicable to SWFs have been adopted. Their analysis too will be undertaken in the present research and in particular in chapter 8.

Wealth Funds: Impacts on US Foreign Policy and Economic Interests; Peterson Institute for international economics; 2008; E. TRUMAN; *Four Myths about Sovereign Wealth Funds*; cit.; E. M. TRUMAN; *Sovereign Wealth Funds: New Challenges from a Changing Landscape;* D. SINISCALCO; cit.; p. 75-86; S. KERN; *Sovereign Wealth funds; State investments on the rise*; cit.; A. DEMAROLLE; cit.; p. 21-33; A. GOLDSTEIN, P. SUBACCHI; cit.; 62-67; J. BIARD; cit.; Gawdat Bahgat; cit.; P. SAVONA, P. REGOLA; cit.; p. 81- 146; L. C. BACKER; *Sovereign Investing in Times of Crisis*; cit.;p. 74-94; R. M. KIMMIT; cit.; p. 126-130

CHAPTER 2.

SOVEREIGNTY OVER NATURAL RESOURCES AND THE CREATION OF COMMODITY SWFS IN INTERNATIONAL LAW.

Introduction

Commodity SWFs are created as tools for the management of the revenues obtained from the exploitation of natural resources. The role natural resources may play *in* and *for* the economy of the countries which own them can be extremely important, especially in case of countries which are rich in natural resources and, at the same time, are scarcely industrialised and are characterised by an underdeveloped and undiversified economy.

In this context, in fact, national wealth is highly dependent on the exploitation of natural resources. The notion of exploitation must be meant in a broad sense, in order to fully encompass all its implications for the purposes of the achievement of sustainable development. It includes not only the extraction of natural resources and their sale in order to obtain the highest price available. It must also include the proper management of the revenues which are thus obtained, which, as explained above, is a task which is increasingly performed by SWFs.

The importance of natural resources in developing countries explains why such States have supported an evolution of rules of international law which might ensure that the natural resources in their territories might be used by them for the purposes of their own economic development. Foreign direct investments (FDIs) undertaken by foreign companies in the natural resource sectors of developing countries have often been perceived as one of the main threats to the possibility to use natural resources in the interest of the host country. It was in this context, in the aftermath of the decolonization process which occurred in 1950s and 1960s, that the concept of sovereignty over natural resources has been developed. The purpose of the present chapter is to study it, to investigate its more recent developments, its implications for transnational investment operations and, in particular, whether the creation of SWFs can be regarded as an application of the principle of permanent sovereignty over natural resources and whether SWFs can be conceived as a tool to enhance the compliance with such principle.

The chapter shall be organised as follows. Paragraph 1 will study the international instruments proclaiming the principle of permanent sovereignty over natural resources, after having outlined the economic, political and legal context in which such principle was developed. Paragraph 2 will investigate whether the instruments previously analysed might be regarded as legally binding or as reproducing of a rule of customary international law and whether the right over natural resources could be regarded as an absolute right. In addition, it will mention the attempts undertaken by developing countries to implement such principle: therefore attention will be paid to nationalizations, expropriations and renegotiations of concession agreements which were undertaken in the 1970s and 1980s, as well as to the reaction of developed countries to these practices. Paragraph 3 will discuss whether the beneficiaries of the principle of permanent sovereignty over natural resources should be the States or the peoples. It will explain why the latter option should be preferred and the implication this might have. Paragraph 4 will explain the more recent evolution of the principle of permanent sovereignty over natural resources and the need to reconcile it with new restrictions imposed on States by the development of international environmental law and, to a greater extent, of international investment law. It will try to re-formulate the notion of sovereignty over natural resources taking into account these recent developments of international law and the necessities mentioned above. In paragraph 5 it will be stressed that in the 1990s developing countries have increasingly accepted investments from foreign firms and that this change in attitude, when combined with more equitable terms of contracts for the exploitation of natural resources and with improved institutions and policies in developing countries, has made some developing countries able to turn their endowment in natural resources into an instrument to achieve wealth and development. In particular, it will be stressed that the exploitation of natural resources has led developing countries to collect capitals to turn from recipients of foreign investments into subjects capable of investing abroad. To investigate this aspect, particular attention will be paid to the emerging role of SWFs. Therefore, the last part of paragraph 5 will be devoted to analyse in which way SWFs, at least those fulfilling certain requirement, might ensure that endowment in natural resources can be used to promote sustainable development benefiting the people living in the States rich in such natural resources. In other words, it will be discussed whether SWFs can represent a new and positive application of the principle of permanent sovereignty over natural resources after half a century from its first formulation.

1.The principle of permanent sovereignty over natural resources in international law: brief review of its historical evolution, sources and content.

Since the development of the principle of permanent sovereignty over natural resources can also be devised as a reaction of newly independent States and developing countries to the threat posed to their economic (but also political) independence by FDIs undertaken in their territories in the aftermath of the decolonization, a proper understanding of such principle needs a preliminary review of the legal framework governing transnational investments at that time. Until the middle of the twentieth century, the protection of FDIs, included those involving the exploitation of natural resources, was in part provided for in agreements establishing trade relations (for instance the bilateral treaties of "Friendship, Commerce and Navigation" concluded by the United States since the eighteenth century) and in part it was an issue of customary international law. At that time the international community was quite small and homogenous and it had been able to agree an array of basic principles providing a minimum standard of treatment and protection of foreign properties, that all the host States were required to respect. These principles were rather vague and their effectiveness was often strengthened by recourse to diplomatic means or even military coercion, in particular to compel host States to refrain from acts impairing the rights of foreign investors, or at least to force them to pay “prompt complete and adequate” compensation in case of commission of such acts. In this context, companies based in industrialized countries and undertaking investments in developing countries or in colonies could enjoy very favourable conditions. In the case of investments involving the exploitation of local natural resources, a great part of the proceeds benefited managers and shareholders of foreign firms and not the country receiving foreign direct investments. As a result, the activity of foreign companies was regarded as a way to impoverish host countries and to keep them in poverty and subjection. Developing countries gave particular importance to natural resources because they did not have other competitive economic sectors (like manufactures); this meant that, in order to promote economic and social development at least in the short term, they needed to rely almost entirely on the proceeds from the use of their natural resources. It was clear that without the possibility to obtain the largest stake of such proceeds, they had no hope to improve their economic condition. This feeling became even stronger when, since the end of the 1950s, the decolonization process brought many countries to political independence. These newly-independent States were convinced that their independence would have been complete and effective only when it would have attained an economic and social dimension too, as the mere political (formal) aspect of self determination would have not been sufficient on its own. Consistently with this approach, foreign investments were regarded as a form of neo-colonialism because they involved foreign control over local means of production. As a result, newly independent States undertook efforts to change international law at that time applicable to foreign investments. They contested the international law governing inter-State economic relation at that time and struggled to promote a *new international economic order* (although this term would have been coined only later, in 1974). Under the new international economic order, international law would have justified and even supported the actions taken by developing countries to gain effective control over means of production and natural resources within their territory and to finally achieve economic independence.[1]

The best framework in which developing countries could have acted to promote such a change of international law was the United Nations General Assembly (UNGA) where they, together with socialist countries, could rely on a wide majority. This would have made it possible to adopt resolutions which, although not legally binding, could have contributed in a relevant way to the creation and to the progressive development of international law. It is important to note that, since the beginning, developing countries have always tried to support the view that the principle of permanent sovereignty over natural resources was deeply intertwined with human rights, economic and social development, protection of the environment, sovereignty and independence of States, self-determination of peoples and the maintenance of international peace.[2] In particular, the links between human rights and the right of Peoples to dispose and benefits from their natural resources were so tight that the first debates which would have brought to the declaration of the principles of permanent sovereignty over natural resources took place within the Human Rights Commission of the United Nations.[3]

[1] G. Sacerdoti; *Nascita, affermazione e scomparsa del Nuovo Ordine Economico Internazionale: un bilancio trent'anni dopo*; in A. Ligustro and G. Sacerdoti; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 129-133; K. J. Vandevelde; *A Brief History of International Investment Agreements*; in *U.C. Davis Journal of International Law & Policy*, 2005; p. 158-194; D. Carreau, P. Juillard; *Droit international économique*; 3rd ed; Paris; Dalloz; 2007; p. 430-431; M. P. Todaro; *Economic development in the Third World*; New York ; London: Longman, 1989; p. 598 seq.; M. Flory, *A north-south legal dialogue: the international law of development*; in F. Snyder, P. Slinn, ed.; International law of development: comparative perspectives; Abington; 1987; p. 13-18.; G. Sacerdoti; *Lineamenti del diritto internazionale dell'economia*; in P. Picone, G. Sacerdoti; ed. *Diritto internazionale dell'economia: raccolta sistematica dei principali atti normativi internazionali ed interni con testi introduttivi e note*; Franco Angeli; 1991.p. 134 -138 ;M. Barbieri; *Developing Countries and their Natural Resources*; cit.; p. 3-4.

[2] N. Kofele-Kale; *Patrimonicide: The International Economic Crime of Indigenous Spoliation*; in *Vanderbilt Journal of Transnational Law*; 1995; p. 74 - 87; M. Frigo; *La sovranità permanente degli Stati sulle risorse naturali*; in. Picone, G. Sacerdoti; ed. *Diritto internazionale dell'economia: raccolta sistematica dei principali atti normativi internazionali ed interni con testi introduttivi e note*; Franco Angeli; 1991; p. 246- 259; I. Brownlie; *Principles of public international law*; 7th ed.; Oxford; Oxford University Press; 2008; p. 536-542; G. Cordini, P. Fois, S. Marchisio; *Diritto Ambientale- profili internazionali, europei e comparati*; Torino; Giappichelli editore; 2005; p. 10-20; B. Conforti; *Le Nazioni Unite* 6. ed.- Padova; CEDAM, 2000; p. 233-245.

[3] N. Kofele-Kale; cit. p. 74- 87.

The first relevant UNGA resolution for the elaboration of the principle of permanent sovereignty over natural resources was adopted in 1952 [4]. Consistently with the above mentioned approach, the resolution stresses the importance of promoting economic development to achieve “universal peace”. Then it explains that, to enhance economic development, it is necessary that poor countries be entitled to use and exploit in a proper way their natural resources. This means that developing countries need to have the “right freely to use and exploit their natural wealth and resources wherever deemed desirable by them for their own progress and economic development”. The resolution remarks that this right is “inherent in their sovereignty” and it is consistent “with the purposes and principles of the Charter of the United Nations”. The resolution contains the prohibition to the other States to act in a way designed to impair the exercise of this right.

In a subsequent resolution[5] the UNGA decided to create a commission whose task would have consisted in the study of the existing situation of the development of the principle of permanent sovereignty over natural resources and to report on this subject to the Economic and Social Council in the following session. In particular, the commission had to determine the nature of the right of permanent sovereignty over natural resources, the manner in which that right should have been exercised and what measures should have been taken according to international law to make this right more effective.

Finally, in 1962 the UNGA adopted resolution 1803 [6], entitled "Permanent Sovereignty Over Natural Resources," which constitutes the broadest, most explicit declaration from the United Nations specifically on the subject [7]. In this occasion, the UNGA does not limit itself to a repetition of principles already expressed in former resolutions: on the contrary it clearly states which are their implications in terms of the regulation of the activity of foreign investor and with respect to the right to expropriate and nationalize them. In fact, according to resolution 1803 “the

[4] UNGA res. 626 (VII) - 21 December 1952.
[5] UNGA res. 1314 (XIII) – 12 December 1958.
[6] UNGA res. 1803 (XVII) – 14 December 1962.
[7] N. KOFELE-KALE; cit.; p. 81-83.

exploration, development and disposition of" natural resources "as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities". Moreover, when States accept foreign investors, they maintain the right to regulate and control them, consistently with domestic legislation in force and with international law. The resolution underlines that this implies the right to expropriate and nationalize them. Nevertheless these powers shall not be exercised by the host State arbitrarily and in a way to deprive foreign investors of any right and guarantee. The resolution, in fact, specifies that "nationalization, expropriation and requisitioning shall be based on grounds of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign." This means that such acts may be undertaken only when there is a real, compelling necessity of the State and without discrimination between foreign and domestic investors or between investors coming from different States. Moreover, in these cases compensation shall be paid. The resolution does not refer to the so-called Hull formula[8], according to which compensation should have been "prompt, adequate and effective" On the contrary it provides that compensation shall be "appropriate" and "in accordance with the rules in force in the [nationalizing] State" and "in accordance with international law". With this formulation, the resolution on one side declares that host States shall not be forced to pay compensation according to criteria applicable in other States (in particular the States of the investors); on the other side they shall remain bound to the respect of some minimum standard of fair treatment and non discrimination dictated by international customary law. Nevertheless, the actual content of such standards is unclear, in particular as at the

[8] The standard of prompt, adequate and effective compensation for expropriation originally was articulated in 1938 by U.S. Secretary of State Cordell Hull in a note to the Mexican government which was nationalizing US direct investments. This language soon became the definitive formulation in the view of the United States and of industrialized, capital-exporting countries, of the standard of compensation required by customary international law in the event of an expropriation of foreign owned property. The standard was understood to require payment without delay of fair market value in a freely convertible currency.

level of the international community there is no agreement about them. Finally, resolution 1803 states that in case of disputes between foreign investors and host State with respect to compensation, tribunals of the host State will have jurisdiction. Recourse to arbitration or to international adjudication is possible only if the host State accepts it independently and freely. This formulation implies a refusal of any attempt of industrialized countries to use extra legal means (diplomacy but also sanctions) to force developing countries to submit disputes with foreign investors in *fora* other than domestic courts of host States.

The principles declared in resolution 1803 were repeated in resolution 2158.[9] It declares that foreign investments, in particular as they can be useful to improve the exploitation of natural resources, can be accepted, but they shall always be regulated by domestic law of host State. In this way, the proceeds from the exploitation of natural resources shall benefit host State and not only foreign investors. It is important to note that in its preamble the resolution reminds that, as many natural resources are exhaustible, “their proper exploitation determines the conditions of the economic development of the developing countries both at present and in the future”. This statement provides a first link between the principle of permanent sovereignty over natural resources and the principles of sustainable development and intergenerational responsibility, which will be better defined under the point of view of the protection of the environment in 1972, in occasion of the Stockholm declaration.[10] The basic idea is that exploitation of natural resources in many cases brings them to depletion. As a result, there is the risk that future generations will not be allowed to enjoy the same level of wealth as present generations do, at least to the extent that wealth derives mainly from the exploitation of natural resources. This concept is very important and it will be analysed in depth in the following paragraphs of the present chapter.

[9] UNGA res. 2158 (XXI) - 25 November 1966.

[10] G. CORDINI, P. FOIS, S. MARCHISIO; cit. p. 10- 20.

In 1966 two other important international instrument were approved. They are the International Covenant on Economic, Social and Cultural Rights [11] and the International Covenant on Civil and Political Rights[12]. It is important to highlight that, differently from the above mentioned UNGA resolution, they are legally binding treaties. Their art 1,2 read as follows: "All peoples may, for their own ends, freely dispose of their natural wealth and resources without prejudice to any obligations arising out of international economic co-operation, based upon the principle of mutual benefit, and international law. In no case may a people be deprived of its own means of subsistence." What is provided for in this article is nevertheless quite different from the principle of permanent sovereignty over natural resources, which, in fact, is not mentioned directly. In particular, the covenants provide that people only "*may"* and not "*shall*" dispose of their natural resources. This possibility shall be exercised without violating the international law and the obligations deriving from it. There is no reference to the right to expropriate or nationalize; on the contrary, the fact that when disposing of their wealth and resources States shall keep on respecting their obligations is likely to impose, implicitly, some restrictions to this right.

The principle of permanent sovereignty over natural resources was declared in a much more radical way in Resolution 3171.[13] It reiterates that full control over natural resources is an indispensable element of the sovereignty of a State, that the UNGA "support[s] resolutely the efforts of developing countries […] in their struggle to regain control over their natural resources", and that the right to nationalize foreign investments is an expression of the right of permanent sovereignty over natural resources and, as a result, of the sovereignty of a State. Moreover, the resolution refers to the issue of compensation, in a way more favourable to nationalizing countries with respect to the formulation contained in resolution 1803. In fact, in

[11] International Covenant on Economic, Social and Cultural Rights - Adopted and opened for signature, ratification and accession by General Assembly resolution 2200A (XXI) of 16 December 1966.

[12] International Covenant on Civil and Political Rights - Adopted and opened for signature, ratification and accession by
General Assembly resolution 2200A (XXI) of 16 December 1966.

[13] UNGA res. 3171 (XXVIII) – 17 December 1973.

resolution 3171 compensation is not required to be “appropriate” but it is declared that “each State is entitled to determine the amount of possible compensation and the mode of payment”. There is no more a reference to standards and principles of international law, which, in spite of their vagueness, could have discouraged an excessive degree of discretion (or even arbitrariness) on behalf of the nationalizing country. Consistently with this approach, disputes which might arise between foreign investors and host States “should be settled in accordance with the national legislation” of the nationalizing State. With respect to resolution 1803, any mention of arbitration or recourse to third States Courts has disappeared.

Finally, in 1974, the principle of permanent sovereignty over natural resources was included in a broader set of principles and rights provided for in three fundamental instruments: the declaration on the establishment of a New International Economic Order (NIEO)[14], the programme of action on the establishment of a New International Economic Order[15] and the Charter of economic Rights and Duties of States[16]

With these instruments, developing countries made it clear that they regarded the economic order created and supported so far by industrialized countries as inherently contrary to their needs and desires. Until this economic order is replaced by a new one, developing countries would have remained in a condition of poverty and underdevelopment as well as of political and economic dependency. In other words, third world States rejected the idea that they might have achieved development acting consistently with the system of international economic relations in force, because this system was regarded as a tool designed and controlled by industrialized countries in order to maintain their supremacy over the third world. Likewise, developing countries thought that international economic institutions as the World Bank (WB), the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT) were actually controlled by rich countries, with the aim

[14] UNGA res 3201 (S-VI) – 1 May 1974.
[15] UNGA res 3202 (S-VI) – 1 May 1974.
[16] UNGA res 3281 (XXIX) - 12 December 1974.

to force developing countries to act in a way matching not their own interests but the interests of industrialized States.

Even though some of these concepts had already informed many previous UNGA resolutions about the permanent sovereignty over natural resources, nevertheless it is only in 1974 that they were expressed with a particular, revolutionary force.

The NIEO wanted to ensure that each State could control all the economic activity within its own borders and, in particular, its natural resources, which were regarded as one of the main source of wealth for developing countries.[17] Specifically, resolution 3201 states at paragraph 4 (e) that one of the founding principle of the NIEO shall be the “full, permanent sovereignty of every State over its natural resources” which shall imply the right to nationalize foreign property when necessary. Moreover, it stresses the need to provide developing countries with more stable incomes for their primary commodity exports. In fact, the high volatility of commodity price could pose a severe threat to countries whose revenues rely in a disproportionate way on the export of a few commodities. Developing countries should have better access to technology and international finance; foreign investments shall remain under the control of the host country and subject to its laws and regulations and would help to promote the development of economic sectors other than the exploitation of natural resources. Another important pledging of the NIEO is about enhancing the role of developing countries in the governance of the international economy. Since international organization as the WB, the IMF and the GATT were regarded as representing the interests of industrialized States, it was necessary to promote the United Nations (and in particular its General Assembly, where developing countries had a broad majority) as the forum for the discussion of development issues and for the enhancement of a new international law, more favourable to the needs and desires of third world countries.[18]

[17] For a comment of the UNGA resolutions which promoted the NIEO see: G. SACERDOTI; *Nascita, affermazione e scomparsa del Nuovo Ordine Economico Internazionale*; cit.; p. 133- 135.

[18] D. BRADLOW; *Development Decision-Making and the Content of International Development Law*; in *Boston College International and Comparative Law Review*; 2004 p. 203-217; B. H. WESTON; *The*

The Charter of economic Rights and Duties of States repeats many of the above mentioned principles in a solemn and systematic way.[19] To the extent of the present chapter I will focus only on its art. 2, which deals with permanent sovereignty over natural resources and its implications on international economic law. Given the importance of this article, it is useful to quote it entirely.

"1. Every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its wealth, natural resources and economic activities.

2. Each State has the right:

(a) To regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities. No State shall be compelled to grant preferential treatment to foreign investment;

(b) To regulate and supervise the activities of transnational corporations within its national jurisdiction and take measures to ensure that such activities comply with its laws, rules and regulations and conform with its economic and social policies. Transnational corporations shall not intervene in the internal affairs of a host State. Every State should, with full regard for its sovereign rights, co-operate with other States in the exercise of the right set forth in this subparagraph;

(c) To nationalize, expropriate or transfer ownership of foreign property in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States […]"

Charter of Economic Rights and Duties of States and the deprivation of foreign-owned wealth; in *American Journal of International Law*; 1981; p. 437- 474.

[19] For a comment of the Charter of the economic rights and duties of states see: G. SACERDOTI; *Nascita, affermazione e scomparsa del Nuovo Ordine Economico Internazionale*; cit.; p. 136-137.

The approach adopted is very different from resolution 1803 and it is rather consistent with more recent resolutions, as res. 3171 and res. 3201. While resolution 1803 was a balanced text which achieved a satisfactory compromise between the respect of international and domestic law, the protection of the rights of foreign investments and the rights and interests of host States, on the contrary the Charter of economic Rights and Duties of States follows an approach valuing the interests and rights of nationalizing countries much more than those of foreign investors and of their States of origin. What is particularly important is that, according to the Charter, the right to nationalize or expropriate can be exercised almost with no limitations. The public purpose or the public utility of the expropriation or nationalization is no more required. A State is free to determine when it is in its interests to undertake such acts. It is not explicitly required to respect the principle of non-discrimination. There is no reference to international law and it is stressed that transfer of alien property, as well as any form of regulation or control of foreign activities shall occur exclusively consistently with the domestic law of the host State. Likewise, with respect to the issue of compensation, it is stated that it *should* only be appropriate, but only according to the standards and principles of the nationalizing State. It is to note that, with respect to the need for appropriateness of compensation, the Charter, unlike resolution 1803, use the hortatory *should* and not the mandatory *shall*. This would leave to nationalizing State further discretionary power when it decides whether to pay an appropriate or rather a “symbolic” compensation. Another relevant feature is the exclusion of any reference to international law: this choice might allow expropriating countries to disregard even the minimum standards of treatments which are provided for in international (customary) law concerning aliens and alien properties. On the other side, absolute arbitrariness on behalf of the nationalizing State should be prevented by the fact that the Charter of Economic Rights and Duties of States at chapter one par. (j) declares that one of its fundamental principle shall be the “fulfilment in good faith of international obligation”. This principle, as it shall apply to all the provisions of the Charter, would prevent States at least from committing grave violations of some basic international rules concerning the treatment of aliens and of their properties (for instance those forbidding violent, discriminatory or arbitrary measures).[20]

The principle of permanent sovereignty over natural resources was also repeated in occasion of the adoption of resolution 41/128, providing a "declaration on the right to development". [21] The resolution declares that the right to development is an "inalienable human right" and it consists precisely in the right for any person and any people to "participate in, contribute to, and enjoy economic social, cultural and political development". According to this perspective, the right to development shall be achieved also trough the respect and the enforcement of the right of permanent sovereignty over natural resources [22]

A last aspect of the principle of permanent sovereignty over natural resources which should be briefly mentioned relates to the issue of its applicability in the context of a war. In a recent judgement,[23] the International Court of Justice was required to assess the consistency with international law of the conduct of Uganda whose soldiers, together with troops from Ruanda and fighters of Congolese rebel movements were involved in the occupation of parts of the territory of the Democratic Republic of Congo. The Court was required to decide, *inter alia*, whether the Republic of Uganda, "by engaging in the illegal exploitation of Congolese natural

[20] M. BULAJIC; *Principles of international development law*; Leiden; Martinus Nijhoff Publishers; 1986; p. 108 seq.; B. H. WESTON; cit. p. 440; D. CARREAU, P. JUILLARD; cit.; p. 432-433; A. DI BIASE; *La Carta dei Diritti e Doveri Economici degli Stati*; in A. GIARDINA; ed.; *Diritto del commercio internazionale: testi di base e note introduttive*; Milano; Giuffrè, 1996 p. 147-164; P. PICONE; *Ordine economico internazionale*; in PICONE, G. SACERDOTI; ed. *Diritto internazionale dell'economia: raccolta sistematica dei principali atti normativi internazionali ed interni con testi introduttivi e note*; Franco Angeli; 1991; p 161-164.

[21] UNGA res. 41/128 – 4 December 1986. For a Comment see: G. VENTURINI; *Diritto allo sviluppo e obiettivi del millennio nella prospettiva della tutela di diritti umani*; in A. LIGUSTRO. G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 175-179; G. CATALDI; *Gli aiuti c.d. "legati": questioni aperte tra diritto allo sviluppo e obblighi internazionali ed europei in tema di concorrenza*; in A. LIGUSTRO. G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 5-8.

[22] I. D. BUNN; *The Right To Development: Implications for International Economic Law*; in *American University International Law Review*; 2000; p 1426- 1467; A. SENGUPTA; *Implementing the right to development*; in N. SCHRIJVER, F. WEISS; ed.; *International law and sustainable development – principles and practice*; Leiden; Martinus Nijhoff Publishers; 2004; p. 341- 378.

[23] ICJ; Armed Activities on the Territory of the Congo (Democratic Republic of the Congo v. Uganda); Judgment of 19 December 2005; in ICJ Report 2005; p. 168 seq.

resources, by pillaging its assets and wealth, by failing to take adequate measures to prevent the illegal exploitation of the resources of the DRC by persons under its jurisdiction or control, and/or failing to punish persons under its jurisdiction or control having engaged in the above-mentioned acts, has violated the principle of the "respect for the sovereignty of States, including over their natural resources".[24] The Court found that in spite of the importance of such principle and of the fact that it constitutes a rule of public international law, nevertheless there is nothing in the UNGA resolutions providing for it "which suggests that they are applicable to the specific situation of looting, pillage and exploitation of certain natural resources by members of the army of a State militarily intervening in another State."[25] Therefore, the Courts excludes the applicability of the rule providing for the principle of permanent sovereignty over natural resources in case of war, since in such a context only the rules pertaining to *jus in bello* shall apply.[26]

In any case, since the focus of the present research is on the investments of SWFs conducted in period of peace, this last aspect will not be investigated more in depth.

2. The effects of the declaration of the principle of permanent sovereignty over natural resources in international law. The uncertainty about the content of international law about foreign investments and the role of bilateral investment treaties.

During the 1960s and 1970s, many developing countries started to put in practice the principles declared in the UNGA resolutions which were surveyed in the previous chapter. Nationalizations and expropriations took place in many African, Latin American and Asian developing countries. In some cases the threat of nationalization without adequate compensation was sufficient to force foreign investors to accept to

[24] Ibid. par. 222

[25] Ibid. par. 244

[26] For a critical comment of such findings see: E. CIMIOTTA; *Conflitto armato nella Repubblica Democratica del Congo e principio della sovranità permanente degli Stati sulle proprie risorse naturali*; in A. LIGUSTRO AND G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 55- 78.

renegotiate the concession agreements and the contracts for the exploitation of local natural resources they had formerly signed with host States. The new terms of contracts were more favourable to host States as they now retained full title and ownership over their natural resources, the concession for the exploitation of their resources was granted for a shorter period of time and it covered smaller territorial areas. The renegotiated agreements now provided specific monetary commitments for exploration and development during early operations with all costs carried by the foreign investor. Moreover actual extraction and exploitation of local natural resources would have been undertaken jointly by the foreign investors and the host State, which would have created a State-owned company to this purpose. This would have assured the host State retaining full control and constant monitoring over the activities of foreign enterprises and, as a result, a greatest stake of the proceeds from the exploitation of natural resources. In any case, the renegotiated agreements provided investors would have paid to host States higher bonuses and royalties for the exploitation of natural resources.[27]

Such expropriations, nationalizations and forced renegotiation of concession agreements gave rise to protestations from multinational enterprises carrying out investments in developing countries and from industrialized countries as well. On the other side, developing countries claimed that they were acting consistently with the principle of permanent sovereignty over natural resources and, as a result, consistently with international law. For this reason it is necessary to analyse whether the principle of permanent sovereignty over natural resources, in particular in the formulation it was given in the Charter of economic rights and duties of States, could actually be regarded as a rule of international law.

[27] K. T. JACOBS, M. G. PAULSON; *The Convergence of Renewed Nationalization, Rising Commodities, and "Americanization" in International Arbitration and the Need for More Rigorous Legal and Procedural Defenses*; in *Texas International Law Journal; 2008*; p. 371-400; K. J. VANDEVELDE; cit.; p. 167-175; T.WÄLDE, G. NDI; *Stabilizing International Investment Commitments: International Law Versus Contract Interpretation*; in *Texas International Law Journal*; 1996; p. 264 - 267; A. REINISCH; *Expropriation*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press, 2008; p. 410-420.

First of all it is necessary to note that such a principle is not contained in universal conventions[28], but it is promoted through the adoption of UNGA resolutions, which are not legally binding instruments [29]. Nevertheless, some governments of developing countries (in particular Mexico) tried to prove that, in spite of being contained in a non-binding instrument, the Charter of economic rights and duties of States and in particular its art. 2 should be regarded as having legal force. In order to support such a view, these governments recalled the solemn and normative character that States had wanted to give to the Charter. The term "charter" itself was meaningful, because this word is commonly used to refer to the document instituting an organization and creating rights and duties which are binding for all the members of this organization. Moreover some developing countries stressed that, unlike the resolutions usually adopted by the UNGA, the resolution containing the Charter is more prescriptive than recommendatory. For these reasons the Charter of Economic rights and duties of States should have been regarded as a legally binding instrument.
All the above mentioned arguments are unconvincing. First of all, there is neither a provision of international law, nor general consensus at the level of the international community, according to which the formal characteristics of a UNGA resolution might determine its imperativeness. Moreover, it can be affirmed that neither the totality nor the majority of States which adopted the Charter of economic rights and duties of States wanted to regard it as a legally binding international treaty. This can be proved by the analysis of its *travaux preparatoires,* which according to art. 32 of the Vienna Convention of 1969 on the law of treaties and according to international customary law as well can be used as a tool to interpret international treaties.[30]

Once excluded that the Charter of economic rights and duties of States is tantamount to an international binding treaty, it is necessary to discuss whether it constitutes a

[28] The International Covenant on Economic, Social and Cultural Rights and the International Covenant on Civil and Political Rights are intergovernmental treaties and thus they are legally binding. Nevertheless, as pointed out the previous chapter, they actually do not provide the principle of permanent sovereignty over natural resources in a way similar to the Charter of Economic rights and duties of States.

[29] B. CONFORTI; *Le Nazioni Unite* cit.; 2000; p. 283-285

[30] B. H. WESTON; cit.; p. 451-458; A. DI BIASE; cit. p. 148-150.

codification of international customary law or whether, together with all the other UNGA resolutions declaring the principle of permanent sovereignty over natural resources, it can have determined the rise of a rule of international customary law whose content coincides with art. 2 of the Charter itself. It must be reminded that a rule of customary international law exists when there is a uniform and constant practice of States (*diuturnitas*) and when States believe that acting consistently with this practice corresponds to an international obligation (*opinio juris sive necessitatis*).[31] *Diuturnitas* may consist in verbal acts, for instance in public statements or in the participation in the adoption of UNGA resolutions. It can also consist in "physical" activities of States, for instance expropriations and nationalizations, or in the reactions of other States to such practices. As explained in the previous chapter, the contents of UNGA resolutions concerning the permanent sovereignty over natural resources are not all exactly the same, so one could put in doubt that they might give rise to a uniform and constant practice. Although there is not a universally agreed standard of uniformity a practice must have to give rise to a customary international rule, it must be noted that since the adoption of resolution 626 in 1952 the content of the UNGA resolutions about the implications of the principle of permanent sovereignty over natural resources in relation to the issue of nationalization and compensation of foreign investors has partially changed. In fact, while the first resolutions provided a higher degree of protection for foreign investors, the Charter of economic rights and duties of States paid a disproportionate attention to the interests of host States, neglecting the rights of the investors and of their countries of origin. For this reason, the existence of the first element of a customary rule (the *duturnitas*) is in doubt. This view is supported by the fact that, although there was a broad practice of developing States in expropriatory activities, on the other side there is also a rather consistent practice of developed countries in opposing them.

[31] See, for instance: COMMITTEE ON FORMATION OF CUSTOMARY (GENERAL) INTERNATIONAL LAW; *Final report of the committee- statement of principles applicable to the formation of general customary international law*; International law association; London Conference; 2000; I. BROWNLIE; cit.; p. 6-11

The existence of the *opinio juris sive necessitatis* is even more uncertain. In fact, in order to assess the existence of a rule of customary international law, it is necessary that all the members of the international community or, at least, a relevant part of them with respect to the rule in question, believe that a certain practice is necessary and that it corresponds to what prescribed by international law. It is indispensable to note that, while previous UNGA resolutions obtained a general support of the international community, the Charter of economic rights and duties of States was approved with six votes against and ten abstentions. In particular art. 2.2 (c), which was adopted by separate vote, was approved with sixteen votes against and six abstention. This means that there was no universal consent about it. What is even more important is that countries voting against it or abstaining were the biggest industrialized, capital-exporting countries. It is clear that a relevant part of the international community opposed the principle of permanent sovereignty over natural resources as it was formulated in the Charter of Economic rights and duties of States. Moreover, when developing countries started to put in practice this principles and undertook expropriations and nationalizations without a proper compensation according to the standards of industrialized States, the international community did not agree on the consistency of this conduct with a rule of international customary law, as capital exporting countries continued to define such a conduct as a breach of international law on the protection of aliens and alien properties.[32] This is sufficient to deny the existence of an *opinio juris sive necessitates* concerning the principle of permanent sovereignty over natural resources as expressed in the instruments adopted by the UNGA in 1974.

To conclude, the creation of a rule of customary international law reproducing exactly the content of such UNGA resolutions did not occur. Nevertheless, this does not mean that the above mentioned resolutions have produced no effect. In fact, their adoption proved useful to show that there was no more agreement in the international community on the validity of the “old” international customary law which

[32] R GORDON, *The Dawn of a New New International Economic Order*; in *Law & Contemporary Problems*, 2009; p. 144-145.

forced States to ensure a high standard of protection to foreign investments and which did not take into account in an adequate way of the principle of sovereignty of peoples or of States over their natural resources. In other words, developing countries have not been able to create a new international customary law applicable to world economic relations, but they have been able to dismiss the old one, which was regarded as disfavouring them.[33] The UNGA resolutions showed the existence of a negative *opinio juris* about the old economic order and if their qualification as *lex lata* or *lex ferenda* is doubtful, it is clear that they can be regarded as *lex delenda*.[34]
In such particular context, some authors had suggested that a "dual norm system" was in force at that time. There was an international customary law applicable to investments between developed countries and, at the same time, there was another international customary law which applied to capital flows between third world countries: nevertheless there were no shared rules of customary international law which might have applied to investments between a developed country on one side and a developing country on the other.[35] As a result, the old economic order was replaced not by a new economic order, but by a disorder, in which no international customary law applicable to foreign investments in all States actually existed. [36]

In the situation described above, there was no more certainty about the content of international customary law applicable to foreign investments. Moreover, capital exporting countries desiring to ensure protection to their firms investing overseas were prevented from using diplomatic pressures or from threatening to use military

[33] O. SCHACHTER; *Compensation for expropriation*; in *American Journal of International Law*; 1984; p. 121- 130; G. SACERDOTI; *Lineamenti del diritto internazionale dell'economia*; cit.; p.134 seq.; K. J. VANDEVELDE; cit. p. 168 -175; M. BULAJIC; cit. p. 66 seq; G. FEUER; *The role of resolutions in the formation of general rules of the international law of development*; in F. SNYDER, P. SLINN, ed.; *International law of development: comparative perspectives; Abington*; 1987; p. 137-144; J. C. N. PAUL; *The United Nations Family: challenges of law and development: the United Nations and the creation of an international law of development*; in *Harvard International Law Journal*; 1995; p. 325 - 328; COMMITTEE ON FORMATION OF CUSTOMARY (GENERAL) INTERNATIONAL LAW; *Final report of the committee- statement of principles applicable to the formation of general customary international law*; International law association; London Conference; 2000.

[34] A. PELLET; *A new international legal order: what legal tools for what changes*? in F. SNYDER, P. SLINN, ed.; *International law of development: comparative perspectives; Abington*; 1987; p. 126-130

[35] M. BULAJIC; cit.; p. 55 seq..

[36] M. P. TODARO; cit.; p. 603 seq..

force against States which enacted measures impairing the rights of foreign investors, In fact, after the end of the second World War, the ban of the unilateral use of military force to solve inter-State disputes (with the exception of the case of self-defence) was established as a principle of *jus cogens*.

If industrialized countries wanted to make their companies enjoy a fair and predictable legal framework for their investments overseas, they were no more able to rely on favourable norms of international customary law, but they were compelled to conclude bilateral treaties with countries where their companies were investing. These agreements became known as BITs (Bilateral Investment Treaties). The first one had been signed between Germany and Pakistan in 1959 and other few BITs, signed by European countries on one side and a developing country on the other, dated back to the beginning of the 1960s. Nevertheless, the number of BITs increased in the 1960s and 1970s, as long as the old economic order was contested by developing countries and industrialized countries could no more rely on commonly agreed standards of protection for foreign investors stemming from international customary law. BITs were remarkably uniform and contained several distinctive features. They dealt exclusively with investments, as trade issues were governed within the multilateral framework of the GATT (and later of the WTO). BITs were negotiated principally between a developed and a developing country, as they were basically devised to ensure protection to the investment of the developed country in the territory of the developing country. Typically, the agreement was drafted by the developed country and offered to the developing country for signature, with the final agreement reflecting only minor changes from the original draft. BITs provided that host country would have granted "fair and equitable treatment", national treatment and most favoured nation treatment to covered investments. Nationalizations or expropriations were possible only under certain conditions and in any case “prompt, adequate and effective compensation” would have been paid. They provided that in case of disputes, recourse to international arbitration, in which the host State and the investor would have been parties, should have been possible.[37]

About 400 BITs had been concluded in the thirty years from 1959 to 1989, but the number of BITs spectacularly increased in the 1990s. This trend continued for more than a decade and now there are about 2500 BITs in force. The success of BITs can be explained if we take into consideration the political and economic changes which occurred since the end of the 1980s. The failure of several economic policies undertaken in developing countries and the collapse of the Soviet bloc seemed to have discredited the principal alternatives to market capitalism as an economic policy. On the other side, it emerged that those Asian economies which had adopted in the 1970s and 1980s an economic model which was essentially open to foreign trade and investments (in spite of maintaining certain controls and important form of State interventions) had reported higher rates of growth compared to other developing countries that had restricted or hindered private investments (foreign and domestic both) and pursued import substitution policies. At the same time in Western countries, in particular in the UK during the period when Ms. Thatcher was prime minister and in the US under Reagan's presidency, there was a revival of neo-liberal economic theories supporting free market, privatisations, deregulations of and the reduction of the role of State in the market. Moreover, such States proved to be much more assertive than they have been in previous decades in promoting such principles. In this context, many developing countries and former socialist States were therefore convinced that they might have benefited from the application of economic principles and practises supported and implemented by western countries. As a result they started to look at foreign investments more as an opportunity rather than as a threat.[38]

[37] For more exhaustive information on BITs see *infra* chapter 4.

[38] See for instance: G. SACERDOTI; *Nascita, affermazione e scomparsa del Nuovo Ordine Economico Internazionale;* cit.; p. 142-143; D. CARREAU, P. JUILLARD; cit.; p. 433-434.
It must be reminded, however, that for many developing countries and countries with economies in transition the adoption of a more capitalist economic model and a greater openness to foreign capitals also entailed several problems, in particular when it occurred in an abrupt way. In some cases the adoption of neoliberal economic approaches was directly or indirectly promoted or even required by

They became ready to milden their intransigence over some principles they have proclaimed so far, for instance that of permanent sovereignty over natural resources, in order to create more favourable conditions to attract foreign capitals. As the debt crisis of the 1980s had reduced the availability of private lending and as there was a reduction of funds from other States or from international organizations for the assistance to development, the best way developing countries could obtain capitals was to accept foreign firms buying equity in their local firms even when this involved the acquisition of a controlling stake (thus giving rise to a foreign direct investment). Moreover, developing countries were ready to accept foreign firms to exploit local natural resources and to this extent they accepted to commit themselves, also at the international level, to create a better legal framework for operations carried out by foreign companies. Because of the evolution of the principle of permanent sovereignty over natural resources and of its partial contestation by a part of the international community, there was no agreement about the content of customary international law about the protection of foreign investments. For this reason States looked for more legal certainty at a bilateral level, signing BITs. In conclusion, the success of BITs in the 1990s depended both on the need of capital exporting countries to ensure protection to their firms investing overseas and on the need of capital importing countries to attract foreign investment.[39]

One could question the consistency of the content of BITs, in particular in relation to expropriations, nationalizations and compensations, with the principle of permanent sovereignty over natural resources. BITs, *per se* do not impair the principle that a State might retain control over its natural resources and that the proceeds from the exploitation of these resources should benefit mainly the State in which they are

international economic organizations in exchange for their assistance and it took place without taking into consideration the peculiarities of each State and in a "dogmatic" way, according to the principles of the so called Washington Convention. All these issues are discussed more in depth in the present work in chapter 3 paragraph 2 of the present research.

[39] K. J. VANDEVELDE; cit. p. 168-175; G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, in *Recueil des Cours*, Vol. 269 (1997); p. 261 seq.; O. SCHACHTER; cit.; p. 127-130; G. KELLEY; *Multilateral Investment Treaties: A Balanced Approach to Multinational Corporations*; in *Columbia Journal of Transnational Law*; 2001 p. 490.

located. Nevertheless BITs contain provisions contrary to the idea, which lies at the foundations *inter alia* of the Charter of economic rights and duties of States, according to which the principle of permanent sovereignty over natural resources shall be exercised irrespective of any other obligation, for instance those concerning the protection of aliens and of their properties.

3. The problem of determining who should be the beneficiary of the principle of permanent sovereignty over natural resources

So far the focus has been on the relation between the principle of permanent sovereignty over natural resources and foreign investments. Another aspect, which relates to the identification of the actual beneficiaries of this principle, has been given less attention. This chapter will attempt to redress this gap.

Resolutions 1314, 1720 and 1803 provide that the subjects entitled to the right to permanent sovereignty over natural resources are "peoples and nations" and that the exploitation of such resources shall occur for their "wellbeing".[40] On the other side, resolution 3201 affirms that the subjects having sovereignty over natural resources are the States[41] and the same approach is followed by the Charter of economic rights and duties of States.[42]

If we consider the approach of classic international law, the subjects of international law are the States and not the peoples and the nations; hence the fact that some resolutions attribute the sovereignty over natural resources to peoples should be regarded as a rhetoric device without much sense under the legal point of view.[43]

[40] UNGA res. 1314 (XIII) – 12 December 1958; preamble; UNGA res. 1720 (XVI) – 19 December 1961; par 1; UNGA res. 1803 (XVII) – 14 December 1962, par. 1.

[41] UNGA res 3201 (S-VI) – 1 May 1974, par 4 e).

[42] UNGA res 3281 (XXIX) - 12 December 1974 art. 2.1.

[43] For a broader discussion on whether States or Peoples should be the beneficiaries of the permanent sovereignty over natural resources see, for instance: K. N. GESS; *Permanent Sovereignty over Natural Resources: An Analytical Review of the United Nations Declaration and Its Genesis*; in *The International and Comparative Law Quarterly*; 1964; pp. 398-449; E. DURUIGBO; *Permanent sovereignty and people's ownership of natural resources in international law*; in *George Washington International Law Review*; 2006; p. 33-67.

Nevertheless in the last decades international law has seen the development of the so-called "third generation rights". They could be regarded as a new category of rights: while classic international law traditionally creates rights and obligations upon States and while political, civil, social and economic rights protected by international conventions mainly relate to individuals, on the contrary "third generation" rights relate to the peoples meant as collective entities. Among the "third generation" rights many authors comprise the right to development[44], the right to self determination, and the right to the environment (which means *inter alia* the right to live in a safe and unpolluted environment). According to this perspective, the right to permanent sovereignty over natural resources would be a third generation right and the peoples should be entitled to it. The idea of the existence of "third generation" rights, in particular with respect to the right to development, was promoted by developing countries especially in Africa. It was consistent with the view that to achieve full protection of human rights it was necessary to dismiss the western approach according to which the rights of the individuals were conceived as a tool to protect the entitlements of single citizens against the interests of the community to which they belonged. On the contrary, the full promotion of civil political, economic and social human rights would have been made possible only as long as it was consistent with the development and the promotion of the collective rights of the community to which individuals belonged.[45] Declaring that the principle of permanent sovereignty

[44] For a discussion of the issue as to whether the right to development should be regarded as a right of individual human beings or as a collective right, i. e. a right of the peoples see: G. VENTURINI; *Diritto allo sviluppo e obiettivi del millennio nella prospettiva della tutela di diritti umani*; cit.; p. 175-179. It must be noted that developing countries have traditionally proven more favorable to the existence of rights of Peoples, while Western countries have more often supported the view that the human rights should be individual rather than collective.

[45] X. FUENTES; *International law making in the field of sustainable development. The unequal competition between development and the environment*; in N. SCHRIJVER, F. WEISS; ed.; *International law and sustainable development – principles and practice*; Leiden; Martinus Nijhoff Publishers; 2004; p. 29-38; M. BEDJAOUI; *Some unorthodox reflections on the "right to development"*; in SNYDER, P. SLINN, ed.; *International law of development: comparative perspectives; Abington*; 1987; p. 90-114; E. BONDZIE-SIMPSON; *A Critique of the African Charter on Human and People's Rights*; in *Howard Law Journal*; 2008; p. 645-665; R. N. KIWANUKA; *The meaning of "people" in the African charter of human and people rights*; in *American Journal of International Law*; 1988; p. 80-101; U. O. UMOZURIKE; *Current development: the African charter on human and people's rights*; in *American Journal of*

over natural resources pertains to the category of third generation rights can provide further justifications for expropriations. In fact, once the primacy of the rights of the collectivity is assessed, expropriations are justified as they limit the rights of individuals (especially in this case the right to private property) in order to ensure the superior rights of the collectivity.

Once it is assessed that permanent sovereignty over natural resources is a third generation right, and, as a result, that the subjects entitled to it can be the peoples, it can be argued that the right *of peoples* to sovereignty over natural resources does not only allow States to adopt measures which might hinder the interests of private (included foreign) investors (whenever such interests run against such principle), but it also creates obligations under international law for the same States (intended as the governments) in whose territories natural resources are located. According to this perspective, States should be no more completely free to use natural resources in their territories, but they would have the duty, under international law, to use such resources with the aim to achieve the development and the wellbeing of their own peoples.[46] However, it cannot be denied that the enunciation of such a principle, although fascinating, might run against other well established principles of international law and might have limited effects in practice, especially if it is wondered whether it could enable the People to invoke against its own State (or *rectius*, its government) the respect of its right to sovereignty over natural resources. While it cannot be excluded that such a claim could be possible under domestic law, in the case the latter provides for such an opportunity, it would be difficult to admit that it might be well-grounded in international law. First of all, as it has been explained above, some of the international instruments dealing with the principle of permanent sovereignty over natural resources refer to the People while others to the States, so there is not a consistent approach as to the indication of the actual beneficiaries of such right. More importantly, despite the development of the notion of third

International Law; 1983; p. 902-912; J. H. KNOX; *Horizontal human rights law*; in *American Journal of international law*; 2008; p. 14-24.

[46] M. BARBIERI; *Developing Countries and their Natural Resources*; cit.; p. 16-19.

generation rights, it is difficult to admit that under international law the People of the State and the State itself may represent two separate entities which could autonomously take part, one against the other, in an international dispute to be settled through the application of international law. In fact, according to international law, the people is, together with the territory and a stable political organization, one of the elements constituting a State[47], and not an entity separate from it and which can file against it legal claims concerning an alleged breach of rules of international law. Moreover, it would be difficult to conceive that a People might have legal standing before an international jurisdiction in order to obtain satisfaction for a claim against its own State. In practise, at least so far, given the current situation of international law, there is no case of Peoples filing a claim before an international jurisdiction (or, in any case, claims based on international law), against their own States and concerning the alleged breach of the principle of permanent sovereignty over natural resources. As explained above, this is the result of lack of clarity about the possibility to construe the right of peoples to sovereignty over natural resources as involving the existence of corresponding specific duties upon their States. This is also the result of the difficult "actionability" of the right of permanent sovereignty over natural resources when it is intended in the above mentioned way.

On the contrary, this does not depend on the lack of cases in which natural resources are not used by the States (or *rectius*, by their governmental organization) in the interest of the people. In fact, if we study the actual use many developing States have made of their natural resources even once they have taken them from the control of foreign companies, it emerges that in many cases they have not acted consistently with the obligation to manage them in the interest of their people, as the

[47] This list of fundamental elements constituting a State is well established in customary international law and it has been also codified in the Montevideo Convention on the rights and the duties of the States signed in 1933. In fact, its art 1 reads as follows: "The state as a person of international law should possess the following qualifications: (a) a permanent population; (b) a defined territory; (c) government; and (d) capacity to enter into relations with the other states." For further discussion on the relation between the State and its people as subjects of the international community, as well as for a distinction between the notion of Stato-comunità on one side and Stato-apparato or Stato-organo on the other see: B. CONFORTI; *Diritto Internazionale*; VIII ed.; Napoli; Editoriale Scientifica; 2010; p. 12-13.

interpretation of the principle of permanent sovereignty over natural resources presented above would have suggested. In these cases, abundance of natural resources have not brought wealth and economic growth to peoples, but rather to the phenomenon which has come to be denoted to the economists as "resource curse." [48] The remaining part of this chapter will be devoted to a brief description of the resource curse: in fact, once it is argued that the beneficiary of the right to permanent sovereignty over natural resources must the peoples, it must be affirmed the existence of a duty upon States with abundant natural resources on their territory to undertake the necessary efforts to prevent the resource curse from occurring. Therefore, explaining the manifold aspects of the resource curse implies the definition of the phenomena and the events that States must try to prevent if they want to ensure the respect of the right of their peoples to sovereignty over natural resources.

One of the first cause of the resource curse is that in many developing countries exploitation of natural resources is regarded as the sole profitable economic activity; as a result, groups establishing their control over natural resources get able to maximize their wealth and their power over the rest of the society. The problem is that they tend to use such wealth not to finance productive investments, but only to maintain and strengthen their control over their source of revenues. In such a way entrepreneurship is disfavoured, rent-seeking behaviours are encouraged and proceeds from the exploitation of natural resources are wasted in unfruitful expenses. When the subjects controlling natural resources are undemocratic governments they use all the revenues to ensure unbounded wealth to the members of the ruling elites, to foster their power and to prevent democratizations, for instance buying political support or financing State organs in charge of repressing opposition. On the other side, when rebel groups get able to control territories rich in natural resources they can loot them and finance their guerrilla operations with the proceeds from smuggling such resources. In this case civil conflicts in poor countries which have abundant

[48] The resource course has been discussed in chapter 1 paragraph 2.

natural resources tend to last more and to provoke more destructions and severe violations of human rights. To this extent, the most dramatic example is represented by the “blood diamonds” of countries like Sierra Leone or Angola.

The resource curse can occur because of strictly economic reasons too. For instance, in several developing countries a dominant primary sector based on the extraction of natural resources discourages investments in other economic sectors which in the beginning are less profitable, but which might provide higher returns than the exploitation of natural resources as soon as they achieve a certain degree of development. Moreover, as the export of massive amounts of natural resources overvalues real exchange rates of developing countries, this undermines international competitiveness of other goods, providing a further incentive to developing countries to specialize in the sectors related to the exploitation of natural resources instead of promoting a greater diversification in their economies. As a result, dependency of developing countries on the exploitation of a few natural resources becomes increasingly entrenched. In such a situation their economy is vulnerable to the changes of world prices of the natural resources they exported, as well as from the possible depletion of the natural resources themselves.[49] It is important to note that, even when these events are not directly caused by the

[49] The literature on resource curse in its manifold aspects is abundant. In addition to what has been explained in chapter 1 paragraph 2 of the present research see, for instance, P. STEVENS, E. DIETSCHE; cit.; p. 56-65; E. BARBIER; cit.; p. 108; E. DURUIGBO; *Managing Oil Revenues for Socio-Economic Development in Nigeria: The Case for Community-Based Trust Funds*; in *North Carolina Journal of International Law & Commercial Regulation*; 2004; p. 123- 196; E. DURUIGBO; *The World Bank, multinational oil corporations and the resource curse in Africa*; cit.; p. 2-65; A. PELLET; cit.; p. 117-130,
A particular aspect of the resource curse is that natural resources can be used by undemocratic regimes to finance repression or by rebels or parties to civil wars to finance their operations. For more information on the role of lootable natural resources in civil wars see: P. LUJALA, N. P. GLEDITSCH, E GILMORE; *A Diamond Curse?: Civil War and a Lootable Resource*; in *Journal of Conflict Resolution*; 2005; p. 538-562; P. LUJALA; *Deadly Combat over Natural Resources: Gems, Petroleum, Drugs, and the Severity of Armed Civil Conflict*; in *Journal of Conflict Resolution* 2009; p. 50- 71; R. SNYDER; *Does Lootable Wealth Breed Disorder?: A Political Economy of Extraction Framework*; in *Comparative Political Studies*; 2006; p. 943-968; O. OLSSON; *Diamonds Are a Rebel’s Best Friend*; in The *World Economy* 2006; p. 1133-1150.
For more information on the use of oil revenues to promote the diversification of the economy in the Gulf Region see: M. TOKSOZ; *The GCC: prospects and risks in the new oil boom*; in J. NUGÉE, P. SUBACCHI; ed; *The Gulf region: a new hub of global financial power*; London: Chatham House; 2008; p. 82-95

activities of governments, nevertheless governments which do nothing to prevent them from occurring could be regarded as well as breaching their obligation to manage natural resources in their territories in a way to promote development for their peoples.

However, it should be underlined that the “resource curse” is not inevitable. A low-income country heavily dependent on its natural resources will not necessarily suffer from the resource curse if it is able to implement adequate policies. It is not possible to survey all these policies in an exhaustive way in this chapter; hence the remaining part of this paragraph will only list a few of them. A part of the proceeds should be devoted to populations living in the areas where the exploitation of natural resources is particularly intensive, in order to repay them for the damages they may suffer in relation to the exploitation. This is especially the case of the exploitation of oilfields or other mineral resources, which involves heavy pollution harming local populations[50]. Moreover, governments should enact policies which discourage rent-seeking behaviours and which provide incentive to use the wealth derived from natural resources to undertake productive investments instead of wasteful consumption. Proceeds should be used to improve the quality of institutions and infrastructures and, in particular, they should be reinvested in other, more dynamic sectors. Such a diversification should permit to avoid the problems dependency on a few exhaustible resources can imply.[51]

Finally, if the domestic market is not large enough to absorb immediately and in an efficient way the entire wealth brought by the exploitation of natural resources, it is possible to use a part of it to purchase foreign assets and to invest in the domestic market the returns of such foreign investments in a second moment, when the domestic economy will be able to use and process broader amounts of liquidity. This is the rationale underlying the creation of Sovereign Wealth Funds. SWFs can

[50] E. DURUIGBO; *Managing Oil Revenues for Socio-Economic Development in Nigeria:* cit.; p. 123-196; E. DURUIGBO; *The World Bank, multinational oil corporations and the resource curse in Africa* cit.; p. 2-65

[51] P. STEVENS, E. DIETSCHE; cit.; p. 60-65; E. BARBIER; cit.; p. 321-340; E. DURUIGBO; *Managing Oil Revenues for Socio-Economic Development in Nigeria*; cit.; p. 168

therefore represent a tool which can be used by States in order to ensure the proper management of revenues obtained from the sale of natural resources.[52] In this way, it could even be argued that SWFs can be used to ensure the compliance with the principle of permanent sovereignty over natural resources.

Before explaining how this could occur in practise, it is necessary to quickly review the notion of sovereignty over natural resources, taking into account the limitations international law provides in relation to it. In fact, given the developments occurred in international law since the years of the earliest declarations of the principle of permanent sovereignty over natural resources, the content of this principle has partially evolved and an effort must be preliminarily made to define it, before studying its relation with the creation of SWFs.

4. Re-defining the notion of permanent sovereignty over natural resources taking into account the limits to this principle emerged in international law

Since the 1960s until the end of the 1980s, many developing States declared that their right to full and permanent sovereignty over natural resources constituted an absolute right according to international law and that this allowed them to expropriate foreign investments as long as doing so corresponded to their interests.

In paragraph 2 of the present chapter it has been explained why the principle of permanent sovereignty over natural resources as provided for in the Charter of economic rights and duties of States and in most UNGA resolutions analysed in paragraph 1 has not became a rule of international law. Paragraph 2 has also stressed that the practice of signing BITs provides further evidence that currently most States (even developing countries) do not mean sovereignty over natural resources as an absolute right. In fact, when they enter into BITs, States agree to get obliged to ensure higher standards of protection for foreign investors, and this implies the partial dismissal of the principle of permanent sovereignty over natural resources

[52] For a more detailed explanation on the way this occur see, supra, chapter 1, paragraph 2.

as provided for in the radical formulation of the Charter of economic rights and duties of States.

Paragraph 3 has identified what could be meant as another limitation for States to the exercise of the right to sovereignty over natural resources. In fact, if sovereignty over natural resources is also meant as a third generation right of people and not (only) of States, when States use and control natural resources in their territory, they have the obligation to do so with the aim to improve the wellbeing of their people.

It should be noted that in the last decades sovereignty over natural resources has been limited even further by the evolution of international environmental law. At the base of this trend there is the increasing concern about the protection of the environment and the awareness that pollution and other environmental damages do not only affect the States in whose territory they occur, but also the world as a whole. For this reason States have the duty to refrain from using their natural resources in a way which can damage their neighbours and the world environment in general.[53] These principles are contained in particular in the Stockholm Declaration of 1972[54] and in the Rio Declaration of 1992[55]. Principle 21 of Stockholm Declaration and principle 2 of Rio Declaration (which are identical) affirm that "States have, in accordance with the Charter of the United Nations and the principles of international law, the sovereign right to exploit their own resources pursuant to their own environmental policies" but at the same time they have "the responsibility to ensure that activities within their jurisdiction and control do not cause damage to the environment of other States or of areas beyond the limits of national jurisdiction." More in general, sovereignty over natural resources must be exercised respecting

[53] A. D. TARLOCK; *Sustainable Development in Latin American Rainforests and the Role of Law: Article: Exclusive Sovereignty Versus Sustainable Development of a Shared Resource: The Dilemma of Latin American Rainforest Management;* in *Texas International Law Journal*; 1997; p. 43-66.; G.F. MAGGIO; *Inter/intra-generational Equity: Current Applications under International Law for Promoting the Sustainable Development of Natural Resources;* in *Buffalo Environmental Law Journal*; 1997; p. 204-205.

[54] The United Nations Conference on the Human Environment; Stockholm Declaration; 1972 available online at http://www.unep.org/Documents.Multilingual/Default.asp?DocumentID=97&ArticleID=1503

[55] The United Nations Conference on Environment and Development; Rio Declaration on Environment and Development; 1992; available online at http://www.unep.org/Documents.multilingual/Default.asp?DocumentID=78&ArticleID=1163

the principles of sustainable development, also according to principle 3 of Rio Declaration which provides: "the right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations". Therefore, the concept of sustainable development would attempt to reconcile the right to development (and the related right to sovereignty over natural resources) with the protection of the environment and the principle of inter-generational equity[56].

It can be concluded that the declaration of the principle of permanent sovereignty over natural resources, as well as the subsequent and contradictory practice of the international community (practice which comprises nationalizing, but also contesting nationalizations and signing BITs) has brought to a situation in which it can only be assessed the existence of a very vague principle according to which a State has a general right to manage and control its natural resources consistently with its desires and its needs, and that it has the right and the duty to make its people benefit from the exploitation of such resources. Nevertheless this right is not absolute, as it should be exercised in accordance with all the obligations deriving from international law which have been reviewed in this paragraph.

For these reasons, when in the next paragraphs of this chapter I will refer to the principle of sovereignty over natural resources, I will mean *sovereignty of peoples* (as opposed to sovereignty of States-governments) and I will not refer to the radical version of this principle we can read in the Charter of economic rights and duties of States, but rather to the "milder" version I proposed in this paragraph, which is much more respectful of the other rights and duties provided for in international law and which actually is more likely to represent a principle of international law today.[57]

[56] G. CORDINI, P. FOIS, S. MARCHISIO; cit.; p. 15-20; Nico Schrijver, Friedl Weiss, ed.; cit; p. 7 ss.; A. D. TARLOCK cit.; p. 43-66.; G.F. MAGGIO;; cit.; p. 205-210.
It should be added that he issue of inter-generational equity has a particular importance in the present discussion, since commodity SWFs, especially when they are created as saving funds serve the purposes of ensuring revenues from the exploitation of natural resources also to future generations and even if natural resources get depleted. Therefore, saving funds can be regarded as a tool through which the principle of inter-generational responsibility is pursued.

[57] M. BARBIERI; *Developing Countries and their Natural Resources*; cit.; p. 19-21.

5. SWFs as a consequence and as an application of the principle of permanent sovereignty over natural resources

In paragraph 2 it was explained how developing countries since the 1960s undertook nationalizations and expropriations of foreign investments. This brought many of them to control their natural resources excluding any other subject, in particular foreign firms. In other cases, when aliens were not deprived of their properties, they were nonetheless forced to accept to renegotiate the concession agreements to which they were parties. In this way developing countries could obtain bigger stakes of the proceeds from the exploitation of their natural resources. Even when, later, developing countries opened their markets to foreign investors again and agreed to sign BITs which ensured a higher degree of protection to foreign companies, the control over natural resources and the right to obtain a relevant part of the proceeds from their exploitation remained to them in most cases. Moreover, foreign direct investments, bringing capitals, technologies, and know-how, proved useful to allow a more effective exploitation of natural resources and a better commercialization of them on the world markets, increasing even further the gains of developing countries. In this situation, not only some developing States got able to increase their revenues from the exploitation of their natural resources, but they were also able to implement political and economic reforms which made it possible to reduce wasteful uses of such revenues. In addition, they invested them in other dynamic sectors of the economy in order to develop them and to reduce dependency on natural resources. In recent years, the increasing demand for commodities has further strengthened the bargaining position of countries rich in natural resources and has enabled them to pretend new renegotiations of concession agreements and to obtain even more favourable conditions. When in the first years of the XXI century the sharp increase of world prices of many commodities occurred, States which have already managed to properly control and exploit their natural resources were able to accumulate in a few years a huge and rather unexpected wealth.[58]

Unfortunately, the pattern described here has occurred only in some emerging economies, like Russia, Mexico, Brazil, Botswana, Malaysia and several States of the Gulf region. Others, for instance Congo or Nigeria, have not been able to transform their endowment in natural resources in economic and social wealth and still remain in poor conditions. Moreover, as explained in paragraph 3, even when developing countries have been able to collect big revenues from the exploitation of natural resources, only a some of them have been able to enhance (at least partially) proper reforms which turned such a State-owned wealth into wealth and development for all their people. Other States, have been able to accumulate a relevant wealth, but they have not been able or willing to use it properly to promote overall development of the country and of the population.[59] In this study it is not possible to study each of these States and it is not possible to provide more detailed examples. What has been provided here has been only a brief analysis of the general trends and obviously it cannot take into account all the peculiarities of single countries.

Many developing countries which as a result of the events described in the first part of this paragraph have found themselves with huge State-owned wealth have

[58] Z. AL QURASHI; *Renegotiation of International Petroleum Agreements*; in *Journal of International Arbitration*; 2005; p. 261-300; A. FARUQUE; *Validity and Efficacy of Stabilisation Clauses - Legal Protection vs. Functional Value*; in *Journal of International Arbitration*; 2006; p. 317- 336.; K. T. JACOBS, M. G. PAULSON; cit.; p. 359- 400; P. LEON; *A Fork in the Investor-State Road: South Africa's New Mineral Regulatory Regime Four Years On*; *in Journal of World Trade*; 2008; p. 671-490; N. MIRANDA; *Concession Agreements: From Private Contract to Public Policy*; in *The Yale Law Journal*; 2007; p. 512-549; J. W. SALACUSE; *Renegotiating international project agreement*; in *Fordham International Law Journal*; 2001; p. 1319-1370; T.WÄLDE; *International energy investments*; in *Energy Law Journal*; 1996; p. 191-215.; T.WÄLDE, G. NDI; cit.; p. 216-264; P. COLLIER; *Corporate Social Responsibility in the Extractive Industries*; in *Yale Human Rights & Development Law Journal*; 2008; p. 10-28; V. ROSSI; *Global financial markets: how emerging-market economies are enlarging the playing field*; in J. NUGÉE, P. SUBACCHI; ed; *The Gulf region: a new hub of global financial power*; London: Chatham House; 2008; p. 13-30

[59] E. BARBIER; cit.; p.344-372; For a discussion of economic development and the role played in this context by natural resources and commodity funds see (for the Gulf Region) the articles contained in: J. NUGÉE, P. SUBACCHI; ed; cit.; and (for Botswana): E. BARBIER; cit.; p. 364-372; D. ACEMOGLU, S. JOHNSON; J. A. ROBINSON; *An African Success Story: Botswana*; MIT working Paper Series; 2001; A. IIMI; *Did Botswana Escape from the Resource Curse*?; IMF Working Paper; 2006.

decided to created Sovereign Wealth Funds. Commodity SWFs can be used to prevent the negative effects and to amplify the positive consequences of windfall revenues from the exploitation of natural resources. As explained *supra* in chapter 1 paragraph 2, they help to avoid the so called resource curse, they allow intergenerational saving and play an important stabilization function. Commodity SWFs can also serve the purposes of diversifying the domestic economy of the State which owns them and to favour its growth in a sustainable way, avoiding its overheating and waste of windfall revenues. In all these cases SWFs can be used to ensure that the People (intended in a broad way, also including future generations) might fully benefit of the exploitation of its natural resources, thus ensuring the respect of the principle of sovereignty of peoples over natural resources as it has been construed in the present chapter. If SWFs are actually and always managed in this way, it is likely that they will ensure in the States where they are created sustainable development and the implementation of the principle of intergenerational equity.[60] SWFs might therefore be regarded at the same time as the best consequence and the best application of the principle of sovereignty of peoples over natural resources. In practice this does not always occur. When States owning SWFs are governed by undemocratic and corrupt regimes, citizens actually have no information and no control on the real use SWFs make of assets under their management. On one side a certain level of independence of the management of SWFs from the electorate corresponds to the legitimate need to "depoliticize" SWFs and to prevent them from being used in accordance to contingent political or electoral needs or for current expenses and not for long-term and high-yielding investments. But on the other side this implies the risk that bureaucrats or politicians which are not democratically accountable might manage resources in a way to pursue sectional interests, actually ignoring the interests of the citizens and without being subject to any form of monitoring and accountability. Actually, the existence of a correlation between the democracy of a State and the transparency of its SWFs has been

[60] J. SANTISO; *Sovereign Development Funds* cit.

proved by empirical studies. Authoritarian regimes have established SWFs which do not disclose sufficient information neither about their structure nor about the rules governing their strategies and organization. Even when a few information are provided, they are vague and hardly accompanied by data revealing if the above mentioned rules are respected in practice[61]. In this context there is no certainty that proceeds from the exploitation of natural resources which are transferred to SWFs will be used for the wellbeing of the peoples which should have sovereignty over them. In other words, the principle of sovereignty of peoples over their natural resources would be hardly enhanced by the creation of SWFs, if SWFs are not *transparent* and if they are not organized and managed in a way to prevent abuses, embezzlements or investment strategies which do not pursue the objective of sustainable development in the interest of the citizens of the States creating the SWFs.

In the current debate about SWFs, *transparency* has become a key issue and many recent documents adopted by international organizations have stressed its importance.[62] It should be noted that existing international instruments applicable to SWFs have been promoted first of all by industrialized countries whose firms are currently the target of SWFs' investments and when they ask for transparency of SWFs they do so primarily in the interest of recipient States. However, consistently with the findings of the present paragraph, a higher degree of transparency might benefit also the citizens of the developing countries which are the owners of SWFs, because it can allow them to verify that the SWF is used in order to manage sovereign wealth obtained from the exploitation of natural resources in a way consistent with the interests of the people. In other words, transparency, could, although indirectly, allow a better compliance with the principle of permanent sovereignty of peoples over their natural resources.

[61] J. BHAGWATI; *Sovereign wealth funds: implications for policy*; cit.; p. 26-32. F. BERTONI; "*Stepping stones" o "stumbling blocks"*; in M. LOSSANI, F. BERTONI, S. CHIARLONE, ed; *Fondi sovrani: economie emergenti e squilibri globali*; Milano: Francesco Brioschi Editore; 2010; p. 81-96.

[62] A detailed analysis of such documents will be provided *infra* in chapter 8.

In summary, encouraging SWFs to be more transparent should benefit both the State which is the recipient of SWFs' investments and the State which owns SWFs. The former will benefit to the extent it will be assured that such investments will not harm its fundamental national interests. The latter would benefit because it will be easier to control and to ensure that the operations of SWFs might manage the proceeds from the exploitation of national natural resources in a way producing wealth for current and future generations both. In detail, transparency is expected to allow the citizens of the States owners of the SWFs, to monitor if SWFs are actually managed to promote sustainable development or if they are used in the exclusive interests of undemocratic elites.

It can be concluded that in theory the rationale of SWFs is consistent with the principles of sustainable development and of sovereignty of peoples over their natural resources. In practice the creation of SWFs can really promote the respect of such principles only if these State-owned investment vehicles meet certain standards of transparency and accountability. This finally depends on the legal framework of the States establishing them, as well as on the quality of their democracy and their institutions. Existing international instruments applicable to SWFs are primary devised in the interest of industrialized States which are the recipient of SWFs' investments; nevertheless, when they encourage SWFs to be more transparent, they can act for the good of the citizens of the States of the SWFs too. In this way SWFs could prove an effective tool to promote the sovereignty of peoples over their natural resources and to ensure their right to benefit from them.[63]

[63] M. BARBIERI; *Developing Countries and their Natural Resources*; cit.; p. 21-30.

CHAPTER 3.

INTERNATIONAL MONETARY LAW, INTERNATIONAL TRADE LAW AND SWFS

Introduction

The topic of the present chapter is the study of the applicability of international monetary law and international trade law (with a focus on WTO law) on issues concerning SWFs and, in particular, their establishment and investments.

The choice made in the present work to analyse all these issues in a single chapter is supported by the existence of a strong relation between international monetary cooperation, balance of payments and exchange rates on one side and, on the other side, international trade.

Firstly, in the present chapter it will be studied whether and how the provisions which have developed in these two areas of international law in the last decades have lead to the establishment of a legal framework which has contributed to the creation and success of SWFs.

Secondly it will be studied whether such provisions can now affect the operations of SWFs, if they can be used in order to regulate SWFs operations (non only overseas but also in the territory of the State which owns them) or if they can be relevant for the regulation of the conduct of the States which are the recipients of the investments of SWFs.

When studying the relation between international monetary law and SWFs, the focus will be mainly (although not exclusively) on one of the two main categories in which SWFs are divided: i. e. on those funds which are established as a result of the accumulation of large amount of foreign exchange reserves.

The chapter will be organised as follows. Paragraph 1 will provide an overview of the problems related to imbalances of the balance of payments and therefore of the importance of monetary cooperation. It will then discuss the forms of monetary cooperation developed by the international community and in particular the role of the IMF. Paragraph 2 will focus on the practice followed by the IMF when it provides financial assistance to States experiencing monetary problems. The practice denoted as conditionality will be analysed in depth and emphasis will be put on the widespread criticism it has risen. It will be stressed how this has contributed to the decision of many States to develop alternatives to the recourse to IMF assistance in case of monetary problems. Finally, it will be explained that one of these alternatives consists in the accumulation of large reserves of foreign currency and that the creation of SWFs is instrumental to the proper and effective management of such reserves. Paragraph 3 will study the role that SWFs today might play in international monetary relations and it will study whether the current world economic environment, which was shaped also by the IMF and which is substantially favourable to transnational capital movements, after having contributed to bring emerging States to create SWFs, might now prove beneficial to the operations of such State owned investment vehicles.

Paragraph 4 will explain the relation between the accumulation of large foreign exchange reserves (and ultimately the creation of SWFs) with the existence of persistent imbalances of the balance of payments and of undervalued currency exchange rates. It will also study the extent to which they are the consequence of currency manipulation. In paragraph 5 and 6 it will be studied whether, respectively, the provisions of the Articles of the Agreement of the IMF and of international monetary customary law have indirectly contributed to the rise of such imbalances and/or whether they can be effectively used to redress them. In addition, in paragraph 5 and 6 it will be studied whether such provisions could be construed in a way to restrict or prevent, or on the contrary to enhance and safeguard, the creation and the operations of SWFs. Paragraph 7 will study whether monetary imbalances could be redressed within the framework of the WTO and the impact this might have on the establishment and the operations of SWFs. It will first study the provisions of the WTO concerning exchange rates and balance of payments as well as the WTO and the IMF provisions governing cooperation between these two international organisations in monetary issues. Then, it will discuss the competence of the Dispute Settlement Body of the WTO, in case of a dispute concerning these monetary issues, and whether the IMF could be involved in them. Paragraph 8 will study whether the currency practises which lead to the accumulation of foreign exchange reserves and finally to the creation of SWFs could be challenged under WTO law by claiming their inconsistency with provisions governing dumping and State subsidies. To this extent a careful analysis of these provisions shall be carried out and it will be discussed whether currency manipulation can be regarded as a form of prohibited State aid or as a form of monetary dumping (and then it will be studied whether monetary dumping is governed by WTO law). Paragraph 9 will continue the discussion on WTO law, and especially on provisions on State aid. However the focus will be no more on the monetary practices underlying the establishment of SWFs, but on the investments undertaken domestically by SWFs themselves. In particular, it will be studied whether and under which conditions the investments of SWFs in the companies which are based in the same State which owns the SWFs at issue, might be regarded as State aid. Then, an analysis will be made of the extent to which these investments can be affected by WTO provisions on State subsidies. Finally, paragraph 10 will investigate whether WTO law contains provisions governing transnational investments. The focus will be on the provisions of the GATS and the TRIM, whose applicability to the investments of SWFs will be discussed.

1. International monetary problems and the instruments developed to cope with them. From the Bretton Wood Institutions to the development of regional forms of monetary cooperation and the establishment of SWFs.

Existing provisions of international monetary law have indirectly contributed to the creation of SWFs in the following way. Forex Funds are created, as already explained, when a State accumulates an amount of foreign exchange reserves which exceeds the quantity it needs for the ordinary management of its monetary policy. Reserves deemed to be in excess are therefore transferred to SWFs, whose operations will be different from those traditionally undertaken by central banks or other monetary authorities[1], but which will be nonetheless complementary with them. Therefore, the decision to create SWFs is also the consequence of a previous decision consisting in accumulating broad amounts of reserves of foreign convertible currencies. Such decision, in turn, was motivated by the need to avoid situations of scarcity of foreign exchange reserves and therefore it can be regarded as a form of insurance against the risks related to sudden shortages of foreign currency (especially of so called "hard currencies"). There is a broad consensus on the severe effects that shortages of foreign currency can cause to the economy of a State: first of all there is the risk that a State might be unable to pay its importation (especially whenever they are invoiced in a currency of which the State at issue has run short) with clear damages on its economy as a whole. In addition, if a State has scarce reserves of foreign "hard" currencies, it will be unable to maintain a peg, if it has decided to fix the value for its currency in relation to a currency of another State, or in relation to a basket of currencies or in relation to another denominator[2]. Likewise, even if it opts for a free floating or a dirty floating regime for its currency, it will be unable to intervene to control and eventually mitigate the excessive fluctuations of the exchange rate. In fact, its ability to sell foreign currency and purchase domestic currency in order to support the price of the latter is dependent on the availability of reserves of foreign currency which can be exchanged in international markets for the purposes of such operations. Moreover, if investors fear that a State is unable to maintain a decent level of stability of its currency, they will not invest in assets denominated in its currencies or they will try to sell the assets they already have in their portfolios. This

[1] R. J. GILSON, C. J. MILHAUPT; cit.; p.1347-1348 and p. 1357; A. WONG; cit.; p. 1086-1087.

[2] The exchange arrangements which a State can adopt according to the International Monetary Fund (IMF) are indicated, inter alia, at art. IV, 2, b) of the Articles of Agreement. For a more detailed list and explanation of different exchange rate arrangements see: A. COMBA; *Lezioni di diritto internazionale monetario*; Torino; Giappichelli, 2007; p. 48-52; R. CARBAUGH; cit.; p. 445-467.

reduces the possibility for that State and for its companies to rise capitals to finance their investments and expenses. Other investors could even decide to "bet" against a fall of the value of that currency and therefore they will start to speculate against it, for instance by means of short selling or other financial techniques including the use of derivatives. This will determine a fall of the demand of the currency at issue and, as a result, strong pressures for its devaluation. A State which has sufficient foreign exchange reserves is able, first of all, to discourage investors from speculating against its currency and, secondly, is able to cope with speculative pressures and to maintain the value of its currency.[3]

However, the creation and the maintenance of very large foreign exchange reserves, although useful for the reasons stated above, can prove extremely costly (and in certain circumstances, very difficult to achieve). For these reasons it has been argued that international cooperation in international monetary matters could enable the achievement of the same objectives while allowing States to maintain more affordable levels of foreign exchange reserves. Such cooperation in principle should consist in the implementation of mechanisms which, *inter alia*, might ensure a certain level of stability of the currencies of States[4] and of their balances of payments[5]. Also for these reasons, in 1944, delegates of 45 nations meeting in Bretton Woods, New Hampshire, agreed on the establishment of an International Monetary Fund (IMF), an international organization in charge of enhancing international monetary cooperation and maintaining an ordered, stable and predictable monetary system, *inter alia* by establishing and enforcing the rules concerning exchange rate arrangements and adjustments and by providing resources on temporary bases to deal with short term balance of payments problems.[6]

The creation of the IMF was part of a broad and ambitious program, undertaken during the Bretton Wood meeting, whose objective consisted in designing a new

[3] For a more detailed explanation on the role of foreign exchange reserves see: R. CARBAUGH; cit.;p. 491-492.

[4] See, for instance, art. I, iii of the IMF Articles of Agreement

[5] See, for instance, art. I, v. and art. I, vi. of the IMF Articles of Agreement

[6] R. M. LASTRA; *The International Monetary Fund in historical perspective*; in *Journal of International Economic Law; 2000*; p. 512-513.

framework governing all the main aspects of international economic relations which was expected to prevent the unbalances and the economic crises which were deemed to have contributed to the economic recession of the 1930s and to social and political tensions which finally led to the rise of aggressive dictatorships and to the outbreak of the Second World War. Therefore, together with the IMF, entrusted with international monetary cooperation, it was also envisaged the creation of the International Bank for Reconstruction and Development (IBRD), for the purposes of international financial assistance mainly through the financing of projects having a positive impact on development, and of the International Trade Organisation (ITO), which would have promoted international trade and inter-State cooperation in this field. The objective of the creation of such institutions was the establishment and preservation of stable economic relations, in order to prevent or at least mitigate severe situations of economic crises and, even more important, to deal with such economic problems through cooperation among States, in order to avoid economic tensions which could eventually lead to political or even military confrontation. The decision to create in the same occasion international economic organisations which would have virtually dealt with all the three main aspects of international economic cooperation (monetary issues, financing and trade) stressed even further the belief that such areas of international cooperation are strongly intertwined. In particular, it was deemed that monetary cooperation, would have avoided situations in which trade between States would have been impaired by the rise of severe unbalances of the balance of payments or by scarcity of convertible currencies. The IMF would have helped to prevent that shortages of international currency would have resulted into a hindrance to international trade. [7]

It must be stressed that, while the IMF started its operations in 1946 and the IBRD too was established in the 1940s, on the contrary ITO had a different fate. In fact the

[7] D. E. SIEGEL; *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements*; in *The American Journal of International Law*; 2002 p. 564-565; C. CRAWFORD LICHENSTEIN; *International Jurisdiction over international capital flows and the role of the IMF: Plus ça change*; in M. GIOVANOLI; ed; *International monetary law: issues for the New Millennium*; Oxford; Oxford U.P., 2000; p. 63-64.

Charter for its establishment had been signed in Havana in 1948, but since the US Congress refused to ratify it, then it never entered into force. Issues related to international trade were therefore governed within the framework of the General Agreement on tariffs and Trade signed in 1947 and entered into force in 1948, which was replaced by a permanent international organization only in 1995 with the entry into force of the legal instruments establishing the World Trade Organisation (WTO) adopted at the successful conclusion in Marrakesh of the Round of Negotiations started in Uruguay a few years before between the contracting parties of the GATT.[8]
The strong relation between issues concerning on one side international monetary cooperation, balance of payments and exchange rate and, on the other side, international trade, which was well clear to the architects of the Bretton Wood system, will be explained in detail below in paragraph 7 of the present chapter, together with the relation between the IMF and the WTO.

It must be remarked that when the IMF was created, its main task was to administer a system of fixed but adjustable exchange rates, while its activities consisting in providing financial assistance to its members in order to deal with problems of their balance of payments was regarded as having a subsidiary, although crucial, role. However, when the Second Amendment entered in force in 1978, modifying art. IV of the Articles of Agreement of the IMF, members were left free to determine their exchange rate policies and therefore the main role of the IMF consisting in the management of a system of fixed but adjustable exchange rates came to end. It was in this context that financial assistance became the main activity and function of the IMF. The wording of the IMF Articles of Agreement, and especially of art. I which declares the purposes of the organisation, is characterised by a relevant degree of

[8] R. M. LASTRA; *The International Monetary Fund in historical perspective*; cit.; p. 507-512; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 61-63. For a more general overview on international financial organizations see: C. DORDI; *Le istituzioni finanziarie internazionali*; in S. CASSESE; ed., *Dizionario di Diritto Pubblico*; Giuffré 2006; A. VITERBO; *Fondo Monetario Internazionale e Banca Mondiale*; in A. COMBA, ed.; *Neoliberismo Internazionale e global economic governance*; Giappichelli; 2008; p 189-191; D. AHN; *Linkages between international financial and trade institutions - IMF, World bank and WTO*; in *Journal of World Trade*; 2000; p. 1-6; R. HOCKETT; *From macro to micro to "mission-creep": defending the IMF's emerging concern with the infrastructural prerequisites to global financial stability*; in *Columbia Journal of Transnational Law*; 2002-2003; p. 160-164.

flexibility and this has favoured such a radical change of approach. The fact that the objectives of monetary cooperation enhanced by the IMF included the "expansion and balanced growth of international trade", the "promotion and maintenance of high levels of employment and real income" and the "development of the productive resources of all members" (art. I) made it possible for the Fund to change its task from the management and control of a complex system of pegs and par values (a task which was no more possible, since such a system had ceased to exist) to a control of the economic and monetary policies of single States which could have an impact on the world economic and monetary stability. Such control is mainly exercised in two ways. The first is envisaged at art. IV,3 of the Articles of Agreement, especially when it is provided that "the Fund shall exercise firm surveillance over the exchange rate policies of members".[9] The second consists in the application of conditions governing the concession of financial assistance to its member States under art. V of the Articles of Agreement.[10] These two mechanisms are strictly related for the following reasons. Firstly, because art. XXVI,2 provides that failure to comply with the advice of IMF provided in relation to the surveillance exercised ex art. IV can determine ineligibility to draw from IMF resources under art. V. Second, because the surveillance under art. IV and conditionality under art. V have been consistently used by the IMF, especially since the 1990s as a tool to push States which were under IMF surveillance or which required financial assistance to promote deep and overarching reforms in their own economic, social and political domestic

[9] For more information on the procedures through which such surveillance is exercised see: G. ADINOLFI; *La sovranità monetaria e il diritto internazionale dell'economia: la politica di tasso di cambio cinese alla luce del diritto del Fondo Monetario Internazionale*; in A. LIGUSTRO, G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 201; R. M. LASTRA; *The Bretton Wood institutions in the XXIst century*; in R. M. LASTRA; ed. *The reform of the international financial architecture*; London; The Hague; Boston; Kluwer Law International; 2001; p. 78-80.

[10] J. SOREL; *Sur quelques aspects juridiques de la conditionnalité du F.M.I. et leurs conséquences*; in *European Journal of International Law*; 1996; p. 42-44; A. VITERBO; *Fondo Monetario Internazionale e Banca Mondiale*; cit.; p. 205 For more details on the second amendment see: A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 71; R. M. LASTRA; *The Bretton Wood institutions in the XXIst century*; cit.; p. 80-89.

organisation.[11] As it will be studied in depth in the next pages, such policies have come under severe criticism in the last years. In fact they have been regarded as the tools through which the IMF has promoted and in some cases even imposed reforms in the developing countries and transition economies which finally resulted into disastrous effects under the economic and social point of view.[12] The effectiveness, or, *rectius*, the perceived effectiveness of the actions though which the IMF provides its members with adequate resources to deal with short term balance of payments problems, may influence the choice of States to rely on the IMF in case such problems occur or to look for alternatives.

Alternatives may consist in developing forms of cooperation on monetary issues at the regional level or in hoarding large reserves of foreign exchange currency. It must be remarked that in this context the world "alternatives" should not be meant as options excluding each other and eventually excluding recourse to the assistance of the IMF, but rather as complementing each other. As to the issue of the development of forms of monetary cooperation at the regional level, South East Asia offers an outstanding example.[13] Here, in n 2000 Japan, China, Korea and the members of ASEAN (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam) have successfully started the so called Chiang Mai initiative. Under this form of cooperation, it has been created the basic framework which enables monetary assistance by means of currency swaps and repurchase agreements both at the multilateral level of ASEAN (thus improving the existing swap arrangement which was in force since 1977 but which so far had been scarcely used) and at the bilateral level. Swap arrangements are devised to provide liquidity support to member countries that experience balance of payment deficits in the short-run; more in detail swaps allow States to exchange their currency for USD, Euro and Yen. It must be remarked that, lacking a system of surveillance

[11] G. ADINOLFI; *Le recenti evoluzioni in seno al FMI tra crisi economico finanziaria e processi di governance economica internazionale*; in *Diritto del Commercio Internazionale*; 2011; p. 294-298

[12] See below, paragraph 2 and 3 of this chapter.

[13] Another form of monetary cooperation having a regional character is the Fondo Americano Latino de Reservas, established by Bolivia, Colombia, Costa Rica, Ecuador, Peru and Venezuela.

within the Chiang Mai initiative, a system of linkage between the IMF (and in particular its conditionality) and swap arrangements concluded under the Chiang Mai initiative, was however recognised as necessary. This has partially reduced the extent of the initial objective to achieve a higher degree of monetary independency from the IMF. Also for this reason, despite the initial purposes, representatives of the States participating in the Chiang Mai initiative have ended up to recognise the role of the IMF and the need to keep on coordinating with it and within it. To address this issue, talks concerning the creation of an independent body entrusted with the surveillance of the participants of the Chiang Mai initiative and with the coordination of the swaps arrangements, have been made since the beginning, but are still ongoing. [14]

Without getting into the analysis of the Chiang Mai initiative further, one point deserves to be stressed. While projects like the Chiang Mai initiative represent a multilateral response to currency imbalances, although at the regional and not at global level, SWFs represent on the contrary a unilateral response. However, the reason which lies at the establishment of the Chiang Mai initiative and of SWFs remain similar, since both initiatives are related to the need to develop instruments which can be used to cope with international monetary problems and especially with sudden reductions of the foreign exchange reserves, without excessively depending on the assistance of the IMF.

After having said that the creation of SWFs as well as the development of regional forms of monetary cooperation can also be regarded as a consequence of the dissatisfaction in relation to the way the IMF provides its assistance, it is necessary to

[14] A. VITERBO; *La cooperazione finanziaria in Asia orientale tra (multi)regionalismo emergente e tentazioni di protezionismo*; in G. VENTURINI; ed.; *Le nuove forme di sostegno allo sviluppo nella prospettiva del diritto internazional*e; Giappichelli; 2009; p. 101-123; A. VITERBO; *Fondo Monetario Internazionale e Banca Mondiale*; cit.; p. 241; C. SUSSANGKARN; *The Chiang Mai Initiative Multilateralization: Origin, Development and Outlook*. ADBI Working Paper 230. Tokyo: Asian Development Bank Institute; 2010. Available online at: http://www.adbi.org/working-paper/2010/07/13/3938.chiang.mai.initiative.multilateralisation/ page visited on 5/9/2011; Y. C. PARK, Y. WANG; *The Chiang Mai Initiative and Beyond*; in *World Economy*; 2005; p 91-101.
However, the enhancement of a regional dimension of monetary cooperation does not exclude the decision to increase the size of foreign exchange reserves and must be considered as a complementary rather than as alternative to it.

clarify more in detail why this satisfaction rose. To achieve this objective it is necessary, firstly, to study the legal aspects of the mechanism through which the IMF provides assistance to States adversely affected by scarcity of foreign exchange reserves and, as a second step, to assess the perception of their effectiveness from the point of view of States which have been the recipients of IMF assistance and, in particular, of those which have later decided to increase their foreign exchange reserves.

According to art. I,5 and I,6 of the Articles of Agreement, one of the purposes of the IMF is "[t]o give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." Consistently with this objective, the IMF shall act so as "to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members". Art. V provides further details concerning the procedure according to which the IMF provides financial assistance to its members, by making foreign currency or Special Drawing Rights (SDR)[15] available to them subject to certain conditions. Art. V, 2,a) in fact, declares that the aim of such form of assistance is "supplying a member, on the initiative of such member, with special drawing rights or the currencies of other members from the general resources of the Fund, which shall be held in the General Resources Account, in exchange for the currency of the member desiring to make the purchase." Additionally, the IMF can also "perform financial and technical services, including the administration of resources contributed by members, that are consistent with the purposes of the Fund. [...]" (art. V,6.). It must be stressed that in

[15] "The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies, and SDRs can be exchanged for freely usable currencies. With a general SDR allocation that took effect on August 28 and a special allocation on September 9, 2009, the amount of SDRs increased from SDR 21.4 billion to SDR 204 billion (equivalent to about $308 billion, converted using the rate of August 31, 2010" (definition provided by the IMF on its website: http://www.imf.org/external/np/exr/facts/sdr.HTM visited on 11/12/2010. For more detail on SDRs in is possible to refer to R. M. LASTRA; *The International Monetary Fund in historical perspective*; cit.; p. 513; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 99-102.

principle financial assistance provided by the IMF does not consist in loans, but in the supply of convertible currencies in exchange for the currency of the State experiencing problems of its balance of payments. In practice, the IMF exchange SDR or dollars, euro or other hard currencies with the currency of the country demanding IMF assistance which, at the expiry of a certain period will be required to re-purchase from the IMF its own currency using the hard currency it had previously received. A commission is charged, which constitutes one of the main sources of revenues in the budget of the IMF which therefore can finance itself.[16] However it must also be acknowledged that in recent decades the IMF has often been involved in financial assistance which went far beyond the mere provision, on temporary basis, of hard currency to States which experience problems with their balance of payments. On the contrary the IMF has often turned into a lender of last resort, an international organization which provides support to the budget of States whose problems are not only related to temporary illiquidity, but to structural insolvency.[17]

2. The practise of the IMF and its impact on the decision of several countries to accumulate larger reserves of foreign exchange and to create SWFs.

Since the beginning, it was clear that the IMF, in order to preserve its ability to provide financial assistance to its members, needed to put in place adequate mechanisms which would have ensured that, at the end of program of financial assistance, it would have been returned the resources it had provided. This implied, inter alia, a careful assessment of the situation of the State which demanded financial assistance to the IMF and, in particular, of the policies it was able to implement in order to solve the problems experienced by its balance of payments. In fact, it was clear that in the absence of proper structural adjustments, the causes of the

[16] C. DORDI; *Profili Giuridici dell'attività di sostegno finanziario del fondo monetario internazionale: le nuove linee guida sulla condizionalità*; in *Diritto del Commercio Internazionale*; 2002; p. 871-872; J. SOREL; cit.; p. 45.

[17] On the evolution of the IMF in this sense see: R. M. LASTRA; *The International Monetary Fund in historical perspective*; cit.; p. 521-523; R. M. LASTRA; *The Bretton Wood institutions in the XXIst century*; cit.; p. 85-90.

disequilibria of the balance of payments could have not been redressed and, as a result, the resources of the Fund would have been uselessly wasted and at the end the IMF would have not been able to receive them back. The final consequence would have been the inability of the IMF to use such resources to provide assistance to other States.[18] In order to deal with these problems, the IMF has developed a practice according to which the concession of financial assistance to a member State is subject to the adoption by the IMF of a so called stand-by arrangement, which in turn is subject to the undertaking of the member State to implement certain adjustment policies it lists in a document called letter of intent[19]. The concession of the financial assistance is dependent on the willingness and ability of the State to implement those policies which are deemed to be necessary in order to solve on a structural point of view the problems of its balance of payments. Refusal to implement such policies results into impossibility to receive the financial assistance. This practice has come to be denoted as conditionality.

Since 1968, through the adoption of decision n. 2603-(68/132), the Fund made it public the set of criteria it followed when it had to deal with requests for financial assistance. In 1979, decision n. 6056-(79/138) brought to the adoption of the first "guidelines on conditionality", which have been modified and updated in 2002 with decision No. 12864-(02/102) and 2006 by Decision No. 13814-(06/98). At this stage, it must be anticipated that the guidelines on conditionality of 1979, and even more their application during the economic crises which occurred in the 1990s in Latin America, South East Asia and Russia gave rise to widespread criticism. The new version of guidelines approved in 2002, as it will be briefly described below, tries to redress the most controversial aspects. When, in the last part of this paragraph, a

[18] R. NAGPAL; *The IMF's pursuit of capital account convertibility: a developing country perspective*; in *Law and Business Review of the Americas*; 2006; p. 31; C. DORDI; *Profili Giuridici dell'attività di sostegno finanziario del fondo monetario internazionale*; cit.; p. 872; R. M. LASTRA; *IMF conditionality*; in J. NORTON, M. ANDENAS; ed.; *International monetary and financial law upon entering the new millennium. A tribute to sir Joseph and Ruth Gold*; British institute of international and comparative law; 2002; p. 556-557.

[19] For a detailed description of the functioning of stand-by arrangements see: J. SOREL; cit.; p. 49-53; A. VITERBO; *Fondo Monetario Internazionale e Banca Mondiale*; cit.; p. 205-209.

critic to the conditionality applied by the IMF will be made, most attention will be paid to complaints formulated in relation to the application in the 1990s of the guidelines of 1979. This choice is motivated by the fact that the decision of several States to hoard larger reserves of foreign currency (later prompting the creation of SWFs) followed their dissatisfaction concerning the assistance provided by the fund in that period.

Although conditionality is not explicitly regulated or even mentioned in the Articles of Agreement of the IMF[20], the possibility for the IMF to adopt decisions detailing out the conditions upon which assistance by the Fund would have been made available is supported by the wording of art. I v, which declares that one of the purposes of the IMF was to make "the general resources of the Fund temporarily available" to its members "*under adequate safeguards*" [emphasis added]. Art. V,3,a) goes further when it provides that "[t]he Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, [...] in a manner consistent with the provisions of this Agreement and that *will establish adequate safeguards for the temporary use of the general resources of the Fund."* [emphasis added]. Art. V,3,b) when specifying some of the conditions upon which a member "shall be entitled to" receive the assistance of the Fund repeats that "the member's use of the general resources of the Fund would be in accordance with the provisions of this Agreement and the policies adopted under them". Such a wording seems to enable the Fund to adopt decisions providing for guidelines on conditionality. Their legally binding nature has been questioned, especially because the term "guidelines" usually refers to acts of so called "soft-law". However, their language, as well as the fact that they are included in a decision, which is a binding instrument, should make it more convincing the theory of their legally binding character. In detail, guidelines on conditionality have a lower rank than the Articles of Agreement, since they should be regarded as secondary law, however they impose legal duties upon the organs of the Fund. Like most secondary law adopted by international organizations, guidelines on

[20] A. NEWBURG; *The changing roles of the Bretton Wood institutions: evolving concepts of conditionality*; in M. GIOVANOLI; ed; *International monetary law: issues for the New Millennium*; Oxford; Oxford U.P., 2000; p. 84-85.

conditionality are not legally binding upon member States.[21] However, since they determine the procedures that the IMF is obliged to respect and the conditions that the latter is required to demand to member States when providing financial assistance, their actual impact on the sovereignty and the discretion of member States in the adoption of policies governing their own economic issues is very strong.[22]

Stand by arrangements, since they are acts adopted by the IMF, must be consistent with the guidelines on conditionality. It must be remarked that the stand-by arrangement and the letter of intent are two separate and formally autonomous decisions adopted, respectively, by the IMF and by the member State, in spite of the fact that they have the same object, the letter of intent is usually included as an annex in the text of the stand-by arrangement and the letter of credit is prepared following a period of discussions and cooperation between the IMF and the State concerned. Formally, it is the State needing financial assistance which imposes itself certain commitments it lists in the letter of intent and submits to the IMF; likewise, the IMF autonomously decides that given such undertakings, financial assistance shall be provided. For all these reasons, the stand-by arrangement cannot be regarded as tantamount to a contract or to a treaty between the IMF and the State.[23] This is confirmed by the guidelines on conditionality, which at par. 9 declare that: "Fund arrangements are not international agreements and therefore language having a contractual connotation will be avoided in arrangements and in program documents".[24]

[21] C. DORDI; *Profili Giuridici dell'attività di sostegno finanziario del fondo monetario* internazionale; cit.; p. 882-886; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 90-91; R. HOCKETT; cit.; p. 183-188.

[22] R. M. LASTRA; *IMF conditionality*; cit.; p. 551-568.

[23] J. SOREL; cit.; p. 47-48; C. DORDI; *Profili Giuridici dell'attività di sostegno finanziario del fondo monetario* internazionale; cit.; p. 872-882; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 95-106.

[24] Decision No. 12864-(02/102) of September 25, 2002, as amended by Decision No. 13814-(06/98), of November 15, 2006. The document is available online on the IMF website at: http://www.imf.org/external/pubs/ft/sd/index.asp?decision=12864-(02/102)

However, the adoption of the standby arrangement by the IMF depends, as specified above, on the undertaking of the State to adopt certain policies. Although they are decided by the State and they are detailed out in the letter of intent which, as already stressed, is a document of the State, actually the policies it provides must be agreed by the Fund. In practice, the IMF has been playing and increasingly relevant role in suggesting, shaping and even imposing certain policies, whose implementation was the condition for receiving the financial assistance of the fund. Especially since the 1980s, the IMF started to apply the so called "structural conditionality", according to which financial support was subject to reforms which implied restructuring entire sectors of the economy and undertaking broad market liberalizations, in most cases according to those economic theories of the "Washington Consensus." [25] The Washington Consensus refers to the set of policies, inspired by neoliberal economic theories, whose appropriateness (or even whose absolute necessity) to promote economic growth and stability was emphasised in the 1980s and the 1990s in the most powerful and influential economic environments, like top universities and business schools, think tanks, financial institutions, international organizations and governmental agencies. Since the majority of these institutions were based in Washington DC and since there was a broad consensus among them on the need to apply such policies and on their suitability virtually for any State, the term Washington Consensus was used to refer to them. The "inventor" of the term Washington Consensus is John Williamson, who originally coined it phrase in 1990 “to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989”. The policies constituting the Washington Consensus can be summarised as follows:

- Fiscal discipline
- A redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education, and infrastructure

[25] R. NAGPAL; cit.; p. 39-42; R. M. LASTRA; *IMF conditionality*; cit.; p. 551-568 and in particular p. 554.

- Tax reform (to lower marginal rates and broaden the tax base)
- Interest rate liberalization
- A competitive exchange rate
- Trade liberalization
- Liberalization of inflows of foreign direct investment
- Privatization
- Deregulation
- Secure property rights[26]

The IMF, therefore, no more limited its assessments to technical issues, mainly related to the control of certain items of the State budget, but it got increasingly involved in macroeconomic and political issues concerning the way a State organises its economy and society.[27] This new approach was consistent with the belief of the world economic elites, as well as of the leaders and staff of the IMF, that limited intervention to favour adjustments of the balance of payments could prove scarcely effective to redress structural problems in the long run and therefore the primary objective of the IMF should consist in the promotion of those reforms consistent with the principles of the Washington Consensus, which in turn would have promoted growth and solved in a definitive way balance of payments problems.[28]

[26] For an outlook on the Washington Consensus see: http://www.cid.harvard.edu/cidtrade/issues/washington.html
See also: J. WILLIAMSON; *What Should the World Bank Think About the Washington Consensus?* in *World Bank Research Observer*; 2000; pp. 251-264. For detailed critics to the Washington Consensus and on the way its policies have been applied see: J. E. STIGLITZ; *Globalization and its discontents*; New York, London; Norton; 2003; N. SERRA, J. E. STIGLITZ; ed.; *The Washington Consensus reconsidered: towards a new global governance*; Oxford; New York; Oxford U.P., 2008. For a detailed study on how the paradigms of the Washington Consensus have become increasingly influential inside the IMF and later, how and why they have been promoted by the IMF in the countries seeking its financial assistance, see: J. M. CHWIEROTH; *Capital ideas: the IMF and the rise of financial liberalization*; Princeton; Oxford; Princeton University Press; 2010. For a more general discussion on the impact of the principles of the Washington consensus on the activities of international economic organisations see: R GORDON; cit. p. 146-149.

[27] C. DORDI; *Profili Giuridici dell'attività di sostegno finanziario del fondo monetario* internazionale; cit.; p. 881-882.

[28] J. MARTINEZ-VAZQUEZ, F. RIOJA, S. SKOGSTAD, N.VALEV; *IMF Conditionality and Objections: The Russian Case*; in *American Journal of Economics and Sociology*; 2001; p. 503-504; A. NEWBURG; cit.; p. 87-91.

The above mentioned approach was largely followed when in the 1980s and in the 1990s the IMF intervened in Latin America and South East Asia to provide financial support, in many case not just to correct temporary imbalances of the balance of payments but rather to provide resources to States which otherwise would have been insolvent.[29] When, in the beginning of the 1990s the Soviet Union collapsed and many socialist governments in Eastern Europe came to end, the IMF assistance was often demanded by countries of this region, which were facing relevant difficulties in the delicate and long phase of economic transition. The Russian Federation has been for all the 1990s a great recipient of the IMF assistance.[30] The letter of intent issued in 1998 by the Government and the Central Bank of the Russian Federation[31] constitutes one of the outstanding examples of the IMF conditionality and it deserves to be analysed in detail. Russian authorities, in order to receive the assistance of the Fund, in the first part of the document declared their commitment to implement policies which traditionally fall within the area of intervention and expertise of the IMF. They comprised fiscal reforms, mainly concerning conversion of the short term debt into long term debt so as to reduce the pressures on the 1998 and 1999 budgets (par. 11) improvements in the system of tax collection and enforcement of tax law (par. 14-16), changes of some taxes, included the VAT (par. 17). However commitments undertaken by Russian authorities covered several other aspects of the economy of the State. The letter of intent, in fact, contained precise undertaking also concerning reforms of the pension system (par. 22), the social security (par. 23), the banking sector (par.31 and par. 44-48) and bankruptcy procedures (par. 32). Bankruptcy law needed to be reformed so as to be modelled to principles of bankruptcy law

[29] What occurred in several Asian countries provides several examples of IMF application of structural conditionality which promoted inter alia abrupt capital account liberalizations and which, far from solving problems of the concerned economies, brought them to financial and economic collapse economic collapse. For an analysis of these cases see: R. NAGPAL; cit.; p.35-41; A. NEWBURG; cit.; p. 88-90.

[30] For a more detailed description of the applicability of conditionality to the Russian Federation see: J. MARTINEZ-VAZQUEZ, F. RIOJA, S. SKOGSTAD, N.VALEV; cit.; p. 501–517.

[31] Memorandum of the Government of the Russian Federation and the Central Bank of the Russian Federation on Economic and Financial Stabilization Policies; July 16, 1998. Available online at: http://imf.org/external/np/loi/071698.htm (Page visited on 12-12-2010).

consistent with market economy and neoliberal economic theories, for instance through the elimination of "the bias [...] toward reorganization rather than liquidation of enterprises" (par 32). Also the labour market would have been reformed in a way consistent with the principles of the Washington Consensus, especially through the promotion of deregulation which consisted mainly in easiness in firing workers and in reducing the role of trade unions (par. 36). It was stressed the need for a continuation of the privatizations process (par. 36-38) where a key role would have been played by "independent financial advisors among experienced and internationally reputable investment institutions" (par. 37) which actually were the same powerful US based investment banks, whose executives often were the same academics or officers who contributed to shape the theories of the Washington Consensus itself. Finally, the letter of intent contained commitments concerning deregulations and liberalizations of utilities and infrastructures and an increase of private capital participation in the companies managing them. (par. 40-43).

It must be remarked that such policies Russian authorities pledged to pursue, formally by mean of autonomous decision, but de facto under the conditionality imposed by the IMF, were very similar to those policies whose adoption in Russia has been supported by the IMF in the previous years and which have contributed to the economic crisis which in 1998 forced Russia to ask for the Fund's assistance. In general, many of the reforms adopted pursuant to the advice of the IMF proved deleterious for the Russian economy and society. In particular the disruptive privatizations of State assets, especially because of the way they were carried out, ultimately resulted into mass spoliation of State wealth in favour of a very few peoples who used their personal connections to purchase at negligible prices controlling stakes of the largest companies of the country.[32]

[32] For a detailed study on privatizations in former Soviet Union during the 1990s and of the economic and social consequences they entailed see: I. JEFFRIES; *The countries of the former Soviet Union at the turn of the twenty-first century : the Baltic and European states in transition*; London : Routledge, 2004; I. W. LIEBERMAN, and D. J. KOPF; ed. *Privatization in transition economies: the ongoing story*; Amsterdam : Elsevier JAI, 2008; B. DALLAGO; *The State and the transformation of Economic Systems*; in S. ICHIMURA and al.; ed. *Transition from Socialist to Market Economies. Comparison of European and Asian Experiences*; Palgrave Macmillian; 2009; p. 164-187; T. MORITA; *Facts and lessons of ten*

The recovery of Russian economy since 1999 instead of appearing as a consequence of the implementation of the IMF supported reforms, seems to be more related to the dismissal of the most radical paradigms of the Washington Consensus in favour of a renewed intervention of the State in the economy, as well as to the rise of price of gas and oil, of which the Russian Federation is one of the greatest exporter.[33] However, irrespective of any opinion on the effectiveness and suitability of policies supported by the IMF in the late 1990s in the Russian Federation, as well as in other States experiencing problems of their balance of payments, what clearly emerges from the reading of the above mentioned letter of intent is the overarching character of the reforms they promoted, which went far beyond the limited technical issues related to exchange rates and balance of payments and encompassed most aspects of the economic and social organisation of the State which was seeking the assistance of the Fund. In this paragraph the choice to mention the Russian Federation as an example has not been fortuitous. In fact Russia is also an example of a country which in the first decade of the XXI century, taking advantage of windfall revenues mostly denominated in USD obtained from the sale of oil and gas in the international markets has been able to hoard large reserves of foreign currency and then to establish two SWF,[34] the Резервный фонд (Reserve Fund)[35] and the Фонд

years of transformation in Central Europe in S. ICHIMURA and al.; ed. *Transition from Socialist to Market Economies. Comparison of European and Asian Experiences*; Palgrave Macmillian; 2009; p. 231-253.

[33] For an overarching analysis of the good economic performance of Russia between 1999 and 2008, as well as for a critical discussion of the elements of weakness which nonetheless persist in Russian economy see: S. GURIEV, A. TSYVINSKI; *Challenges Facing the Russian Economy after the Crisis*; in A. ÅSLUND, S. GURIEV, A. KUCHINS; ed.; *Russia after the Global Economic Crisis*; Peterson institute for international economics; 2010; p. 9-16. See also: A. ÅSLUND, A. KUCHINS; *The Russia Balance Sheet; Peterson institute for international economics*; 2009; p. 39-56. On other important aspects of Russian economy in that period see: A. ÅSLUND; *The Russian Economy: More than Just Energy?*; Testimony for the Committee on Foreign Affairs of the European Parliament; April 2009, available online at: http://issrb.ru/content/program/409.pdf page visited on 13/12/2010.

[34] S. GURIEV, A. TSYVINSKI; cit.; p. 12. For an in-depth analysis of the macroeconomic objectives of the two Russian SWFs and the political debate which underlying their creation see: S. FORTESCUE; cit.; p. 113-132; R. S. SHIYKO; *The changing framework for sovereign wealth management in Russia*; in M. RIETVELD; ed.; *New perspectives in sovereign asset management*; Central Banking Publication; 2008; p. 99-107.

[35] More information can be found on the website of the Ministry of Finance of the Russian Federation at the page: http://www1.minfin.ru/en/reservefund/ . Page visited on 12-12-2010. It must be stressed

национального благосостояния (National Wealth Fund)[36]. During the recent economic crises which affected the entire world since mid 2007 and Russia since mid 2008, the large reserves of foreign exchange previously amassed and held by the Central bank and by the two Russian SWFs, have played an important role in mitigating the effects of this critical situation on the Russian economy. In particular they have prevented a slump of the Rouble, an excessive deterioration of the balance of payments and they have laid the foundations of a relatively quick financial recovery.

Conditionality was criticised not only because it was related, as demonstrated above, with severe interferences in the way States organise and manage their economic and social life, resulting *de facto* into a reduction of their sovereignty. (I say "*de facto*" because, formally, the commitment to engage in broad and overarching arrays of reforms was an autonomous choice of the demanding State and not an imposition of the Fund). It was also criticized for its "one size fits all" approach, which tended to support the adoption of policies and reforms which, although consistent with the (abstract) paradigms of neoliberal economic theories supported by the IMF, on the other side did not take into account the peculiarities of each States. It has also been put in question the consistency of the conditionality applied by the Fund in the 1990s with the Article of Agreements, which have a higher rank than the decision containing the guidelines on conditionality and therefore which cannot be derogated by it. More precisely, emphasis has been put on article IV,3, especially where it provides that: "principles [leading the conduct of the IMF] shall respect the domestic social and

that the Reserve Fund, with respect to its origin and source of financing is a commodity fund, since it is financed by federal budget revenues from production and export of oil as well as from from production and export of natural gas and oil products. However, since the contracts for the international sale are mostly invoiced in USD, the resources which are transferred to the fund are mainly constituted of USD. Like any commodity fund, its main task consists in the stabilization of revenues related to the exploitation of Russian natural resources, however, since the assets under its management are denominated in foreign currency, it can also play, and it has actually played, functions of monetary stabilization.

[36] More information can be found on the website of the Ministry of Finance of the Russian Federation http://www1.minfin.ru/en/nationalwealthfund/ Page visited on 12-12-2010. The National Wealth Fund is dedicated to support the pension system of the Russian Federation; it is financed by the proceeds from the sale of oil and gas.

political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members."[37] However, it must be stressed that art IV deals with IMF surveillance on exchange rate arrangements and on some other macroeconomic issues of member States and not with financial assistance in case of problems of the balance of payments or with conditionality. Therefore, extending the wording and the principles of art IV to the scope of art. V can rise some doubts.

Assistance of the Fund was often made subject to full liberalisations of capital movements, consistently with the belief of the IMF management and staff in the 1990s according to which the IMF needed to promote economic growth, which in turn could be promoted by a rise of investments[38]. Since the States which were demanding financial support from the IMF had scarce resources to undertake investments, in most cases investments whose necessity was emphasised were those undertaken by the private sector. Especially in case of developing countries and States with economies in transition, which were the major recipients of Fund's assistance in 1980 and 1990s, domestic private investors were scarce and undercapitalised, therefore the increase of investments would have occurred by means of attracting foreign capitals. It must be remarked that, together with longer-term relational investments such as foreign direct investment, which ensured a higher degree of stability and continuity, as well as positive externalities like transfers of technology and know-how and better integration with world markets, the IMF supported the need to welcome portfolio investments too, included those, often defined "hot capital", which could prove particular unstable.[39] Therefore, the full

[37] A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 104.

[38] R. NAGPAL; cit.; p. 33; J. MARTINEZ-VAZQUEZ, F. RIOJA, S. SKOGSTAD, N.VALEV; cit.; p. 503; J. M. CHWIEROTH; cit.; p. 150-210

[39] T. A. CANOVA; *Financial liberalization, international monetary dis/order, and the neoliberal State; in American University International Law Review*; 1999-2000; p. 1287-1288. For a broader discussion on the positive externalities that FDIs can bring, and on the way they can promote development see, for instance: UNCTAD; *World investment report 1999 - Foreign direct investment and the challenge of development*; UNCTAD 1999; L. CUYVERS, and F. DE BEULE, ed.; *Transnational corporations and economic development: from internationalization to globalization*; Basingstoke: Palgrave, 2005; L. RESMINI; *Il ruolo degli investimenti diretti esteri* in G VENTURINI ed.; *Le nuove forme di sostegno allo sviluppo nella prospettiva del diritto internazionale*; Torino; Giappichelli, 2009; p. 67-80. For a more critical view see: J. STIGLITZ; *Globalization and its discontents* cit.

liberalisation of capital movements prompted by the IMF also involved the abolition of restrictions to speculative inflows and outflows of capitals, which could prove particularly dangerous for countries with financial and banking systems which still presented relevant weaknesses.

It must be stressed that no provision of the Articles of Agreement provides for a full liberalisation of the capital account.[40] In fact, art. VIII provides that "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions". They are defined at art. XXX as "payments which are not for the purpose of transferring capital". Portfolio Investments, but also FDIs, seem to be excluded from this general definition. In addition, art. XXX provides a (non exhaustive) list of payments for current transactions, which includes: "1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities; (2) payments due as interest on loans and as net income from other investments; (3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and (4) moderate remittances for family living expenses." Investments are clearly not included in these list.

In addition, it must be recalled that the liberalisation of payments itself, as it is laid down at art. VIII, is subject to the exceptions provided for at art. VII and XIV, which, respectively, deal with scarce resources and lawful restrictions during transitional periods. On the contrary, art. VI,3, provides that "Members may exercise" controls "as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV,

[40] On the other side, it can be argued that this should not be construed in a way such as to prevent the IMF from considering also the degree of liberalisation on capital movements achieved by a State when performing its function of surveillance or of financial assistance in respect to that State under, respectively, art. IV and V of the Articles of Agreements. On this aspect see: G. ADINOLFI; *Le recenti evoluzioni in seno al FMI*; cit.; p. 291.

Section 2".[41] Therefore, the possibility for a State to control and restrict capital movements, provided that this does not constitutes a disguised restriction to movements of payments, is ensured by the Article of Agreements. Policies of the Fund which, although indirectly, urge member States to abolish such controls seems to be hardly consistent with the wording and, even more, with the spirit and the objectives of the IMF.

It must be recalled that, at the time of the negotiations for the establishment of the IMF, there were two opposite view as to restrictions of capital movements. While the Plan drafted by Harry Dexter, which was supported by the US, suggested that all IMF members would have abandoned any restriction on capital movements within one year after joining the Fund, on the contrary the Plan drafted by Keynes proposed a distinction between so called productive and speculative capitals. Only movements of the former, which were related to trade and to some aspects of productive investments, should have been liberalised, while restrictions on hot money should have been maintained, in the interests of the stability of the monetary and financial system as a whole. Finally, the international Community endorsed the Plan of Keynes as the Articles of Agreement discussed above have clearly shown.[42] It is difficult to admit that a practice adopted by the IMF staff when providing financial assistance to member States might legitimately evolve in a way to clearly contradict

[41] For an analysis of the provisions of the Articles of Agreements dealing with restrictions of payments and other transfers of capitals, see: C. PROCTOR; *Mann on the legal aspect of money*; 6th ed. Oxford : Oxford University Press, 2005; p.371-407; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 72-82. See also: R. NAGPAL; cit.; p. 28 and p. 34; C. CRAWFORD LICHENSTEIN; *International Jurisdiction over international capital flows and the role of the IMF*; cit.; p. 63-68; A. VITERBO; *Fondo Monetario Internazionale e Banca Mondiale*; cit.; p. 218-220; M. WAIBEL; *BIT by BIT: The Silent Liberalization of the Capital Account;* in VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford : Oxford U.P.; 2009; p. 503-505; K. SONO, H. KANDA; *In search of order in the world monetary system. State intervention after the decline of lex monetae*; in M. GIOVANOLI, D. DEVOS; *International monetary and financial law: the global crisis*; Oxford; Oxford University Press; 2010; p. 512-513; A. KOLO; *Transfer of funds: the interaction between the IMF articles of agreement and modern investment treaties: a comparative law perspective*; in S. W. SHILL; ed.; *International investment law and comparative public law*; Oxford; Oxford U. P.; 2010; p. 348-351.

[42] C. CRAWFORD LICHENSTEIN; *International Jurisdiction over international capital flows and the role of the IMF*; cit.; p. 62-72; F. GIANVITI; *The prevention and the resolution of international financial crisis: a perspective from the International monetary Fund*; in M. GIOVANOLI*; ed; International monetary law: issues for the New Millennium; Oxford; Oxford U.P; 2000*; p. 100-109.

the political decisions taken by the States which created the IMF. The IMF could legitimately impose full liberalization of capital movements only is there is a political choice in this sense of the States, a choice which would necessarily imply amending the Articles of Agreement and in particular of art. VI and VIII.[43]

Further criticism relative to IMF structural conditionality was related to the lack of transparency and to the excessive discretion of the decisions and operations of the Fund as well as to the fact that financial assistance was given according to procedures whose timing proved to be inadequate given the quick developments of the monetary and financial crises the IMF was supposed to contribute to mitigate.

Finally, the effectiveness of IMF interventions has been seriously questioned. It has been remarked that States which have obtained the assistance of the IMF and which have followed its advice also undertaking burdensome and painful reforms, have not achieved any relevant improvement of their economic situation and this is proved also by the fact that several times they have been forced to ask the IMF for more assistance.[44]

In the beginning of the XXI century, not only the conditionality of the IMF was the object of increasing criticism, but also the principles of the Washington Consensus

[43] Proposals to amend the IMF Articles of Agreements, so that to "institutionalize" the practice consisting in promoting full liberalization of capital movements developed within the framework on conditionality has been made in the past, but they have been unsuccessful, thus confirming the opinion of the international community that some restrictions of capitals movements can be useful and desirable, contrary to the approach endorsed by the IMF especially in the 1990s. On these issues see also: T. A. CANOVA; cit.; p. 1284-1285.

For sake of completeness, it must be reminded out that some authors do not deem that the practice of the IMF to focus on microeconomic, structural adjustments within States instead of focusing exclusively with macro-economic and monetary issues is inconsistent with IMF Articles of Agreements. This stance leans on the convincement that, since the entry into force of the second amendment, the purposes of the IMF, and in particular the pursuit of financial stability, could be achieved by promoting domestic policy which could enhance the soundness and the stability of the monetary system. Such objectives, in fact, could no more be achieved by means of controls over exchange rate arrangements since the end of a system based on fixed exchange rates. On this point see, for instance: R. HOCKETT; cit.; p. 153- 193 and in particular p. 187-190. In many cases domestic microeconomic reforms which were encouraged by the IMF in order to improve the stability and soundness of the international monetary system concerned the financial and banking sector. On this aspect see: D. SINGH; *The role of the IMF and World Bank in financial sector reform and compliance: an outline*; in *European Business Law Review*; 2007; p. 1395-1421.

[44] A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 104; A. NEWBURG; cit.; p. 91-93; A. VITERBO; *Fondo Monetario Internazionale e Banca Mondiale*; cit.; p. 212-214.

themselves were increasingly questioned. The Washington Consensus was replaced by the Monterrey Consensus,[45] whose principles are laid down in a document adopted at the end of the International Conference on Financing for Development, which was convened by the UN in Monterrey in 2002. That fact that the Monterrey Consensus was developed within the framework of an international conference sponsored by the UN, seems to underline the renewed role of governments and intergovernmental organisations in attempting to shape world policies affecting economic and development. On the contrary, the Washington Consensus, as explained above, developed in a more informal way (actually there is not an official document providing for it) from the interaction between several subjects, among which non-State actors were particularly influential. The analysis of the content of the Monterrey Consensus would clearly fall outside the scope of the present work; however some references to elements which can be of interest for the purposes of the present discussion can be briefly outlined.

The Monterrey Consensus, like the Washington Consensus, supports the role of domestic and foreign investments in promoting development. It recognises that not only FDIs, but also other form of foreign capital could prove beneficial (parr. 20-25). However, it also stresses at par. 25 that: "measures that mitigate the impact of excessive volatility of short-term capital flows are important and must be considered." This formulation implicitly recognises that full capital account liberalisation, which has been often supported by the IMF as a tool to promote economic growth, now is reconsidered, since it is recognised that it can introduce excessive volatility of capital flows. Therefore, State measures providing for some restrictions of capital account could prove beneficial, and States should not be encouraged to dismiss the all. The Monterrey Consensus also seems to address the problems related to the so called "one size fits all" approach often applied by the IMF. In fact in the document, at par.

[45] Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002 (A/CONF.198/11, chapter 1, resolution 1, annex. Available online at: http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf page visited on 14/12/2010 . See G. VENTURINI; *Il dibattito sul finanziamento allo sviluppo nelle organizzazioni internazionali*; G VENTURINI ed.; *Le nuove forme di sostegno allo sviluppo nella prospettiva del diritto internazionale*; Torino; Giappichelli, 2009; p. 43-65

56, it is stressed the "need for multilateral financial institutions, in providing policy advice and financial support, to work on the basis of sound, nationally owned paths of reform that take into account the needs of the poor and efforts to reduce poverty, and to pay due regard to the special needs and implementing capacities of developing countries and countries with economies in transition [...]"

It is in this context that the new guidelines on conditionality 2002 have been adopted,[46] trying to address some of the problems mentioned above.[47] In particular, emphasis has been put on "national ownership of sound economic and financial policies" in order to increase the role of the States in shaping their own domestic policies and to deal with the critics that the IMF tended to impose its own policies (par. 3 of the guidelines). Par. 7 of the guidelines explains that "program-related conditions governing the provision of Fund resources will be applied parsimoniously." In particular conditions subject to which the IMF will provide financial assistance "will normally consist of macroeconomic variables and structural measures that are within the Fund’s core areas of responsibility. Variables and measures that are outside the Fund’s core areas of responsibility may also be established as conditions but may require more detailed explanation of their critical importance." Par. 7 goes even further by enumerating the Fund’s core areas of responsibility for the purposes of the guidelines on conditionality. They are: "macroeconomic stabilization; monetary, fiscal, and exchange rate policies, including the underlying institutional arrangements and closely related structural measures; and financial system issues related to the functioning of both domestic and international financial markets." From this list it seems that intervention in the field of privatisations, reforms of the labour market and deregulations, which clearly fall outside the scope of the above mentioned core areas of responsibility of the IMF, could be established as condition only in limited cases. Finally, par. 8 promotes cooperation with the World bank and abolishes any form of

[46] Decision No. 12864-(02/102) of September 25, 2002, as amended by Decision No. 13814-(06/98), of November 15, 2006. The document is available online on the IMF website at: http://www.imf.org/external/pubs/ft/sd/index.asp?decision=12864-(02/102)

[47] R. NAGPAL; cit.; p. 41-42. It must be remarked that in 2009 Guidelines on conditionality underwent further motifications, in order to exclude from conditionality most performance criteria having a structural character: G. ADINOLFI; *Le recenti evoluzioni in seno al FMI*; cit.; p. 316-317.

cross conditionality, according to which assistance of the IMF could be made subject to the respect of requirements and conditions laid down by other organisations.[48]

An assessment of the actual improvements of the policies of assistance of the IMF and of the change of the perception of States relative to IMF operations pursuant to the adoption of the new guidelines on conditionality of 2002 falls outside the purposes of the present research. What this chapter meant to underline is that the practice of the IMF on conditionality in the 1990s brought several States to rethink their strategies to minimize risks related to monetary problems in order to achieve a higher independence from the assistance of the IMF. As anticipated in the beginning of the paragraph, this included the development of forms of monetary cooperation on a regional scale, included regional monetary organizations which could prove more effective than the IMF and more respectful of the economic and social peculiarities of the countries which would have required financial assistance. More important, this implied in several countries a renewed attention to the management of monetary issues and policies aiming at increasing the size of the reserves of foreign currencies. Since the "insurance" against problems related to the balance of payments, which was traditionally offered by the IMF, was no more perceived as effective or convenient, the accumulation of foreign exchange reserves constituted a form of self insurance against shocks of the balance of payments.[49] As it has been discussed above, the increasing level of such reserves, and the increasing costs of their maintenance and management, are among the main reasons for the establishment of SWFs.[50]

3. New perspectives in the relation between the IMF and the SWFs owned by emerging economies

[48] For a more in-depth analysis of the guidelines of conditionality see: C. DORDI; *Profili Giuridici dell'attività di sostegno finanziario del fondo monetario* internazionale; cit.; p. 886-899.

[49] H. R. TORRES; *Reforming the International Monetary Fund - Why its legitimacy is at stake*; in *Journal of International Economic Law*; 2007; p. 443-444; G. ADINOLFI; *Le recenti evoluzioni in seno al FMI*; cit.; p. 316.

[50] Z. FENG; cit.; p. 488-489

Until the inception of the recent world economic crisis it was often claimed that the IMF was losing its relevance and utility. At that time, less and less countries were applying for its financial and technical assistance, because of the growing scepticism about the legitimacy and effectiveness of its interventions and because of the development of the alternative forms of self insurances by its member States which have been described above.[51] Moreover, the growing and the persistence of imbalances of the current and the capital account in many members of the IMF seemed to be a further prove that the IMF was unable to perform one of its main tasks which consisted in "oversee[ing] the international monetary system in order to ensure its effective operation" also through the "firm surveillance over the exchange rate policies of members," as provided in art. IV of its Articles of Agreement.[52]

However, the recent economic crisis has provided the IMF with many occasions to intervene and provide financial assistance to its members, which culminated in 2010 and again in 2011 in interventions in favour of countries which belong to the Euro Area (an event which would have been hardly predictable until a few years ago). These more recent developments prove that today the IMF, despite the crisis of legitimacy it has undergone until 2007, cannot be regarded as an useless or obsolete organisation.

In addition, it must be remarked that the development of forms of monetary cooperation on a regional scale (also by means of creating "regional monetary funds" or similar organizations) and the accumulation of larger foreign exchange reserves and the creation of SWFs, although they are alternatives to the IMF, do not exclude a role for it and they are all consistent with the purposes of maintaining monetary stability and preventing problems of the balance of payments.

[51] The idea that the IMF, if it didn't want to become irrelevant, needed to undertake drastic changes, was very popular. On this point see, for instance: H. R. TORRES; p. 443–460.

[52] On the role of the IMF is tackling imbalances of the current account and of the capital account, especially through the surveillance on exchange rates, see, infra, paragraph 5.

It could be even argued that those States which in the past required the IMF assistance and which now have large reserves of foreign currency could make such resources available, on a temporary basis, to the IMF, in order to facilitate it in the fulfilment of its tasks. This is made possible by the increase of the quotas owned by several emerging economies[53] and also by the development by the IMF of new financial facilities: the General Arrangements to borrow (GAB) and, much more important for the purposes of the present analysis, the New Arrangements to Borrow (NAB).[54] Through the GAB and the NAB some IMF member States lend a part of their monetary resources to the IMF, which in turn uses them to provide financial assistance to other members. The GAB were established in 1962 and enables the IMF to borrow specified amounts of currencies from 11 industrial countries (or their central banks), under certain circumstances, at market-related rates of interest. The NAB have a similar nature, but the element which needs to be stressed is that countries supplying resources to the IMF also are emerging economies: several of them are owners of SWFs. For instance, the list of countries which participate in NAB includes: Chile (or, rectius, its central bank) Hong Kong (or, more precisely, its monetary authority), Korea, Malaysia, Saudi Arabia and Singapore, Brazil , China, India, and the Russian federation[55]. From such list, even more interestingly, it emerges that some of the countries which today are able to provide the fund with additional resources in order to support it to fulfil its task, are countries which until a few years ago experienced problems with their balance of payments and with scarcity of foreign reserves and had asked for the Fund assistance.[56] Finally, it can

[53] M. FRIGESSI DI RATTALMA; *La riforma della governance mondiale nel tempo della crisi*; in: *La comunità internazionale*; 2011; p. 214-216.

[54] The IMF in the last decades have developed several forms of financial assistance other than those provided though the stand by arrangements and the letters of intent. For a short review see: R. NAGPAL; cit.; p. 30; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 102-104; G. ADINOLFI; *Le recenti evoluzioni in seno al FMI*; cit.; p. 308-310.

[55] For more information on GAB and NAB see: IMF; *IMF Standing Borrowing Arrangements*; Factsheet; IMF; 2010, available online at: http://www.imf.org/external/np/exr/facts/gabnab.htm page visited on 13/12/2010.

[56] However, the fact that a country has become a participant in the GAB or in a NAB does not means that its financial situation is such as to exclude that it might need IMF assistance. For instance, Greece and Ireland are participants in the NAB, but in 2010 the IMF has intervened to provided them with

be suggested that the IMF, within the framework of the GAB and of the NAB not only could deal with Governments and Central Banks of the concerned States, but also with their SWFs. This idea is suggested by the fact that SWFs play macroeconomic functions in the countries establishing them, and, especially in case of forex funds, they play monetary policies tasks; therefore they could be regarded as governmental or monetary authorities. In addition, the wording of art. V,1 of the Articles of Agreements seems to support such view, when it declares that "[e]ach member shall deal with the Fund only through its Treasury, Central Bank, stabilization fund, or other similar fiscal agency, and the Fund shall deal only with or through the same agencies". Although the conclusion of the IMF Articles of Agreement predates the establishment of the first SWF (which took place in 1953 in Kuwait) the terms "stabilization funds" should not be construed so as to exclude SWFs.

Therefore, while the creation of forex SWFs can be seen as an indirect consequence of the refusal of many countries to exclusively rely on the IMF for the solution of their monetary and financial problems, as well as of a more general refusal to keep on accepting the mainstream economic and political neoliberal doctrines supported inter alia by the IMF, the developments occurred in the last decade, which included the creation of SWFs themselves, introduce new elements of discussion. In particular, it seems that the same policies promoted by the IMF, after having indirectly contributed to the creation of the SWFs, might now turn into an element which benefits SWFs themselves (as well as the countries owning them) since the operations of SWFs undertaken overseas are facilitated by the existence of an open environment for movements of capitals whose establishment has been favoured, as explained above, by the spread of the principles of the Washington Consensus and by IMF sponsored economic reforms. Especially since the late 1980s, the liberalisation of capital movements and the establishment of an international legal framework which reduces

financial assistance. However it could be argued that in such case IMF intervention, which was coordinated with the European Union and the European Central Bank, was not limited to an attempt to deal with temporally problems of the balance of payments, but it was a much broader intervention aimed at preventing the risk of insolvency of such States. For the increasing role of the IMF as a provider of financial support and as lender of last resort see: R. M. LASTRA; *The International Monetary Fund in historical perspective*; cit.; p. 521-524.

restrictions to foreign investments, included portfolio ones, have been supported by the IMF and, with different degree, by governmental authorities of several developed economies, *in primis* those of the US. This had been often considered as a tool for the promotion of the interests of financial investors based in rich countries, which were able (and are still able) to exercise strong influences on western governments and international financial institutions. Such investors in this manner were given the possibility to freely invest and divest in developing countries and countries with economies in transition. It has been argued that the interests of such countries, on the other side, were substantially disregarded and in particular the argument that for their monetary and financial stability the maintenance of certain forms of capital controls was desirable was neglected. The abolition of restrictions to inbound capital flows allowed foreign investors to obtain great profits from their investments in countries in which initial supply of capital was scarce and therefore in which foreign capital could obtain a higher remuneration. Likewise, the abolition of restrictions also to outbound capital flows allowed foreign investors to quickly and easily divest and repatriate their capitals, as soon as they realised that the economy of the country they were investing in was overheating, that the economic bubble also determined by previous massive foreign capital outflows was about to bust, or, more generally speaking, when they deemed that the profitability of the investment was decreasing. Such unregulated inflows and outflows of foreign capitals, when they occurred suddenly and massively, had often determined disruptive effects on the economies of recipient States, especially when they were developing countries or countries in transition, with weak banking and financial systems and an economies whose size was small relative to foreign capitals flows.

The emergence of SWFs seems to reverse such traditional approach. The creation of an open environment for financial investments and investors now advantages also SWFs, included those owned by the same developing countries and countries with economies in transition which in the 1980s and in the 1990s seemed to be the losers of massive liberalisations of capital movements. Likewise, some of the countries which until a few years ago were supporting the efforts of the IMF in promoting openness to foreign investments, direct and financial both, are now starting to rethink their attitude, in the light of the recent increase of investments undertaken in their territory originating from emerging economies and which often occurs through the operations of SWFs.

4. The existence of imbalances of the current account and their impact on the creation of SWFs.

After having studied that the accumulation of large amounts of foreign exchange reserves is at the same time the reason and the condition underlying the decision to create a (forex) SWF, it is necessary to study how such accumulation might occur. In particular, the present analysis will focus on the role played by persistent surpluses of the current account in the accumulation of foreign exchange reserves.

Countries which experience a relevant surplus of the capital account are able to hoard relevant volumes of foreign currency. Likewise, countries which experience a relevant deficit of the current account, experience a parallel surplus of the financial account, which in turn can be related to the investments undertaken in their territory by foreign entities, including SWFs. For these reasons, the creation of SWFs and their investments overseas can be regarded as one of the consequences of the persistence of surpluses and deficits of the current account and of the financial accounts of the balances of payments of the States which are the owners of SWFs and of those which are the recipients of the investments of such investment vehicles.

For a better comprehension of these arguments, and for the purposes of the discussion developed in the following paragraphs, a brief explanation, from an economic perspective, of the structure and of the functioning of the balance of payments is necessary.

The balance of payments accounts of a country keep track of both its payments to and its receipts from foreigners. Any transaction resulting in a payment to foreigners is entered in the balance of payment as a debit and it is given a negative sign, while any transaction resulting in a receipt from foreigners is entered as a credit and it is registered with a positive sign. The balance of payments is divided into three sections. The first is the current account, whose main items are exportations of goods and services (which are recorded with a positive sign, because they represent a payment received from foreigners) and importations of goods and services (which are recorded with a negative sign, because they consist in a payment made to foreigners in exchange for the purchase of the goods or the services). When the total value of exportations exceeds that of importations, the current account is in surplus, while a current account deficit occurs when importations exceed exportations. The second section of the balance of payments is the financial account, which deals with transactions concerning the purchase or sale of assets, which are meant in a broad sense, such as to include, for instance, money, monetary deposits, stocks, debt, factories, real estate. In particular, foreign assets held abroad are registered in the financial account with a negative sign (because they correspond to a payment made to foreigners for the purchase of such assets), while domestic assets held by foreigners are registered with a positive sign (because they are connected with a payment received by foreigners). This means, for instance, that if in a country the total volume of inbound foreign investments exceeds the total volume of outbound foreign investments, then the financial account will register a surplus. Finally, the third section of the balance of payments, which however is less important for the purposes of the present analysis, records other international transactions which do not fall in the financial account which are, for instance, remittances or payments for non tangible and nonfinancial assets like trademarks. According to the well established rule of double entry bookkeeping, every international transaction automatically enters the balance of payments twice, once as a credit and once as a debit. For this reason the current account, the financial account and the capital account add up to zero. In practice, this implies that if a country experiences a deficit in the current account, then it will have a surplus of the same entity in the financial account and /or in the capital account.[57] This principle can be explained with a simple example. Suppose that US importers buy footwear from China for the equivalent of 1 million USD. From the point of view of the US balance of payments, this represents a payment made to foreigners in relation to international trade and therefore it is registered as a debit in the US current account, thus increasing the deficit of the US current account. Likewise, Chinese exporters receive 1 million USD and this is registered in the Chinese balance of payment as a credit in the current account, thus increasing the Chinese surplus of the current account. Since Chinese exporters cannot use in China the USD they have earned, they exchange them with Yuan with their bank, which in turn gives these USD to the Chinese Central Bank, thus receiving in exchange the equivalent amount of Yuan. This means that, as a result of such transactions, the Chinese Central Bank owns 1 million USD more in its official reserve assets. They are deposited in accounts opened in US banks. Such deposits of USD held by the Chinese Central Bank in US banks clearly are financial assets owned by foreigners in the US and therefore are registered as a credit in the financial account. In this way, they increases the surplus of the financial account of the US exactly to the same extent they are related to the increase of the deficit of the US current account. This also explains the mechanism through which exportation of goods or services determines an increase of the foreign exchange reserves owned by the Central Bank of the country of the exporters.[58]

In the forthcoming pages the implication of such disequilibria concerning the US and the Chinese balance of payments will be studied in depth, given in particular their impact on the creation of the Chinese SWFs and their investments (also) in the US.[59]

[57] P. KRUGMAN, M. OBSTFELD; cit.; p. 301-307; M. D. LEVI; cit.; p. 145-155; R. CARBAUGH; cit.; p. 321-330; C. THOMAS; *Balance of payments crises in the developing world: balancing trade, finance and development in the new economic order*; in *American University International Law Review*; 1999-2000; p. 1251-1255; A. MATTOO, A. SUBRAMANIAN; *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization*; in *World Economy*, 2009; p. 1138.

[58] For a more detailed explanation on the mechanism through which current account surpluses lead to the increase of the reserves of foreign currency see: P. KRUGMAN, M. OBSTFELD; cit.; p. 307-312; M. D. LEVI; cit.; p. 151-155; R. CARBAUGH; cit.; p. 320-321.

[59] For more information on the Chinese SWFs, as well as on their relation with other State owned entities and their role in implementing domestic economic policies see: A. ARDUINO; cit.; L. H. LIEW, L.

Trade between the US and China has led to a broad deficit of the current account in the US and to a specular surplus of the Chinese current account. As a result, China has accumulated large reserves of USD. Part of them have been transferred to the Chinese SWFs and used to purchase financial assets in the US and denominated in USD. In other words this has increased the volume of investments, undertaken by Chinese entities included Chinese SWFs, in the US. From this perspective, SWFs can be also considered as tools for recycling international capitals: capitals flow from the US to China under the form of payments in exchange for goods and flow from China to the US to finance the purchase of US assets by Chinese entities, which are privately-owned firms, State owned firms, and of course, SWFs. Such a situation has risen concerns in the US, since many commentators have underlined that China is taking advantage of the current account deficit of the US in order to purchase stakes in US companies as well as US sovereign bonds, thus gaining a particular ability to influence US stock markets, public finances and, even more, US currency. To these arguments, it is often added the claim that China manipulates the exchange rate between its currency, the Yuan, and the USD, by artificially preventing the Yuan from appreciating relative to the USD, in order to preserve the competitiveness of Chinese exportations. Therefore, it is argued that the persistence of the disequilibria of the balance of payments and in particular the persistence of the US current account deficit especially relative to China is also caused by such foreign exchange manipulations.[60] More in detail, since 1994 China adopted a managed floating

HE; *Contribution to a harmonious society: China's Sovereign Wealth Fund*; in X. YI-CHONG, G. BAHGAT; ed.; *The political economy of Sovereign Wealth Funds*; Basingstoke; Palgrave Macmillian; 2010; p.. p. 26-46; L. C. BACKER; *Sovereign Investing in Times of Crisis*; cit. p. 99-140; L. C. BACKER; *The Chinese Communist Party and the Governance Structures of SWFs and SOE*; cit.; H. FAN, Z. MING; *China's sovereign wealth fund: challenges and weaknesses*; in M. RIETVELD; ed.; *New perspectives in sovereign asset management*; Central Banking Publication; 2008; p. 107-122.

[60] In this chapter, the analysis which will be made concerning the relation between currency undervaluation, foreign exchange reserves and SWFs will be carried out by referring to the economic relations between the US and China. However, the relation between currency undervaluation and of creation of SWFs is important also in the case of SWFs owned by oil exporting countries. Between end-2001 and July 2007, real oil prices increased by about 250 per cent. The increase of the price of the main item of the exportation of a country determines an appreciation of its currency, since the increase of the price of the goods exported by one country causes an increase of the demand of the currency of that country. Economists have estimate that a 100 per cent increase in real oil prices leads

exchange-rate regime. However, also as a result of fears related to the South East Asia crisis, since 1997 China has restored the peg of the Yuan with the USD at the rate of 1USD = 8,28 Yuan. In the beginning this practice did not rise particular criticism but since 2003, with the deepening of US trade deficit with China (which nonetheless started in the end of the 1970s) pressures on Beijing for letting the Yuan appreciate became stronger. In 2005 Chinese monetary authorities introduced important changes. The value of the Yuan was established in relation to a basket of foreign convertible currencies. Only very limited fluctuations, due to market forces, were allowed. In any case in 2007 the exchange rate of the Yuan could float within a range of +/- 0,5% on a daily basis. The exact composition of the reference basket was unknown and it was estimated it could change in a dynamic way. Therefore, while in the beginning the USD by far constituted the largest part of the basket, since 2007 a broader diversification was undertaken and finally, in 2008, the importance of the Euro in the composition of the reference basket equalled that of the USD. These changes resulted into a partial appreciation of the Chinese currency which appreciated by 18.6 percent in real effective (trade-weighted) terms from June 2005 to August 2008. However, since mid 2008 the process of Yuan appreciation stopped and even reversed. On one side the appreciation of the dollar was the consequence of the fact that the worsening of the financial crisis brought an increasing number of investor to demand for assets denominated in dollars, since US currency (and US treasury bills which were denominated in USD) were still considered a safe haven. On the other side, the stop of the process of Yuan appreciation in USD terms was also the result of a strategy pursued by Chinese financial authorities. They didn't mean to hinder the competitiveness of Chinese goods in international markets by

to a long-run real appreciation of the currencies of oil exporting countries of about 50 per cent. By that yardstick, oil-exporting countries' currencies should have appreciated in real terms by 125 per cent. However, this has not occurred in the main oil exporting States. In fact, between 2001 and 2007, in Norway, Russia and Iran the average depreciation of the currency has been about 24%, while in the United Arab Emirates, Kuwait, Saudi Arabia, Bahrain and Venezuela the domestic currencies have even depreciated by about 20% on average. Therefore, the issue of currency undervaluation and global imbalances goes much beyond US-China relation, and it affects trade relations between several States. On this issue see: A. MATTOO, A. SUBRAMANIAN; cit.; p. 1136-1137; P. SAVONA, P. REGOLA; cit.; p. 39-40.

leaving the Yuan appreciate too much: in fact, this would have put at risk the export-based model of economic growth China has successfully pursued so far.[61] It must be reminded that such a decision was taken in a moment in which the world financial crisis started during the previous year in developed countries was getting a catastrophic character, although, it must be said for sake of completeness, China would have been affected by it very marginally. Therefore it can be concluded that although since 2008 China has no more a peg to the USD, however it is still far from leaving its currency floating, but it is acting in order to maintain it undervalued, especially relative to the USD and the currencies of China's main trading partners.

The elements sketched in this example rise several issues from the point of view of international monetary law. First, it should be analysed whether existing international monetary law has contributed to the establishment of an economic and legal framework which has in turn contributed to the rise of such imbalances and as a result, to the establishment of SWFs. Secondly, it should be studied whether, on the contrary, provisions of international monetary law could be effectively used in order to prevent or correct such imbalances, or at least to mitigate their effects. In particular, since imbalances can persist if a State "artificially" keeps its currency undervalued, it will be investigated whether international monetary law can prevent States from undertaking such practice. Since a State can keep its currency undervalued both by mean of establishing a peg with another currency or by manipulating the exchange rate in a system of free floating currency, both the alternatives will be studied when assessing their consistencies with rules of international monetary law. Thirdly, it will be studied whether the creation and the transactions of SWFs might rise elements of inconsistency with international monetary law or on the contrary whether international law can be construed in a way to afford to them a certain degree of protection.

[61] L. YANG, R. L. KUHN; *China's banking and financial markets - the international research report of the Chinese government*; John Wiley & Sons; 2007; p. 290-303; W. R. CLINE; *Renminbi Undervaluation, China’s Surplus, and the US Trade Deficit*; Peterson Institute for international economics; Policy brief 20-30; 2010; C. PROCTOR; *USA v China and the Revaluation of the Renminbi: Exchange Rate Pegs and International Law*; in *European Business Law Review*; 2006; p. 1334-1335; G. ADINOLFI; *La sovranità monetaria e il diritto internazionale dell'economia;* cit.; p. 194-195.

The study of international monetary law applicable to these issues will develop firstly into an analysis of provisions contained in the Articles of Agreement of the IMF[62] and secondly in provisions contained in customary international law. Provisions contained in other international treaties and which might have a relevance with respect to monetary issues (in particular some provisions contained in instruments concluded within the framework of the WTO) will be dealt with in separate paragraphs. Instead of carrying out a general discussion, the focus will be on the case of the Chinese SWFs whose main features have been outlined above. This choice is due to the importance Chinese SWFs have in relation to their size and their investments, as well as in relation to the role that the country owning them has in today international economic but also political relations. However most of the conclusions to which the discussion will lead could apply to other forex SWFs.

5. The issue of the consistency with the Articles of Agreement of the IMF of the monetary practices related to the creation and the management of SWFs

To answer to the first two questions mentioned in the end of the previous paragraph, which concern the relation between international monetary law, imbalances of the balance of payments and accumulation of foreign exchange reserves, it is preliminary necessary to study the provisions of international law governing exchange rates and current account imbalances and their developments in the last decades.

The IMF Articles of Agreement and precisely art. IV originally provided for a system of fixed but adjustable exchange rates. The main task of the IMF was to administer such system, especially by means of firm surveillance on State monetary policies and exchange rates (art IV) and interventions to solve temporary problems experienced by member States, in most cases related to scarcity of convertible currencies (art. V). Under this system, which was also called Bretton Wood System, the US were required to peg the dollar to the value of gold. The official price for gold had to be

[62] For a brief overview of IMF law on currency manipulations and competitive devaluations see: D. CARREAU, P. JUILLARD; cit.; p. 580-581.

maintained at 35 USD for an ounce and the US Central Bank, the Federal Reserve, was under the obligation to redeem USD for gold. All the other members of the IMF were required to keep their currency pegged to the dollar. They could modify the exchange rate, but adjustments (or the cumulative result of several consecutive adjustments) could not exceed +/- 10% of the exchange rate as it was originally fixed. In addition, adjustments were lawful only when they were undertaken in order to correct a "fundamental disequilibrium" in the balance of payments. For adjustments exceeding, also cumulatively, the +/- 10% of the initial exchange rate, previous consent of the Fund had to be given. In this case the IMF would have only taken into consideration issues concerning the balance of payment and, in particular, it would have assessed whether the adjustments at issue would have been appropriate for the purpose of correcting structural imbalances of the balance of payments and especially of the current account.

This system, at least in principle, should have prevented the creation of excessive and persistent imbalances, since it allowed for adjustments of the initial par values. The main element of weakness of this system resided in the fact that it relied on the ability of the US to maintain the parity of their currency with the price of gold. In the 1960s this became increasingly difficult, since the US experienced protracted deficits (both of the State budget and of the current account) and the reduction of the ratio between gold reserves owned by the US and dollars in circulation put increasing pressures for a devaluation of the dollar. In August 1971 the US abandoned the parity of the dollar with gold, in December of the same year the so called Smithsonian Agreements tried to revive a new system of fixed but adjustable exchange rate, with different exchange rates; however also this attempt resulted into a failure and by March 1973 the major currencies began to float against each other. Under the point of view of international law, this new situation was recognized in 1978, with the entry into force of the Second amendment to the Articles of Agreement, which had been adopted in 1976. Since this change, art. IV leaves States free to determine its exchange rate regime. Today, in fact, art. IV of the Article of Agreement provides that "each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply [...] and shall notify the Fund promptly of any changes in its exchange arrangements" Art. IV continues explaining that "under the international monetary system of the kind prevailing on January 1, 1976", i. e. the date of the adoption of the Second amendment, four years after the *de facto* dismissal of the previous Bretton Wood system, "exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice"[63]

It seems therefore that art. IV still envisages the possibility for a State to peg its currency against the currency of another one[64]. If art. IV,2 is applied in an unqualified manner, it would follow that a member's choice of exchange rate regime could never be subject to challenge by another member. This has a particular importance in relation to the study of the case of the Chinese SWFs, because until 2005 the Yuan was pegged against the USD and, and such an interpretation of art. IV,2 would imply that no country has the right to require China to modify its exchange rate system.

[63] For a review of the evolution of the international monetary system under the IMF law see: G. SACERDOTI; *Sistema monetario internazionale*; in PICONE, G. SACERDOTI; ed. *Diritto internazionale dell'economia: raccolta sistematica dei principali atti normativi internazionali ed interni con testi introduttivi e note*; Franco Angeli; 1991;.p. 555-564; R. M. LASTRA; *The Bretton Wood institutions in the XXIst century*; cit.; p. 74-78; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 61-71; C. PROCTOR; *USA v China and the Revaluation of the Renminbi*; cit.; p. 1336-1338; A. VITERBO; *Fondo Monetario Internazionale e Banca Mondiale*; cit.; p. 190-193; G. ADINOLFI; *La sovranità monetaria e il diritto internazionale dell'economia*; cit.; p. 196-198; G. WOOD; *The IMF in a changing world*; in J. NORTON, M. ANDENAS; ed.; *International monetary and financial law upon entering the new millennium. A tribute to sir Joseph and Ruth Gold*; British institute of international and comparative law; 2002; p. 528-549; D. CARREAU, P. JUILLARD; cit.; p. 568-577; A. F. LOWENFELD. *The International Monetary System: A Look Back Over Seven Decades*; in *Journal of International Economic Law*; 2010; p. 575-595; For a review of such evolution from a more economic approach see: P. KRUGMAN, M. OBSTFELD; cit.; p. 515-529; M. D. LEVI; cit.; p. 212-215; R. CARBAUGH; cit.; p. 448-449. For an explanation of the intrinsic weakness of the Bretton Wood system of par values and the impossibility for it to be sustainable in the long run see: R. HOCKETT; cit.; p. 168-171.

[64] C. PROCTOR; *USA v China and the Revaluation of the Renminbi*; cit.; p. 1339.

However, art. IV,2 cannot be read in isolation, but it must be interpreted taking into consideration the purpose of the instrument in which it is included and in the light of the other provisions of the Articles of Agreements.[65] Such an interpretative approach is consistent with art. 31 of the Vienna Convention on the law of treaties of 1969, which declares that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." The promotion of "international monetary cooperation" (art. I,i.) and the promotion of "exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation" are among the main purposes of the IMF. While in principle the membership in the IMF does not deprive a State of its sovereign right to determine the exchange rate arrangements concerning its own currency, on the other side the evolution of international monetary law since the establishment of the IMF relies on the recognition of the fact that such arrangements can affect the money and, more broadly speaking, the economy as a whole, of other countries. Against this background, States (at least those which are members of the IMF) are no more completely free to determine the exchange rate arrangements concerning their money. This is confirmed by art. IV,3 of the Articles of Agreements which, *inter alia*, provides that the Fund shall exercise "firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Even more important, art. IV,1,iii of the Articles of Agreement provides that IMF members shall "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members". Therefore, the main issue which must be addressed is whether, and under which circumstances, a peg, which formally seemed to be consistent with art. IV ,2 b) can be regarded as a form of currency manipulation under art. IV 1, iii and therefore prohibited.

[65] C. PROCTOR; *USA v China and the Revaluation of the Renminbi*; cit.; p. 1340.

The notions contained in art. IV,1,iii seem evident, however, once they must be applied in practise to analyse concrete situations, several problems may arise. In fact, art. IV fails to specify, from an "operative" point of view what must be regarded as manipulation of the exchange rate and of the international monetary system. Moreover, it does not clarify when a State, through its actions, prevents adjustments of the balance of payments. Finally, it is not clear neither the notion of competitive advantage over other members nor when it must be regarded as unfair.

The Board of directors of the IMF is entitled, under art. IV, 3, b. to adopt decisions providing for the principles and the modalities according to which the firm surveillance shall be exercised. The most recent one is decision 13919-(07/51).[66] Since it contains some partial clarifications of the notion of currency manipulation, a brief analysis of its relevant provisions is the necessary.

The decision builds upon the convincement that, in order to achieve the stability of the international monetary system, the monetary and economic policies adopted by member States aiming at ensuring external stability play a very relevant role, and therefore they need to be subjected to firm surveillance. The State policies at issue include exchange rate policies.[67] The issue is detailed out in par. 14, which lists four principles. It also specifies that only principle A is binding, but it is a mere repetition of art. IV, 1 and therefore it does not create new obligations upon IMF members. On the contrary, principles B,C and D "constitute recommendations rather than obligations of members." Therefore, a "determination by the Fund that a member is not following one of these recommendations would not create a presumption that that member is in breach of its obligations under Article IV, Section 1". This is confirmed by the fact that, while in laying down principle A the verb which is used is "shall", on the contrary in the other principle the verb used is "should", thus denoting a hortatory rather than mandatory language. Principle B reminds that a "member should intervene in the exchange market if necessary to counter disorderly conditions, which may be

[66] Decision 13919-(07/51) of June 15th 2007; Bilateral Surveillance over Members' Policies; available online at: http://www.imf.org/external/pubs/ft/sd/index.asp . For a comment see: G. ADINOLFI; *La sovranità monetaria e il diritto internazionale dell'economia*; cit.; p. 202-205.

[67] Decision 13919-(07/51); par. 1 to 12 and in particular par. 5.

characterized inter alia by disruptive short-term movements in the exchange rate of its currency." Principle C provides that "Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene". Therefore, the massive purchase of the currency of a State, in order to prevent the appreciation of the domestic currency relative to such foreign currency, should be carried out in a way not to jeopardise the interests of that country. In the case of the operations of SWFs, it could be argued that such a principle would encourage Chinese authorities in charge of the management of these State entities to take into consideration the interests of the countries whose currency is massively purchased in order to finance the investments denominated in the currency of those States. Finally, principle D simply states that "[a] member should avoid exchange rate policies that result in external instability". Par. 15 provides for a list of "developments" which should be taken into consideration when performing the surveillance under art. IV of the Articles of the Agreement. The wording of par. 15 suggests that the list aims at providing examples, and that it must not be construed as being exhaustive. The first "development" to be mentioned consists in the existence of "protracted large-scale intervention in one direction in the exchange market". Another aspect which should be considered is whether a State is engaging into "an excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes". This would be related, inter alia, with the creation and the maintenance of "large and prolonged current account deficits or surpluses".

Therefore, it could be argued that if a country creates a SWF as a result of protracted current account surpluses and, therefore, of a persistent accumulation of foreign exchange reserves, then this could be inconsistent with par. 14 of the decision 13919-(07/51) and this could threaten the stability of the international monetary system. Such threats could also occur when a State uses its SWFs with a view to prevent market mechanisms to bring exchange rates and the balance of payments back to a situation of equilibrium. Moreover, when a State uses its SWF to buy assets denominated in a the currency of one country, this could constitute a protracted intervention in the exchange market, since it would increase the demand for that currency and therefore lead to its appreciation.

Other aspects which should be considered in the course of the surveillance undertaken pursuant to art. IV of the Articles of Agreement and with a view to assess the existence of currency manipulation should also be "the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments or [...] the inflow or outflow of capital". Likewise, it is important to assess whether a State undertakes "for balance of payments purposes" "monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows"

As it will be clarified below, several emerging countries with SWFs, for instance China, maintain important restrictions to investment inflows, thus preventing the demand for the Yuan from rising and then preventing an appreciation of the Chinese currency.

Several arguments suggest that the Chinese peg is not tantamount to a prohibited form of currency manipulation. First of all, it must be underlined that the term "manipulating" used in the Articles of Agreement, suggests the existence of an unfair behaviour which is designed to achieve a prohibited objective by mean of subterfuge. The primary objective of a peg is to ensure stability to the currency of the State establishing it and to prevent the disruptive effects that sudden and sharp appreciation and depreciation of such currency can cause. It is possible that a peg also causes an advantage to the exportations of one country; however the recognition of this effect of the peg is not sufficient to reach the conclusion that the peg represents a form of manipulation. In fact, in order to assess the existence of currency manipulation it is necessary to prove that currency manipulation is not the mere economic effect, but the purpose of a particular monetary activity undertaken by a State. It is therefore quite difficult to prove that when it established a peg with the USD, China intended to use it as an instrument for currency manipulation. It could be argued that, although at the beginning the peg with the USD served the need of China, at the time a poor country at the initial stages of its development with a trade deficit with the US, to maintain the stability of its currency, later it would have turned into an instrument to manipulate its currency. In particular this would have occurred because of the refusal of China to adjust periodically the parity of the Yuan relative to the USD. However, the credibility of a peg depends upon its continued maintenance, while it is hindered by an excessive number of adjustments. In fact, a peg is established in order to afford a higher degree of certainty and predictability to businessmen involved in transnational trade and investments. Frequent adjustments jeopardise its utility and effectiveness and finally they would be inconsistent with the same rationale of a peg: in other words a peg which is always subject to adjustments is no more a peg! Furthermore, it can be added that, although the system of Bretton Wood is no more in force and although the aim of the IMF is not to ensure the existence of a system of par values, however art. IV,1 of the Article of Agreement still declares that the IMF seeks to "promote a stable system of exchange rate" and therefore it is difficult to conclude that the maintenance of a peg, since it helps to ensure the stability of the "system of exchange rate", might be inconsistent with this objective.

Some arguments, however, can be risen to support the view of the illegitimacy of the peg that China maintained until 2005. In particular, it could be noted that art. IV, 2 b), when allowing for a peg with the currency of another countries, talks about "*cooperative arrangements* by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members". The words "cooperative arrangements" could be construed in order to exclude the legitimacy of pegs which are established unilaterally by a State and not in cooperation with the country against whose currency the peg is established, but even inconsistently with its interests. In this case it might seem that the decision of China to maintain the peg is not the result of cooperative arrangements with the US but of a unilateral decision which has also been severely criticised by US authorities. Moreover, it can be argued that while in the beginning the peg was established in good faith and legitimately, later developments have turned it into a device for currency manipulation. More precisely, the large trade surplus of China (and the related increase of the demand of

Yuan) would have increased pressures for an appreciation of the Yuan, which have made the maintenance of the peg impossible, without proper adjustments of the exchange rate. However Chinese authorities have undertaken several measures which have tackled such pressures for an abandonment of the peg or at least for some adjustments[68]. The measures at issue could represent a form of currency manipulation, which mainly consist in market interventions in order to buy foreign currencies, thus keeping high the demand for them (and consequently their price relative to the Yuan).

In conclusion, while it is difficult to decide whether the peg that China established against the USD is consistent with the IMF Articles of Agreement, given the existence of convincing arguments which both support and dismiss such a conclusion, on the other side there is more evidence that some measures that China has undertaken in order to maintain the peg and to avoid suitable adjustments despite the change of the monetary situation, might amount to currency manipulation. In summary, inconsistency with the IMF provisions would be determined not by the existence of the peg itself, but by those measures which are adopted for its maintenance. Therefore the present discussion should now turn from the analysis of the legitimacy of a peg to that of the legitimacy of the measures which prevent the depreciation of foreign currencies (or the appreciation of domestic currency) and which eliminate the need for adjustments of the peg. Since such measures are similar to those which can be adopted also under a system of free floating exchange rate, the discussion which will be undertaken below will deal with the practices amounting to currency manipulations both in a system of fixed parities and of free floating currencies.

As anticipated above, since 2005 China seemed to have moved towards free floating exchange rates. In principle this system should prevent the formation and in particular the persistence of unbalances of the balance of payments. It should operate automatically, without the need for periodical adjustments as it occurred under the Bretton Wood regime, and for this reason it would correct imbalances even

[68] C. PROCTOR; *USA v China and the Revaluation of the Renminbi*; cit.; p. 1342-1344.

in a smoother and faster way. In fact, if a country experiences a relevant trade surplus, this should lead to an appreciation of its currency (related to the increase of the demand of the currency of this country in order to buy its goods and services) and to an increase of inflation (related to the increase of the supply of money which in turn is the consequence of the increased amount of foreign currency owned by monetary authorities). Both these factors modify the real exchange rate in the sense of reducing the competitiveness of the exportations of such country. As a result, the exports of such country tend to decrease, the trade surplus is reduced and the imbalances of the balance of payments are eliminated.[69]

However, the functioning of this mechanism could be prevented if a State artificially keeps its currency undervalued, especially vis-à-vis its main trading parties. This can occur if it undertakes so-called official foreign exchange interventions, which are financial operations undertaken in the international markets of currencies by the Central Bank or other State authorities in charge of the monetary policy. They consist in the purchase of deposits or of other assets denominated in foreign currencies (thus increasing the worldwide demand for such currencies and contributing to their appreciation) and/or in the sale of domestic currency (thus increasing the worldwide supply of it and determining its depreciation)[70];

In addition, a State can introduce restrictions to capital inflows, which prevents the increase of the demand for domestic currency to buy assets denominated in domestic currency.[71] Another way China prevents its currency from appreciating is the transfer of a part of its reserves of USD which are deemed to be in excess by

[69] P. KRUGMAN, M. OBSTFELD; cit.; p. 366-378 and 535-537.

[70] P. KRUGMAN, M. OBSTFELD; cit.; p. 472-473; R. CARBAUGH; cit.; p. 446-447. For a more detailed on the impact this have on base money in China see: L. YANG, R. L. KUHN; cit.; p. 50-51.

[71] It must be underlined that, since 1996, China has put an end to the transitional period (according to art. XIV of the Articles of the Agreements of the IMF) and undertook not to impose restrictions on the making of payments and transfers for current international transactions, consistently with art. VIII of the Articles of the Agreements. However, relevant restrictions to capital movements related to portfolio and direct investments as well as to loans remain in force. For additional information on the way Chinese authorities restrict financial investments in China see: A. ARDUINO; cit.;. See also: G. ADINOLFI; cit.; *La sovranità monetaria e il diritto internazionale dell'economia* p. 194-195.

Chinese policymakers [72] to its SWFs, which undertake investments in assets denominated in USD. In fact, had China exchanged such USD in excess with Yuan, the increase of supply of USD in the world markets would have led to a depreciation of the US vis-à-vis the Yuan. In addition, in order to prevent the growth of reserves of foreign currency from increasing the domestic supply of money and, as a result of domestic inflation, the operation which is called sterilization of foreign exchange reserves can be undertaken by national monetary authorities. Sterilisation essentially consists in the sale, carried out by the Central Bank or other authority in charge of the monetary policy, of bonds or other collaterals in order to reduce the supply of money.[73] Since such bonds need to pay interests, thus representing a cost for the issuer, then the need for a use of foreign exchange reserves which might entail higher yields in order to repay at least the costs of sterilizations, becomes even more important. SWFs, by investing in a differentiated array of assets aim at achieving higher returns, than the traditional form of management of foreign exchange reserves. It must be remarked that although the effect of all the measures listed above is preventing an appreciation of the domestic currency, however it is always difficult to definitely assess whether depreciation is only an indirect consequence of such measures or whether, on the contrary it is their objective. Only in this second case it is possible to regard them as currency manipulation and claim their inconsistency with art. IV of the Articles of Agreement of the IMF.

If the Chinese SWFs can be considered as the consequence of the persistent current account imbalances at the same time they might also be blamed for being the tools through which such imbalances are maintained. For this reason it must be studied whether their creation and their investments can be regarded as contrary to the Articles of Agreement of the IMF. This implies an assessment of the lawfulness under the Articles of Agreement and especially of their provision forbidding currency manipulations, firstly of the practise of foreign currency sterilization (which is

[72] USD in excess are, for the purposes of the present discussion, USD which are hoarded as a result to Chinese trade surplus and are more than those which need to be kept as part of the reserves of foreign currency under the direct management of the central Bank for prudential purposes.

[73] P. KRUGMAN, M. OBSTFELD; cit.; p. 301-307; M. D. LEVI; p. 464-465.

instrumental to the creation of SWFs) and secondly of the investments of SWFs themselves

As to sterilisation of the foreign exchange reserves, which is necessary to collect the resources through which the Chinese SWF is financed, it can hardly be regarded as a kind of currency manipulation ex art. IV of the Articles of Agreement. In fact, it mainly consists in a legitimate measure of domestic monetary policy a State undertakes to tackle domestic inflation.

As to the argument that SWFs, by means of their investments are tools for monetary manipulations, a broader discussion needs to be made. In can be argued, in fact, that Chinese SWFs, through their investment activities, contribute to the persistence of current account imbalances, by preventing automatic adjustments of the exchange rate. This would occur because the purchases of assets denominated in a certain currency (activity which characterises the SWFs) increases the demand for that currency and therefore contributes to its appreciation. However, it must be stressed that the Chinese SWFs which buy, *inter alia*, USD-denominated assets, contribute to the appreciation of the USD like any other investor undertaking similar operations. It is very difficult to demonstrate that the main reason why Chinese SWFs invests in USD denominated assets is to prevent a depreciation of the USD relative to the Yuan. It is more likely that Chinese SWFs undertake such investments for the same reasons of other non-sovereign investors: they are attracted by the openness, liquidity and efficiency of US financial markets, by the potential returns of investments in US securities. The appreciation of the USD is not, under this point of view, a currency manipulation but it is one of the consequences, predicted by the economic theory, of a legitimate investment activity.

While it is very difficult to conclude, for the reasons stated above, that the establishment and the investments of Chinese SWFs entail a breach of art. IV of the Articles of Agreement of the IMF, on the other side some State policies which create the conditions for the establishment of SWFs, i. e. State policies amounting to currency manipulation, can be partially regarded as a consequence of such a breach.

A SWF which is created as a result of manipulations of the exchange rate might rise issues of inconsistency with art IV of the Article of the Agreement of the IMF. The consequences of such a conclusion could be disruptive, since this could imply that the creation of the Chinese SWFs (but the same reasoning can be made in relation to many other forex SWFs) constitutes a breach of international monetary law. To mitigate the conclusions of such findings, it could be argued that art. IV does not define in detail what it means when it refers to "manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members". Therefore the IMF Articles of Agreement leave room to the international community to deem that the monetary practises at issue do not fall within the scope of art. IV. Another issue which must be discussed at this point related to the availability of remedies in international monetary law, which can be used to prevent a State from keeping on pursuing monetary practices which cause the monetary imbalances described above. Continuing the discussion from the point of view of Treaty law, (the applicability of rules of customary international law to these issues will be analysed below) attention must be paid to art. XXVI of the Articles of Agreement of the IMF, which lays down the sanctions which can be imposed to member States which fail to abide by its provisions. First of all, "the Fund may declare the member ineligible to use the general resources of the Fund". Moreover, "if, after the expiration of a reasonable period following a declaration of ineligibility under (a) above, the member persists in its failure to fulfil any of its obligations under this Agreement, the Fund may, by a seventy percent majority of the total voting power, suspend the voting rights of the member." The third sanction envisaged, and the most severe, can be inflicted "after the expiration of a reasonable period following a decision of suspension ". In this case, if the "the member persists in its failure to fulfil any of its obligations under this Agreement, that member may be required to withdraw from membership in the Fund by a decision of the Board of Governors carried by a majority of the Governors having eighty-five percent of the total voting power".[74]

The effectiveness both of the surveillance undertaken by the Fund in exchange rate issues as well as the effectiveness of such sanctions as deterrents, especially in the case of a country like China, is very uncertain.[75] As to the effectiveness of the IMF firm surveillance on exchange rate issues, it must be preliminarily observed that since the entry into force of the Articles of Agreement, the number of consultations under its auspices has probably reached something between forty and fifty thousand. In most of these consultations, issues regarding the member's exchange rate and exchange rate policy have received scant attention and finally the Executive Board has never concluded that a member was in breach of art. IV because of its exchange rate policies.[76]

As to sanctions, the reasoning is more articulated. The first sanction mentioned above consists in declaring ineligibility in using the Fund's resources and therefore it can be effective against States which are affected by scarcity of foreign exchange reserves or which experience severe problems in financing. China has large foreign exchange reserves (paradoxically, it can be said that the problem of China is not that it has too little, but too much foreign currency) and a broad budget surplus. It is unlikely that it will need IMF assistance and, therefore, threats to declare it ineligible to IMF resources might hardly prove effective. Likewise, the increasing involvement

[74] D. CARREAU, P. JUILLARD; cit.; p. 603-604; A. SANTA MARIA, *Cina, regole internazionali e dumping sociale e monetario*; cit.; p. 676-678.

[75] G. ADINOLFI; *La sovranità monetaria e il diritto internazionale dell'economia;* cit.; p. 210-211.

[76] M. MUSSA; *IMF Surveillance over China's Exchange Rate Policy. Paper presented at the Conference on China's Exchange Rate Policy*; Peterson Institute for International Economics; 2007; p. 40.

of China in international economy and, more in detail, with the activity of the IMF,[77] makes it extremely unlikely a suspension or a termination of its membership.[78]

It must be remarked that violations of art. IV by means of currency manipulations, in principle constitute a breach of a provision of international law against all the members of the IMF. However, it is possible that some members might consider that they have been damaged in a particularly severe way. The legal framework established by the IMF does not provide for a mechanism for interstate dispute tantamount to the one put in place, for instance, in the context of the WTO[79]. In the next paragraphs an effort will be made to study whether monetary practices which are associated to SWFs could somehow be regulated (and whether disputes concerning them might be settled) under customary international law or under the law of other international organization, like, for instance the WTO.

[77] For instance, as to 8/12/2010 China contributed to the 3.72% of the resources of the Fund, which means

8,090.1 Billions SDR. The size of its contribution (which for many commentators still remains disproportionally lower than its actual economic importance) is comparable to those of the biggest IMF contributors like the United Kingdom (4.94%) France (4,94%) Saudi Arabia (3,21%). For these data see: http://imf.org/external/np/sec/memdir/members.htm#r , page visited on 18/12/2010

[78] On the importance of China in the current international monetary system and on the inability of the IMF to adequately act in order to ensure its respect of art. IV of the IMF see: A. MATTOO, A. SUBRAMANIAN; cit.; p. 1141-1142.

[79] Lacking the IMF an organ entrusted with the task of settling disputes between member States concerning the application of IMF law, art. XXIX of the Articles of the Agreement simply provides that "[a]ny question of interpretation of the provisions of this Agreement arising between any member and the Fund or between any members of the Fund shall be submitted to the Executive Board for its decision." It then adds that: "[i]n any case where the Executive Board has given a decision [...] any member may require, within three months from the date of the decision, that the question be referred to the Board of Governors, whose decision shall be final." It also provides that "[a]ny question referred to the Board of Governors shall be considered by a Committee on Interpretation of the Board of Governors. The "membership, procedures, and voting majorities of the Committee" shall be established by the Board of Governors. It must be remarked that as to the end of 2010, the Committee on interpretation has not been constituted yet, and therefore the procedure envisaged above has not been established yet. See: G. ADINOLFI; cit.; *La sovranità monetaria e il diritto internazionale dell'economia;* p. 210. In any case, also if the procedure laid in art. XXIX is put in place, it could hardly be regarded as providing States with a forum for the settlement of disputes which might prove as much effective as the one designed to govern trade disputes under the law of WTO. See also: A. MATTOO, A. SUBRAMANIAN; cit; p. 1143-1153. This article *inter alia* contains suggestion on which rules should be developed within the framework of the WTO to ensure that issues relative to exchange rate manipulation might be adequately settled by the DSB of the WTO

6. The issue of the consistency with customary international law of the monetary practices related to the creation and the management of SWFs

After having discussed the consistency of exchange rate practices related to SWFs with IMF law, it is useful to analyse their consistency with customary international law. In particular, it must be discussed whether provisions of customary international monetary law can be used to prevent States from putting in place those monetary policies related to the establishment of SWFs. In addition, it must be studied whether the same SWFs are consistent with customary international law and whether customary international law can be construed so as to provide particular duties or rights upon SWFs.

The starting point for such a discussion is the study of the principle of monetary sovereignty which provides that each State is entitled to regulate its own currency. Such principle has been declared as constituting a fundamental rule of customary international law since two famous judgements of the Permanent Court of International justice of 1929.[80] It is therefore necessary to understand what the expression "regulate its own currency" actually means. Monetary sovereignty, which must be conceived as a right of the State[81], exhibits features both of an internal and external character.[82] Internal monetary sovereignty is in turn a multidimensional concepts. First of all it pertains to the right of a State to define its monetary system, which includes the right to issue relevant laws which establish what shall be regarded as money, its role as unit of account, mean of payment and store of value. It also implies the right for a State to lay down rules related to the physical characteristics of banknotes and coins, including, for example, their metal content, their size and other

[80] See: IPCJ; *case concerning the payment of various Serbian loans issued in France*; Judgment of 12 July 1929 - A 20; p. 44 and IPCJ: *case concerning the payment in gold of the Brazilian federal loans issued in France*; Judgment of 12 July 1929 - A21.

[81] T. TREVES; *Monetary sovereignty today*; in M. GIOVANOLI; ed; *International monetary law: issues for the New Millennium*; Oxford; Oxford U.P.; 2000; p. 111.

[82] For a detailed review of the content of monetary sovereignty and of its legal implications see: G. BURDEAU; *L'exercice des compétences monétaires par les Etats*; in *Recueil Des Cours* 1988; p. 240-254; C. PROCTOR; *Mann on the legal aspect of money*; cit.; p. 500-502.

features. It also includes the right to conduct a monetary policy, i. e. to determine the applicable interest rates, the rate of marginal reserves the banking system is mandated to have, the supply of money. In particular, if monetary sovereignty is regarded as including the right to determine the supply of money, this also entails that international monetary law recognises States the right to adopt the measures necessary for the control of the credit, and, as a result, of one of the main aspect of the banking activity itself [83]. This conclusion is unquestionable if it is considered the role of the credit institutions in influencing the amount of money in a monetary system.[84] Finally, the internal dimension of monetary sovereignty implies the right for a State to create and to shape according to its preferences and its needs all those institutions which are in charge of the management of the monetary policy and, more in general, of the domestic monetary system as a whole. Monetary sovereignty also has an external dimension, which mainly pertains to the right of a State to impose a system of exchange control.[85]

As it occurs with respect to several areas of the domestic jurisdiction, States can accept to renounce to a part of their monetary sovereignty in order to make international monetary cooperation possible and to achieve objectives like international monetary stability which are deemed to be desired by all States and which in an increasingly globalised world (especially in issues pertaining to money and finance), can be better achieved by means of inter-State cooperation. Such limitation of the principle, acknowledged by customary international law, which provides for the monetary sovereignty of States, can occur through the conclusion of international treaties. In the monetary field the most important has been the Treaty establishing the IMF, which has been studied in the previous chapter. Therefore today international monetary law comprises both the principles, essentially provided

[83] G. BURDEAU; cit.; p. 224-225 and p. 254-255. See also: A. SÀINZ DE VICUÑA; *An institutional theory of money*; in M. GIOVANOLI, D. DEVOS; *International monetary and financial law: the global crisis*; Oxford; Oxford University Press; 2010; p. 517-532.

[84] On the way banks affect the monetary policies enacted by State authorities, as well as on the instruments used by States in order to control activities of banks in order to retain a greater control on their monetary policy see: D. BEGG, S. FISCHER, R. DORNBUSCH; cit.; p. 385-415.

[85] G. BURDEAU; cit.; p. 240- 255.

for in customary law, of monetary sovereignty with all it corollaries and the limitations to their sovereignty with regard to the definition and the governance of their money.[86] State acts performed in relation to the exercise of its monetary sovereignty cannot be questioned by other States. This principles flows from the broader rule of customary international law which requires to recognise the exclusive jurisdictions of States over their own internal affairs. The regulation of the currency as well as the broader management of the monetary policy undoubtedly fall within the notion of domestic jurisdiction. Customary international law enables States to regulate the issues pertaining to monetary sovereignty without any interference from foreign powers and likewise customary international law prevents States from questioning decisions adopted by any other State in the exercise of its monetary authority. [87] Under international law, domestic law issued by a State and regulating the money of such State enjoys a sort of extra-territorial effect, since the other State has to recognise and to apply it, whenever issues concerning that money rise.[88] This principle, which is also called as principle of *lex monetae* is a consequence of the general principle of monetary sovereignty as enshrined in customary international law.[89]

The principle of monetary sovereignty would allow a State to create SWFs and to take all the activities which, as discussed above, can be regarded as instrumental to the creation of SWFs. Therefore, the establishment of a peg with another currency or the implementation of market interventions aiming at maintaining favourable exchange rates, the accumulation of foreign exchange reserves and their sterilization, are all State acts which fall within the notion of monetary sovereignty. Likewise, a State has the sovereign right under customary international law, to establish SWFs, since this must be regarded as a tool for the management of its monetary policy.

[86] T. TREVES; cit.; p. 112-116.

[87] F. A. MANN; *Money in Public International Law*; in *British Year Book of International Law*, 1949; p. 259; C. PROCTOR; *Mann on the legal aspect of money*; cit.; p. 500-502; A. COMBA; *Lezioni di diritto internazionale monetario*; cit.; p. 1-9. On basic legal concepts on money and monetary systems see, again,: C. PROCTOR; *Mann on the legal aspect of money*; cit.; p. 5-85.

[88] G. BURDEAU; cit.; p. 228.

[89] It must be mentioned that recent developments of international economy and finance may nonetheless jeopardise the monetary sovereignty of States see. For a discussion of these issues see: K. SONO, H. KANDA; cit.; p. 507-516.

After having concluded that States are under a general international duty to recognise the monetary systems of the other States and the decisions they take to govern such system (included those affecting the establishment and the management of SWFs), it could be asked whether there are duties which go beyond mere recognition and, in detail, whether there is also a general duty to afford protection to foreign monetary systems. The existence of such a general duty could only be asserted if the development of international law had progressed so far as to outlaw all activities which might prove injurious to foreign States or even to impose States to adopt all the measures which are necessary for the protection of the interests of other States. Although it has been argued that in the last decades international law has developed in a way so that it does no more aim at ensuring the mere coexistence among States, but also their cooperation it cannot be concluded that, at present, there is a general rule of customary international law which obliges States to protect the interests of the other States and that this rule includes a more specific duty to protect their monetary system.[90] Some specific obligations concerning the protection of foreign monetary system can exist. For instance, it has been argued that international law obliges States to prevent in their territory counterfeiting of currencies of other States and to punish those who are responsible of such illegal activity[91]. Likewise, some rules concerning the duties of the belligerent occupant towards the currency of the occupied territory have developed[92]. However, these are very specific obligations, which concern limited issues and which do not flow from a broader duty but they rather represent exceptions. Therefore, it can be concluded that the principle of monetary sovereignty cannot be construed in a way to imply an obligation upon States to afford special protection to foreign SWFs

[90] C. PROCTOR; *Mann on the legal aspect of money*; cit.; p.530; C. PROCTOR; *USA v China and the Revaluation of the Renminbi*; cit.; p. 1350.

[91] C. PROCTOR; *Mann on the legal aspect of money*; cit.; p. 531-532; G. BURDEAU; cit.; p. 256. It must be remarked that the international prohibition of counterfeiting is provided for not only in customary international law, but also in the International Convention for the Suppression of Counterfeiting Currency, signed in Geneva on 20 April 1929 and entered into force in 1931. However, given the limited number of States which ratified it, the majority of States are currently obliged to prevent counterfeiting of foreign State currencies by virtue of customary international law and not of treaty law.

[92] C. PROCTOR; *Mann on the legal aspect of money*; cit.; p. 532-538; G. BURDEAU; cit.; p. 282.

operating in their territory, special protection which would follow from the particular role SWFs, differently from other investors, play with respect to the management and implementation of the monetary policy of the States which own them. Therefore rules of international law affording a certain form of protection to SWFs are not to be found in international monetary law, but in international investment law and they will be discussed in the next chapter.

The definition of the content and of the implications of the principle of monetary sovereignty could also prove useful in order to understand whether monetary sovereignty can be construed so as to lay down limitations or restrictions to the monetary practices which are related to the creation of SWFs or even if they can pose restrictions to the establishment and to the operations of SWFs. In other words, after having focused on the monetary sovereignty of the State which owns the SWFs, it is now necessary to focus on the monetary sovereignty of States other than the owner of the SWFs and in particular on the States which are the recipients of the investments of the SWFs, in order to understand whether it can be hindered by certain monetary practices of States which own SWFs .

First of all, it is necessary to recall the monetary practices which have led to the accumulation of foreign exchange reserves and therefore to the creation of SWFs and whose consistency with IMF law has already been discussed. The focus of the analysis must be on the alleged exchange rate manipulations that States like China make in order to maintain an exchange rate which favours their exportations. Such a practice could be regarded as prejudicing the monetary sovereignty of other States (and especially of those which are the main trading partners of China or those against whose currency the Yuan is pegged) if it restricted the ability of those States to regulate their own currency. Only in this case customary international law would prohibit China to undertake such a practice, which, in conclusion, would be inconsistent with the same principle of non-interference in issues pertaining to the domestic jurisdictions of other States. To address this issue it must be noted that not every act whose direct or even indirect effect can be a reduction of the ability of a State to completely determine its domestic affairs, can be regarded as an interference prohibited by international law. In particular in last decades, also as a result of globalization, there has been an increased interdependency among the members of the international community, especially in economic matters. Therefore, the fact that certain economic activities of a State might indirectly affect other States can be regarded as a typical development of current international economic relations. The establishment of a peg against the currency of another State, or exchange rate operations which can lead to the appreciation of a foreign currency, can hardly be considered as coercive activities aiming at depriving the State intervened against of control over matters within its domestic jurisdiction. For this reason they would hardly be prohibited by international law. In addition, it must be argued that a State does not enjoy, as an incident of its monetary sovereignty, the right to dictate the price paid for its currency on the international markets, nor can it impose to other States the exchange rate arrangements they shall apply in relation to their own currency. [93] Therefore the right of States to regulate their own currency would entitle them to decide and affect the exchange rate of their currency, without being forced by other States to act otherwise. It follows that it would be difficult to conclude that customary international law prevents States from creating SWFs and from implementing policies which bring to the accumulation of foreign exchange reserves and to the creation of SWFs, on the ground that among the economic effects of these policies there is also the impairment of some interests of other States. In fact, the principle of monetary sovereignty cannot be construed so as to provide for an obligation upon States to refrain from adopting any measure which can be inconsistent with the interests of the monetary system of the other States.

Finally, it could be questioned whether the investments of SWFs in the economy of another State can be regarded as an interference in its domestic economic and monetary system. It could be argued, in fact, that investments and divestments made by a SWF can provoke sharp and potentially destabilizing peaks and falls of the financial assets they purchase or sell. Such abrupt fluctuations concern as well the

[93] C. PROCTOR; *USA v China and the Revaluation of the Renminbi*; cit.; p. 1349-1350.

currency in which such assets are denominated. Therefore, the massive purchase of US stocks (denominated in USD) by the Chinese SWF causes a sharp increase of the price of such asset and an appreciation of the USD. Likewise, if the Chinese SWF decides to dismiss such investments, the effects would be a fall on the stock price of the divested firms and a sudden depreciation of the USD. However, such arguments can be dismissed once it is considered that fluctuations of prices of assets and of currencies (since foreign exchange rates can be simply considered as the price of one currency expressed in terms of another currency) are the normal economic consequence of any investment and divestment operation. The size of the investors undertaking them, or in general the financial volumes concerned, affect the impact of such operations on prices; SWFs' transactions produce the same effects of investments undertaken by any other big institutional investor.[94] If a State desires to avoid the effects that investments concerning its assets or its money might entail of prices, it cannot claim the existence of a rule of international law obliging other States to ensure that financial operations undertaken by their SWFs or by private investors based in their territory might not have undesired consequences on the economy of foreign States. It should rather forbid or strongly restrict investments in assets denominated in its currency. For instance, one of the (several) tools used again by China to prevents the appreciation of its currency resides in limiting the access to its financial markets to foreigners. Only a few foreign investors have the right to purchase a vast array of Chinese financial assets denominated in Yuan and in this way upward pressures on the Yuan are avoided.

It is absolutely necessary to repeat that such currency and investment restrictions, if their aim is to ensure the absolute stability of the domestic monetary system, must apply to the same extent to SWFs and private investors both, otherwise they would prove useless. It could be even added that some investment practices undertaken by private investors, and especially by hedge Funds, are able to hinder the monetary

[94] On the way private investors may affect the monetary system of a State and, finally, its monetary sovereignty see: A. COMBA; *Lezioni di diritto internazionale monetario*;cit.; p. 18-20. On the difficulties to demonstrate that financial transactions which adversely affect the monetary system of another State should be prohibited under international law see: F. A. MANN; cit.;p. 292-293.

systems of other States much more than those practices traditionally used by SWFs and under this point of view speculative Funds can threaten the stability of the monetary system of other States much more than SWFs can do. Short selling, consisting in borrowing a currency, selling it and repurchasing it later in order to profit from its depreciation (since in case of depreciation the sale price is expected to be higher than the price at which the currency is purchases) is a common way to speculate against a currency, or, *rectius*, to speculate on its depreciation. Short selling, as it implies a massive sale of a currency causes strong downward pressures on it. This undeniably undermines the ability of a State to regulate and manage its own currency and even its monetary policy. Many other financial operations can result into speculations against a currency, for instance those implying the use of Credit Default Swaps on sovereign debt or other financial derivatives. The use of financial leverage, while multiplying potential gains of losses for investors, also emphasises the impact of such financial operations on the currency and the financial markets of the State affected.

The question is whether there is the an obligation, arising from international law, upon the State in which such funds or their managers or partners are based to prevent their speculations against the currency of another country. It does not seem that current practice might support the existence of such an obligation. For instance in 1992 some powerful investors like Soros and its hedge fund, forecasting difficulties for Italy and GB to continue their participation in the European Monetary System undertook massive speculations against the Lira and the Sterling pound. Such operations undeniably damaged Italy and GB, which where even forced to abandon the European Monetary System and undermined the monetary sovereignty of such States since their decision to participate in an area of monetary integration was without doubt an act they undertook within the framework of their monetary sovereignty. It did not seem that in these circumstances it was invoked the existence of an obligation under international law upon States where such speculative funds were based to take adequate measures to stop their harmful activities.

More recently, in 2010 the international community, and in particular the EU and its member States had to deal with the financial rescue of Greece and Ireland which found themselves in a situation of quasi-insolvency severely aggravated by a wave of massive speculation against them. As a result of such speculative operations also the EU single currency was severely threatened. Measures adopted by the international community in order to deal with this emergency, although accompanied by rhetoric against speculation, could not be regarded as the result of an obligation flowing from international law to prevent financial operations which can hinder monetary and financial systems of States. They were rather grounded on the perception of the international community of the need to act in a cooperative way in order to pursue common interests and to face economic emergencies.

7. The hypothesis of settling the disputes concerning monetary issues within the framework of the WTO

In the previous paragraphs it has been argued that international monetary law, which has been meant as including IMF provisions and rules of customary international law dealing with monetary issues, does not provide any effective tool to prevent States from artificially maintaining a foreign exchange rate which allows them to obtain allegedly undue advantages for their exportations and to hoard "excessive" reserves of foreign currency.[95] However, it appears evident that such practices have a clear impact on international trade and for this reason it could be questioned whether international trade law, and in particular WTO law, could contain provisions having a relevance for what could be defined as trade-related monetary issues. The undeniable relation between monetary issues and trade issues, and in particular between exchange rates, disequilibria of the balance of payments and competitiveness of goods and services internationally traded, confirms the opportunity of such a study. From the point of view of the economic science, it could be argued that an undervalued exchange rate works as an import tax, since it

[95] E. M. Truman; *Sovereign wealth funds: threat or salvation*; cit.; p. 25-33

increases the price, in terms of the currency of the importing country, of the imported goods, thus making them less competitive relative to domestic products. Moreover it also produces effects which are similar to those of an export subsidy, because it reduces the price of the exported goods, in terms of the currency of the country of destination of the exportations, thus making them more competitive relative to the domestic products of that country.[96]

As it has been explained above, in the first paragraph of the present chapter, the creation of international organisations governing monetary issues and trade was part of a coherent design aiming at ensuring that difficulties related to monetary problems might not result into hindrances to international trade. Consistently with these objectives, provisions have been developed within the legal framework of the IMF and the WTO in order to ensure adequate cooperation between the two organizations in fields in which both organisations can have a competence, without prejudice to the undeniable fact that the way the IMF and the WTO operate and achieve their objectives remain different.[97] In addition, the GATT of 1947, and today WTO law, contained clauses specifically addressing issues concerning trade-related aspects of monetary matters. In the following pages a review of such provisions will be made, while as a second stage of the present analysis the focus will be on the relation between the WTO and the IMF provisions, which might have a relevance for the governance of economic practices connected to SWFs as well as for the governance of SWFs themselves.

Art. XII,1 of the GATT[98] allows WTO contracting parties to impose quantitative restrictions which would be otherwise forbidden under art. XI GATT, when such measured are adopted in order to safeguard their external financial positions and their balance of payments. Art. XII,2 lays down in detail which are the conditions

[96] A. MATTOO, A. SUBRAMANIAN; cit.; p. 1139.

[97] D. E. SIEGEL; cit.; p. 563-566; M. VELLANO; *La cooperazione tra le principali organizzazioni internazionali economiche*; in A. COMBA, ed.; *Neoliberismo Internazionale e global economic governance*; Giappichelli; 2008; p. 286.

[98] For an introduction on this article, see, for instance: D. AHN; cit.; p. 9-10; M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; Milano; Giuffrè, 2003; p. 116-118.

under which quantitative restrictions aiming at dealing with problems of the balance of payments can be admitted. State measures shall be strictly necessary to enable the State undertaking them to achieve one of the two following goals: "to forestall the imminent threat of, or to stop, a serious decline in its monetary reserves; or [...] to achieve a reasonable rate of increase in its reserves" when its monetary reserves have reached a very low level. In addition, there is a duty upon States to relax quantitative restrictions as soon as the situation of their balance of payments improves. Therefore, States "shall eliminate the restrictions when conditions would no longer justify their institution or maintenance".

Art. XII,3 specifies that "[c]ontracting parties undertake, in carrying out their domestic policies, to pay due regard to the need for maintaining or restoring equilibrium in their balance of payments on a sound and lasting basis and to the desirability of avoiding an uneconomic employment of productive resources. They recognize that, in order to achieve these ends, it is desirable so far as possible to adopt measures which expand rather than contract international trade". Such a provision seems to stress once again that measures undertaken with a view to dealing with problems of the balance of payments should have a structural character and that, in any case they should not be inconsistent with the need to promote international trade and economic development in the long run. Finally, par. 4 and 5 of art. XII provide for a duty upon the State enacting the restrictive measures at issue to inform the other WTO contracting parties and to carry out consultations with them. The modalities trough which such consultation shall be carried out are detailed out in the same provisions.

Art. XVIII GATT establishes a broader balance of payments exception for developing countries, taking into account the elements of weakness of their economies which make them particularly prone to severe problems related to balance of payments disequilibria, problems which can rise even faster and in a more unexpected way than it might occur in developed countries. In the wording of art. XVIII some of the conditions under which quantitative measures can be adopted are significantly relaxed. While art. XII,2 referred to actual decline of foreign exchange reserves which need to be stopped or to an "imminent threat" of it, art. XVIII,9 talked about the existence of a mere "threat", without the need that it be "immediate". Moreover, while art. XII,2 required that monetary reserves be "very low", art. XVIII,9 requires them to be simply "inadequate".

Art. XII allows the implementation of quantitative restrictions only if the objective is to "safeguard" the external financial position of a State, while art. XVIII also acknowledges the need for a State to ensure that the level of its reserves of foreign currency might be sufficient to enable it to implement its "programme of economic development". Art. XVIII,11 provides for less stringent obligations upon developing countries as to the duty to relax restrictions as soon as the situation of the balance of payments improves. In conclusion, art. XVIII appears to grant developing countries a larger margin of manoeuvre in imposing trade restrictions for balance of payments purposes.[99] The provisions of art. XII and XVIII of the GATT are substantially reproduced in art. XII of the GATS[100], which also provides for differentiated treatment for developing countries. referring to the case of US-China relations discussed in the previous paragraphs of the present chapter, it could be wondered whether the US could introduce quantitative restrictions under art. XII GATT in order to cope with the problems of its balance of payments. Given the wording of art. XII,2 this does not seem to be feasible, since the deficit of the US current account has not brought (and it is not expected to bring) to cause a relevant decline of the reserves of foreign currency owned by the US. The alleged fact that such imbalances could be also the consequence of exchange rate manipulations undertaken by other States is irrelevant.[101] Therefore, for the purposes of the analysis undertaken in this chapter, art. XII and XVIII GATT and XII GATS have a limited applicability.

In order to complete the analysis of GATT and GATS provisions on the balance of payments, it must be noted that, with the aim to improve the consultations referred to in art. XII and XVIII of the GATT, two important documents have been adopted by the contracting parties of the WTO. The first is the 1979 Declaration on Trade Measures

[99] C. THOMAS; cit.; p. 1255-1257.

[100] D. AHN; cit.; 12-13; A. KOLO; *Transfer of funds*; cit.; p. 351-352.

[101] In any case the deficit of US current account could hardly be ascribed to Chinese undervalued currency, but it rather depends on US high marginal propensity to consume

Taken for Balance-of-Payment Purposes, while the second is the Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994. Under these documents a Committee on Balance-of -Payments restriction has been created, within whose framework consultation shall be carried out.[102]

As regards the cooperation between the IMF and the WTO, it must be preliminary remarked that the Marrakesh Declaration of 15 April 1994, issued at the outcome of the Uruguay Round which in turn marked the creation of the WTO, provides that: "Ministers confirm their resolution to strive for greater global coherence of policies in the fields of trade, money and finance, including cooperation between the WTO, the IMF and the World Bank for that purpose."[103] Cooperation between the IMF and the WTO is explicitly required in the international agreements establishing them. Art. III,5 of the WTO declares that: "with a view to achieving greater coherence in global economic policy-making, the WTO shall cooperate, as appropriate, with the International Monetary Fund and with the International Bank for Reconstruction and Development and its affiliated agencies". Such duty is emphasised in the Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking, adopted in the occasion of the Uruguay Round.[104] The document is based on the belief of the existence of "ever-growing interactions [...] between the structural, macroeconomic, trade, financial and development aspects of economic policymaking."[105] It mentions the importance of monetary cooperation with the aim to ensure monetary stability which, in turn, favourably affects international trade. To this extent it is declared that "Greater exchange rate stability, based on more orderly underlying economic and financial conditions, should contribute towards

[102] C. THOMAS; cit.; p. 1257-1258.

[103] Marrakesh Declaration of 15 April 1994; par.3. The text is available online at: http://www.wto.org/english/docs_e/legal_e/marrakesh_decl_e.htm page visited on 31-12-2010. See also: D. AHN; cit.; p. 10-11.

[104] D. AHN; cit.; p. 12.

[105] Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking; par. 1. The document is available online at: http://www.wto.org/english/docs_e/legal_e/32-dchor_e.htm page visited on 31/12/2010

the expansion of trade, sustainable growth and development, and the correction of external imbalances".[106]

Art X of the Articles of the agreement of the IMF does not explicitly mention the WTO. However, it provides for the legal base for cooperation with it since it states that "the Fund shall cooperate within the terms of this Agreement with any general international organization and with public international organizations having specialized responsibilities in related fields. [...]"[107]

Art. XV of the General Agreement on tariffs and trade (GATT) provides for more details on the duties to cooperate with the IMF, [108] especially "with regard to exchange questions within the jurisdiction of the Fund and questions of quantitative restrictions and other trade measures within the jurisdiction of the CONTRACTING PARTIES of the WTO" (par. 1). Par. 2 of art. XV of the GATT details out which are the matters in relation to which the contracting parties of the WTO are required to "consult fully with the International Monetary Fund": they consist in issues "concerning monetary reserves, balances of payments or foreign exchange arrangements".

The duty to consult with the IMF implies that the WTO contracting parties "shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments" and that they shall "accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund, or with the terms of a special exchange agreement" in force. In other words, while for issues concerning monetary reserves and balance of payments there is only a duty to consult the IMF in order to obtain data and other information

[106] ibid par.2
[107] D. E. SIEGEL; cit.; p. 567-569
[108] D. AHN; cit.; p. 8-13; M. WAIBEL; *BIT by BIT;* cit.; p. 507-508. Also the GATS contains a provision allowing for cooperation with the IMF. It is art. XXVI which reads as follows: "The General Council shall make appropriate arrangements for consultation and cooperation with the United Nations and its specialized agencies as well as with other intergovernmental organizations concerned with services." The IMF is not explicitly mentioned, however, as it is a specialised agency of the United Nation since 1947, with the conclusion of the relationship agreement with the UN, the General Council has a duty to consultation with him

concerning factual matters (consistently with the idea that the IMF is the entity which has the widest and most reliable information on this issue), on the contrary in relation to exchange rate arrangements there is a duty to respect any determination of the IMF also concerning legal issues. In fact, when art. XV, 2 refers to the issue of the "determination of the Fund as to whether action by a contracting party in exchange matters" is consistent with the IMF Articles of Agreement, such determination clearly consists in a legal ruling.[109] In addition, it must be underlined that this does not prevent panels or the Appellate Body, when they are required to settle a dispute arising out of the application of agreements concluded within the WTO framework, from consulting the IMF also on other issues. This is consistent with the art 13,1 of the Dispute Settlement Understanding (DSU), which provides that "each panel shall have the right to seek information and technical advice from any individual or body which it deems appropriate." Therefore, panels have the faculty, but not the legal duty, to accept or solicit information or advice of the IMF in issues other than those explicitly mentioned at art. XV,2. In this case the IMF could simply act as *amicus curiae*, thus providing its contribution given its expertise in monetary issues. The discretion of panels to consult outsiders generally, has been admitted in the so-called Shrimp/Turtle case. In this case, the panel argued that, consistently with art. 13 of the Dispute Settlement Understanding, it had the right to seek or to accept unsolicited briefs from non-parties under its right to seek information, although it was not obliged to do so.[110] The Appellate Body confirmed the lawfulness of such a practice, which could therefore allow the panels to discretionary accept information or determinations of the IMF concerning issues falling within its domain of expertise.

The fact that there is a mere possibility and not an obligation upon the panel to seek for an advice of the IMF for issues falling within the jurisdiction of the IMF but which are not explicitly mentioned at art. XV,2, has been stressed in the footwear case

[109] D. E. SIEGEL; cit.; p. 570-571

[110] *United States - Import prohibition of certain shrimp and shrimp products*; Report of the Panel; 15 May 1998; WT/DS58/R par 7,7 a-7,8. These findings were supported by the appellate body: *United States - Import prohibition of certain shrimp and shrimp products*; Report of the Appellate Body; 12 October 1998; WT/DS58/AB/R par. 104-108

(Argentine v USA).[111] The panel had to settle a dispute between the US and Argentina which concerned an import surcharge imposed by the former on imported footwear. Argentina claimed that such measure was lawful since it was taken in order "to cover the cost of providing the statistical service" which was a "commitment" it has undertaken vis-à-vis the IMF in order to receive its financial assistance. In the course of the proceedings, the question arose as to whether the panel was obliged under art. XV of the GATT to consult with the IMF for issues eventually falling also within the jurisdiction of the latter. The panel concluded, *inter alia*, that it was not required to consult the Fund because the adjustment measures adopted by a State within the IMF conditionality were not among those specifically listed in Article XV,2. The Appellate Body confirmed such findings, stating that there was an obligation upon the panel to consult with the IMF exclusively on the matters specified in Article XV,2 and measures included in a Fund-supported program were not among them. It added that the Cooperation Agreement, concluded between the IMF and the WTO in 1996 consistently with art. XV, 3 of the GATT, did not allow that measures adopted within the framework of IMF conditionality, or otherwise supported by the IMF, might exculpate breaches of WTO law.[112]

In another case, concerning quantitative restrictions imposed by India in an attempt to deal with serious problems with its balance of payments,[113] the panel did not clarify whether its decision to seek the advice of the IMF on issues concerning balance of payments was made pursuant to art. XV GATT, but it simply justified it by referring to art. 13 of the DSU[114]. The panel, in fact, argued that it was not "necessary for the

[111] *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*; Report of the panel issued on 25 November 1997 WT/DS56/R

[112] D. E. SIEGEL; cit.; p. 575; M. VELLANO;cit.; p. 287-288; D. AHN; cit.; p 23-24; M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 118.

[113] *India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*,; Report of the Panel; 6 April 1999; WT/DS90/R. For background information on India's balance of payments restrictions see: C. THOMAS; cit.; p 1264- 1269; A. KOLO; *Transfer of funds*; cit.; p. 370.

[114] The panel explained that "article 13.1 of the DSU provides that each panel has "the right to seek information and
technical advice from any individual or body which it deems appropriate." Article 13.2 further provides that panels may "seek information from any relevant source and may consult experts to obtain their opinion on certain aspects of the matter". With regard to balance-of-payments issues, the IMF, as a

purposes of this case to decide the extent to which Article XV:2 may require panels to consult with the IMF or consider as dispositive specific determinations of the IMF." It only stated that "in the circumstances of this case certain assessments of the IMF" could be considered. The panel stressed that "whether or not the provisions of Article XV:2 extend[ed] to panels, the Panel ha[d] the responsibility of making an objective assessment of the facts of the case and the conformity with GATT 1994, as incorporated into the WTO Agreement, of the Indian measures at issue, in accordance with Article 11 of the DSU".[115]

The objection made by India before the Appellate Body[116] that the panel, instead of making an objective assessment of the facts simply delegated to the IMF the responsibility to do so, was substantially rejected, together with the allegation that the panel allowed the opinion of the IMF to substitute its own reasoning. In fact, the Appellate Body underlined that the Panel, although it paid "considerable weight to the views expressed by the IMF" on the other side did not exclusively rely on them but, on the contrary developed its own analysis, also taking into consideration information obtained from other sources, like the Bank of India.

The solution adopted by the panel and the Appellate Body in the above mentioned case on one side ensures a certain degree of flexibility and discretion to the panel when it decides the extent to which it can seek and use the advice of the IMF in balance of payments issues. However, on the other side it seems to reduce the role of the IMF from that of the highest and mostly influential international institution whose information and determination must obligatorily be taken into account in

recognized body with extensive expertise in these matters, is obviously a highly relevant source of information. We find that, whatever the interpretation of Article XV:2 of GATT 1994, Article 13.1 of the DSU entitles the Panel to consult with the IMF in order to obtain any relevant information relating to India's monetary reserves and balance-of-payments situation which would
assist us in assessing the claims submitted to us." India - Quantitative Restrictions; cit.; par. 5,12.

[115] *India - Quantitative Restrictions*; cit.; par. 5,13. It must be recalled that art. 11 of the DSU, quoted in this report, provides, inter alia, that "a panel should make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements, and make such other findings as will assist the DSB in making the recommendations or in giving the rulings provided for in the covered agreements."

[116] *India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*; Report of the Appellate Body; 23 August 1999; WT/DS90/AB/R; par. 48-50 and 149-151.

certain circumstances, into a simple body provided with a certain expertise in monetary matters and which therefore can be consulted when the panel deems it appropriate.[117] In fact, the idea that the IMF might operate as a mere consultant, whose "legitimacy" flows from the accuracy of its technical advice, would be hardly consistent with the status of the IMF as the leading authority, acknowledged worldwide, in international monetary issues, entrusted with the task of ensuring monetary cooperation by the international community.[118]

Other obligations related to IMF-WTO cooperation, which can be found in art. XV of the GATT, consist in the duty of the WTO members to refrain from frustrating and jeopardise by exchange action the intent of the provisions of the GATT. Likewise, the same art. XV requires States to refrain from frustrating, by mean of trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund. In addition, WTO members which are not members of the IMF yet are required to join that organisation, thus stressing the strong link between the two organisations and the need to coordinate their efforts, given the complementarity of their tasks. Finally, par. 9 of art XV GATT specifies that the GATT shall not preclude "the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES, or the use by a contracting party of restrictions or controls in imports or exports, the sole effect of which, additional to the effects permitted under Articles XI, XII, XIII and XIV, is to make effective such exchange controls or exchange restrictions". This implies, *inter alia*, that the participation in the WTO does not prevent States from pegging their currency to the currency of another country, since this exchange rate arrangement is allowed by the Articles of Agreement of the IMF. Therefore the decision of China to

[117] For comments on the case India - Quantitative Restrictions see: D. E. SIEGEL; cit.; p. 576-282; M. VELLANO; cit.; p. 289-290; C. THOMAS; cit.; p. 1270-1276; D. AHN; cit.; p. 17-23.

[118] D. E. SIEGEL; cit.; p. 282.

peg its currency (as it made until 2005) to the USD did not amount to a breach of art. XV.9 of the GATT.[119]

The above mentioned cooperation agreement of 1996 between the IMF and the WTO also provides that IMF officer will participate in the meeting of the balance-of - payments committee of the WTO. Since the IMF and the WTO recognise each other the status of observer, officers of the secretariat of the IMF can participate to relevant meetings of technical and political bodies of the WTO, and *vice versa*. Finally, the agreements provides for exchange of documents and reports between the two organisations; since most of these documents are already published and often put online, the actual impact of such commitment is relatively limited. [120]

The analysis carried out in the present paragraph has so far allowed to conclude that there are legal provisions which ensure a proper cooperation between the WTO and the IMF and which empower the dispute settlement mechanisms of the WTO to obtain support and advice from the IMF, when the former has to deal with monetary issues affecting international trade. In addition, it has been pointed out that the WTO has a competence in monetary issues and that its DSB can settle disputes concerning monetary issues. In the previous paragraphs, it has been studied that the rise of SWFs is connected to certain monetary practices consisting in the hoarding of foreign exchange reserves and, to exchange rate arrangements (and alleged exchange rate manipulations) on behalf of the countries which create and manage SWFs. While it has been studied that customary international (monetary) law and IMF provisions do not provide for the proper legal framework to deal with such issues, and especially with inter-State disputes concerning such issues, in the remaining part of the present paragraph it will be studied how, in practice, the WTO can provide for more effective remedies. It must be remarked that in the context of the WTO it is not the international organisation itself which autonomously undertakes legal initiatives against States which do not abide by its provisions. On the contrary, it is each

[119] G. C. HUFBAUER, Y. WONG, K. SHETH; *US-China Trade Disputes: Rising Tide, Rising Stakes*; Peterson Institute for international economics; 2006; p. 17

[120] M. VELLANO; cit.; p. 287; D. AHN; cit.; p. 13-16.

member State which, whenever it deems its interests are impaired by a conduct of another WTO member inconsistent with WTO law, is empowered to initiate legal proceedings against that other State, in conformity with the provisions laid down in the agreements concluded within the framework of the WTO and, in particular, of those contained in the DSU. Coming back to the example of the economic relations between the US and China, which has been broadly described above, it can be investigated whether the US could invoke WTO provisions to prevent China from manipulating its exchange rates. In particular the US could claim a breach of art. XV,4 of the GATT, which prevents contracting parties from "by exchange action, frustrat[ing] the intent of the provisions of this Agreement".[121] In fact, it can be argued that when China undertakes exchange actions whose aim is to keep the Yuan undervalued vis-à-vis the currency of its main trading partners like the US, it obtains unfair competitive advantages for its goods. In a hypothetical dispute, within the WTO, between US and China and concerning alleged exchange rate arrangements the panel would be mandated to ask for the consultation of the IMF. More precisely, in the light of what has been explained in this paragraph, the panel would have the duty to demand advice not only in relation to factual issues, data and information, but also in relation to legal determination of the IMF. In detail, the Fund could be required to determine the consistency with Chinese exchange practices with the IMF Articles of Agreements. Such determination might have a relevant impact on the content of the report adopted by the panel and, finally, on the possibility that the panel might conclude that the conduct of China has impaired the rights of the US under WTO law and therefore that the US are allowed to adopt countermeasures, consistently with the DSU, against China. In this way, the IMF might have the possibility to "indirectly" sanction States whose conduct is not consistent with art. IV of the Articles of Agreements, but which could have not been effectively sanctioned given the

[121] It must be remarked that there is not a similar provision in the text of the GATS. The fact that the obligation not to frustrate the liberalization of trade in goods by means of exchange arrangements has not been extended to the trade in services (trough the inclusion in the GATS of a provision similar to art. XV.4 GATT) has brought some authors to suggest that the prohibition of exchange rate arrangements affecting trade does not amount to a general principle of WTO law. On this opinion see: G. C. HUFBAUER, Y. WONG, K. SHETH; cit.; p. 19.

unsuitability of the remedies contemplated in the Articles of Agreement. Such indirect sanction would consist in the possibility to influence, by means of the legal and factual advice provided, the findings of the panel and, ultimately, the possibility that a State might adopt countermeasures against China. In must be remarked that in this case non compliance with IMF provisions could only be sanctioned if the two following conditions are fulfilled. First, a violation of art. IV of the Articles of Agreement must be accompanied by a violation of a WTO provision. Second, a member of the WTO must deem that pursuant to such a violation the rights conferred upon it by the agreements concluded within the framework of the WTO have been jeopardised by such a violation. To this two requisites a third one could be added, although it pertains to the sphere of economy and politics rather than to the legal sphere in a narrow sense. The State which invokes the responsibility of another States claiming that the latter has, by means of exchange rate actions, deprived it of its rights under WTO law, must be sufficiently strong and must have a sufficiently large economy. In fact, only in this case it will be able to inflict, when it adopts countermeasures allowed by the DSB, sufficiently effective damage to the other State which is pursuing unlawful exchange rate practices. The US seem to fulfil the requirements to challenge the lawfulness of Chinese exchange rate practices before the DSB of the WTO. If a panel of the WTO deems that China's exchange rate practices are unlawful, this might have important consequences on the Chinese SWFs. This is even clearer if, as a result of the legal procedure initiated before the DSB, the US, as well as all the other countries which trade with China and which claim that the Yuan is artificially maintained undervalued, are subsequently allowed to adopt countermeasures having a relevant economic reach. If the costs connected to the countermeasures at issue exceed the benefits of keeping the Yuan undervalued, then China could decide to leave the Yuan to appreciate. In this case, less foreign currency will be accumulated and finally the Chinese SWFs will be prevented from continuing their growth. The extreme outcome of such process could be a relative loss of importance of the Chinese SWFs, as well as of all the forex SWFs which are created in connection with accumulation of foreign exchange reserves which, in turn, are deemed to be caused by unlawful exchange rate manipulations.

However, it remains debatable whether a WTO Panel might find that China is in breach of art. XV,4 GATT. In particular, attention should be paid to the addenda to art. XV,4, which provides that: "The word “frustrate” is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article." The addenda provides two example of this principle, which however do not seem to shed further light in the view of an assessment of the monetary practices of China. In any case, it has been argued that such addenda should be interpreted as providing that, before art. XV,4 might be invoked, another specific GATT provision must be violated in an important way together with art. XV,4. Therefore, it should be proved that the monetary practices of China determines a clear and severe departure from the objectives of another specific provision of the GATT and this could be extremely difficult.[122]

It has been argued that the practise of State authorities consisting in keeping the domestic currency undervalued in order to allow domestic exporters to gain unfair competitive advantages can be regarded as a form of State subsidy to such exporters. Moreover, it has been argued that currency undervaluation can constitute a form of dumping. WTO law provides for rules on State subsidies and dumping and antidumping measures. If exchange rate manipulations ex art. XV,4 of the GATT cause a severe breach of such rules, then a panel could enable WTO member States affected by such practices to adopt countermeasures against the offending State. In the next paragraph it will be studied the applicability of WTO provisions on subsidies, dumping and countervailing measures to the alleged Chinese currency undervaluation.

[122] G. C. HUFBAUER, Y. WONG, K. SHETH; cit.; p. 19.

8. Other WTO provisions which could affect the creation of SWFs: the rules on subsidies and dumping.

WTO law recognises that subsidies granted by States to their firms can cause severe distortion of international trade. Some subsidies, given their nature and their aims, can prove particularly harmful. Therefore, articulated provisions have been developed to govern them and to restrict the discretion of States in adopting them, as well as to adopt countermeasures against States which subsidise their industries. Relevant provisions are contained in art. XVI of the GATT and in the Agreement on Subsidies and Countervailing Measures, adopted in the occasion of the Uruguay Round. Such agreement replaces the code adopted during the Tokyo Round and entered into force in 1980 and it contains several innovative provisions also with respect to the GATT.[123]

Art. 1 of the Agreement on Subsidies and Countervailing Measures adopts a very broad notion of subsidy, which can be granted by "a government or any public body within the territory of a Member". When the result is the conferral of a benefit to the recipient firm, the subsidy can consist in "a government practice" which "involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees)" or in a governmental practice according to which "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)" State subsidies are also deemed to be granted when "a government provides goods or services other than general infrastructure, or purchases goods" to the beneficiary firms.

It is difficult to conclude that currency devaluation could fall within such notion, save if we consider that maintaining the currency undervalued is a provision of a service by the State its firms, but this interpretation would read too much into the text of art. 1. It must be added that art. 1,1 a) 2. of the Agreement on Subsidies and Countervailing

[123] For an introduction to WTO rules on subsidies see: G. VENTURINI; *L'OMC e la disciplina degli scambi internazionali di merci*; in G. VENTURINI; *l'Organizzazione Mondiale del Commercio*; 2nd ed. Giuffrè; 2004; p. 21-24; P. VAN DEN BOSSCHE; *The law and policy of the World Trade Organization: texts, cases and materials*; 2nd ed.; Cambridge; Cambridge U.P.; 2008; p. 557-604; C. MANDRINO, E. GRANZIERA; *Gli accordi commerciali multilaterali e settoriali*; in A. COMBA, ed.; *Neoliberismo Internazionale e global economic governance*; Torino; Giappichelli; p 118-121.

Measures adds that State subsidies can consist in "any form of income or price support in the sense of Article XVI of GATT 1994". The reading of such provision suggests that the notion of subsidy includes "any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory" In principle a devaluation of the domestic currency, although very indirectly, could fall into this notion, especially since its effect is to increase the price of foreign goods in terms of domestic currency and to reduce the price of domestically produced goods in terms of foreign currency and ultimately, to favour exportations and jeopardize importations.

Subsidies are divided into three categories: prohibited, actionable, non actionable. Prohibited subsidies are indicated at art. 3 of the Agreement on Subsidies and Countervailing Measures and are in turn divided into two categories. Firstly, they are the subsidies which are "contingent, in law or in fact whether solely or as one of several other conditions, upon export performance". Secondly, they are the subsidies "contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods." In other words, WTO law always and explicitly prohibits subsidies granted to firms which in exchange undertake to export subsidised goods or to firms which in exchange undertake to use, as inputs, domestic goods instead of imported goods. It is in fact argued that these are the commercial practices which are most likely to directly jeopardize international trade. Such subsidies are always prohibited and remedies provided for at art. 4 of the Agreement apply. It is clear that currency undervaluation cannot fall within the scope of art. 3.

However a subsidy which is different from those listed at art. 3 can nonetheless be subject to legal proceedings (according to a procedure which is different from the one laid down at art. 4 and which is provided for at art. 7) whenever it causes "adverse effects to the interests of other Members" (art. 5).

In detail, art. 5 provides three examples of actionable subsidies: they are those which cause:

"(a) injury to the domestic industry of another Member;

(b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits of concessions bound under Article II of GATT 1994;

(c) serious prejudice to the interests of another Member."

Art. 8 offers a broad and detailed list of non actionable subsidies, against which no legal proceeding can be initiated under WTO law. It comprises measures aiming at achieving particularly important objectives, like "assistance for research activities conducted by firms or by higher education or research establishments on a contract basis with firms" as well as for disadvantaged regions or for the protection of the environment. What is of the utmost importance for the research undertaken in the present chapter is art. 8,1 a) which provides that "subsidies which are not specific within the meaning of Article 2" "shall be considered as non-actionable". Subsidies which are not specific in character are not subject to WTO law. A subsidy is specific when it is selectively granted "to an enterprise or industry or group of enterprises or industries". Art. 2 provides for further clarifications of the circumstances under which a subsidy is to be regarded as specific. It is the case, for instance, when "the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific" or when they "establish objective criteria or conditions governing the eligibility for, and the amount of, a subsidy [...]". In addition, art. 2,1c) provides that that "if, notwithstanding any appearance of non-specificity resulting from the application of the principles laid down" above "there are reasons to believe that the subsidy may in fact be specific, other factors may be considered. Such factors are: use of a subsidy programme by a limited number of certain enterprises, predominant use by certain enterprises, the granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy [...]"

According to par.2 of art. 2, specificity occurs also when a subsidy "is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority". Finally, according to par. 3, subsidies referred to in art. 3 shall be deemed to be specific.

In principle, the maintenance of an undervalued currency can fall within such notion of art. 5, since it benefits domestic exporters and at the same time is able to cause "injury to the domestic industry of another Member" and/or to cause "nullification or impairment of benefits accruing directly or indirectly to other Members" under WTO law and/or to cause "serious prejudice to the interests of another Member". However, since such monetary practice advantages all the exporters, it clearly fails to fulfil the requirement of specificity under art. 2 and therefore it rather fall within the empire of art. 8,1 a). In conclusion, what provides for a definitive answer on the applicability or, *rectius*, on the non applicability of WTO provisions on subsidies to currency devaluation is art. 2 of the Agreement on Subsidies and Countervailing Measures read together with art. 8,1 a) of the same Agreement.[124]

The second issue which needs to be explored is whether the maintenance of an undervalued currency can be regarded as dumping. From the point of view of economists, dumping can be defined as a form of price discrimination in which a firm charges a lower price for exported goods than it does for the same goods sold domestically. A firm might profitably engage in dumping if two economic conditions are fulfilled. First, the sector in which firms operate at the domestic level must be imperfectly competitive, so that firms with their behaviour are able, at least in part, to determine prices, instead of taking them as given. The second condition is that markets must be segmented so that domestic residents cannot easily purchase goods intended for export.[125]

[124] A. SANTA MARIA, *Cina, regole internazionali e dumping sociale e monetario*; in *Diritto del Commercio Internazionale*; 2003; p. 679; A. SANTA MARIA; *Il diritto internazionale dell'economia*; in S. M. CARBONE, R. LUZZATTO, A. SANTA MARIA; *Istituzioni di diritto internazionale*; 3. ed. - Torino : Giappichelli; 2006; p. 513-524

[125] For a definition of dumping from an economic perspective, as well as for a clear description of the economic model explaining its functioning see: P. KRUGMAN, M. OBSTFELD; cit.; p. 135-138. See also: P. GRAMATICA; *Economia e tecnica degli scambi internazionali*; Milano; Vita e pensiero; 2002; p. 301-302.

While dumping, if defined in this way, merely consists in the determination of firms, individually taken, concerning the prices at which they sell the same goods in the domestic market or abroad, the notion of dumping has been sometimes construed in a broader way. To this purpose, a part of the economic literature has developed the notion of social and monetary dumping; interestingly China is blamed for both of them and its successes as leading exporting countries are often ascribed to such practices.

Social dumping would occur when a firm located in a country is able to produce at lower prices than firms operating in another country (thus ensuring a higher degree of competitiveness to its goods) because the former is allowed by the legislation of its State to pay much less its workforce or not to respect basic standards of treatment of workers concerning for instance their social security rights, their health, the number of worked hours.[126] Irrespective of the ethical assessments which can be made on this practice, it seems difficult to make it fall within the definition of dumping as illustrated above. What is called social dumping seems rather to be a strategy adopted by a State to reduce the cost of labour as a factor of production and thus to obtain a comparative advantage in labour intensive sectors. In any case, the issue of social dumping falls outside the scope of the present research and it must not be discussed further.

As to the monetary dumping, it occurs when a State, by means of competitive devaluation of its currency, reduces the price, expressed in terms of foreign currency, of the goods its firms export.[127] Once again, under the economic point of view, the notion of monetary dumping is quite inconsistent with the definition of dumping provided above. Monetary dumping should be regarded rather as a practice adopted by a State, and not by individual firms, by which it tries to increase the competitiveness of its firms, maybe in an unfair way.[128]

[126] P. GRAMATICA; cit.; p. 307.
[127] P. GRAMATICA; cit.; p. 307-308.
[128] P. SAVONA, P. REGOLA; cit.; 39-40

After having explained under an economic point of view the notion of dumping it is necessary to investigate the content of WTO rules related to it.[129] It must be preliminarily argued that, since dumping is essentially a practice undertaken by firms and not by States, and since WTO law applies to States and not directly to firms and to individuals, WTO law can hardly impose obligations upon firms which engage in dumping. On the contrary, WTO law rather applies to measures States adopt in order to protect domestic industry against (alleged) dumping undertaken by firms located in other countries.[130] Anti-dumping measures adopted by States are regarded as much more dangerous for international trade than dumping undertaken by firms, therefore WTO intervenes to regulate antidumping measures rather than dumping. This means that WTO rules specify which are the conditions under which dumping occurs and which are the countermeasures which can be legitimately adopted by States claiming that their industry is adversely affected by dumping. In other words a country could impose anti dumping measures (essentially consisting in tariffs applied to dumped importations) only in a manner consistent with WTO law. The relevant provisions are art. VI of the GATT and the "Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994" which has been adopted in the context of the Uruguay Round. Art 2,1 of such Agreement provides that "product is to be considered as being dumped, i.e. introduced into the commerce of another country at less than its normal value, if the export price of the product exported from one country to another is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country". Par 2 to par. 5 of art. 2 lay down in detail other methods for assessing the existence of dumping if what provided for in par. 1 cannot apply since "there are no sales of the like product in the ordinary course of trade in the domestic market of the exporting country or because of the particular market situation or the low volume of the sales in the domestic market of the exporting country, such sales do not permit a proper

[129] For a detailed overview of the WTO provisions of dumping and anti-dumping duties see: P. VAN DEN BOSSCHE; cit.; p. 509-556; A. SANTA MARIA; *Il diritto internazionale dell'economia*; cit.; p. 513-524.
[130] G. VENTURINI; *L'OMC e la disciplina degli scambi internazionali di merci*; cit.; p. 18-19.

comparison". It could be argued that manipulations of the foreign exchange rate could fall within the scope of art. 2 because, for some respects, it determines the introduction of a good "into the commerce of another country at less than its normal value". However, such an interpretation could run against the spirit and the aim of the provision, and in particular against the opinion that dumping is a practice adopted by firms and not by States. As it has been explained above, so called social and monetary dumping, are not real dumping, but they rather represent strategies, or sometimes mere situations, which can be desirable or which can even occur against the will of a State[131], which bring a trade advantage to the exporters of that State.

The wording of the GATT and of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994", although they do not explicitly state that dumping is a practice of firms and not of States, in any case do not seem to contradict such approach but, on the contrary seem to take it as a basic assumption. The same fact that, as explained above, they do not regulate dumping but only State measures adopted to offset its effects show the convincement that dumping cannot be performed by States.

Therefore, it can be concluded that WTO provisions on dumping cannot be construed in a manner such as to include so called monetary dumping, since the latter really is not dumping but only currency devaluation finalised at the achievement of trade competitive advantages.[132]

At the outcome of the analysis undertaken in this chapter, it seems possible to conclude that the WTO does not provide for an effective forum in which disputes arising out of monetary imbalances, disequilibria of the balance of payments and

[131] In some cases, in fact, an excessive domestic currency undervaluation can favour only those firms which buy their inputs domestically and sell their output overseas. In all the other circumstances it could be absolutely undesirable from many point of view: it could damage importers, enhance inflation, increase the costs of financing of firms and of the State itself when money is borrowed by means of loans denominated in a foreign currency. Therefore it must always be reminded that while in certain cases currency undervaluation can be desirable and can be even pursued as a strategy to obtain trade advantages, in many other circumstances it could have disruptive effects and States might be striving in order to prevent it.

[132] On this point see also: A. SANTA MARIA, *Cina, regole internazionali e dumping sociale e monetario*; cit; p. 675-679; A. SANTA MARIA; *Il diritto internazionale dell'economia*; cit.; p. 513-524.

manipulation of exchange rates, can be properly redressed. The monetary practices which, as explained above, have led and are still leading to the establishment of forex SWFs cannot be adequately governed within the framework of the WTO. It seems therefore that the best fora for such issues are still those international summits like the G 7 and the G 10, where, irrespective of the level of institutionalisation attained, the political aspects are still prevalent. This should ensure a higher degree of flexibility which is particularly useful lacking proper rules of "hard law" on this subject. The role of institutions like the G 7, the G 10 and other international meetings, both relative to the governance of global monetary imbalances and relative to the regulation of SWFs will be the object of chapter 7.

After having explained that the WTO does not provide for a suitable legal framework for the solution of those monetary imbalances underlying the creation of forex SWFs, it can be argued that, on the contrary, the legal framework established by the GATT and later by the WTO has even contributed to the creation of forex SWFs. As it was explained above, the accumulation of large amounts of foreign exchange reserves which is the condition underlying the creation of SWFs, was made possible by the existence of persistent current account surpluses of the States which later established SWFs. These surpluses were caused by a rise of exportations of these States, which in turn, was allowed also by the establishment of an international legal framework favouring international trade. It is undeniable that the GATT and later the WTO, have played a very important role in liberalizing international trade and in expanding it. The inclusion of countries like China into the WTO in 2001 has increased their ability to sell their products abroad with less obstacles and restrictions. This, in turn, has determined an increase in their exportations (which have grown faster than their importation) and therefore the increase of reserves of foreign currency, which have made it possible, convenient and desirable the creation of SWFs.

For these reasons, the creation of forex SWFs can also be regarded as an "unexpected" and indirect outcome of the liberalization of international trade in which the GATT and, since 1995, the WTO, have played an extremely important role. This is consistent with the general idea that SWFs, although they have often been created by States which have not been the traditional supporters of the principles of monetary, financial and trade liberalization, are nonetheless the result of such liberalizations and today they prove to be the among their main beneficiaries.

9. The issue of the applicability of WTO provisions to the operations of SWFs: the agreement on subsidies and countervailing duties and its relevance for domestic investments

After having studied the (very limited) applicability of WTO law to economic issues related to the *creation of SWFs*, and especially of forex SWFs, in this paragraph it will be investigated whether WTO law can contain provisions governing *the operations of SWFs*.

The first issue which will be studied will concern the WTO provisions on State subsidies, which have been discussed in the previous paragraph but which in this context shall be investigated from a different perspective: the perspective of their applicability to the investments that SWFs undertake in the companies which are based in the same State which is the owner of SWFs at issue.

The reasoning developed in the present paragraph will not only apply to forex SWFs but to all kind of SWFs and especially to those which are used as stabilization funds or as vehicles entrusted with the task of inter-generational savings, as it is often the case of commodity SWFs.

Art. 1,1 (a) 1 of the Agreement on Subsidies and Countervailing Measures provides that a subsidy consists in "a financial contribution by a government or *any public body* within the territory of a Member..." [emphasis added]. The notion of "any public body" has been construed so that to include entities which were controlled by the State. The Korea-Commercial Vessels case [133] provides further insight. In that occasion, the Panel declared that: an entity is to be considered a public body "if it is

[133] *Korea - measures affecting trade in commercial vessels*; Report of the Panel of 7 March 2005; WT/DS273.

controlled by the government (or other public bodies)." The panel also added that "if an entity is controlled by the government (or other public bodies), then any action by that entity is attributable to the government and should therefore fall within the scope of Article 1.1(a)(1) of the SCM Agreement." In the case at issue, the Panel had to assess whether the entity providing subsidies, which was called KEXIM, was a "public body" of Korea. The panel considered that "KEXIM is 100 per cent owned by" the Government of Korea or by "other public bodies". It also took into consideration other elements, in particular "the fact that the operations of KEXIM are presided over by a President (Article 9(1) of the KEXIM Act) appointed and dismissed by the President of the Republic of Korea (Article 11(1) of the KEXIM Act), and that the KEXIM President shall be assisted by a Deputy President and Executive Directors (Article 9(2) and (3) of the KEXIM Act) to be appointed and dismissed by the Minister of Finance and Economy upon the recommendation of the President of KEXIM (Article 11(2) of the KEXIM Act). Government control is also exercised through the Ministerial approval of the annual KEXIM Operation Programs (Article 21 of the KEXIM Act)." The panel concluded that KEXIM was a public body under art. 1,1 of the SCM agreement.[134]

The discussion carried out so far brings us to believe that SWFs fall within the notion of subjects which can provide a subsidy, because even when they are not agencies and instrumentalities of the government, they are however public bodies under art. 1,1 (a) 1 of the SCM Agreement and in the light of the findings of the Korea-Commercial Vessels case. In fact, SWFs which are separate from the government are however controlled by it in a way which is very similar to the one KEXIM was controlled by the Government of Korea.

If a State uses its SWF as a vehicle to subsidize its firms, WTO provisions on subsidies shall apply. To make this concept clearer, it must be reminded that SWFs not only undertake foreign portfolio investments (although this is the activity which characterises them and makes them so much important abroad), but the majority of

[134] ibid.; par. 7.50. See also: P. VAN DEN BOSSCHE; cit.; p. 562-565.

them can also undertake direct and indirect investments in the same State which owns them.[135] This possibility finally depends on the domestic legal framework governing them, in other words whether the constitution or other law adopted by the State which owns the SWFs provides that they shall only invest in foreign assets or they can also invest in domestic ones. This is consistent with the rationale underlying the creation of SWFs. They are required to invest overseas in periods when State revenues are more than expected or, in any case, when they exceed the amount which can be properly used for domestic consumptions or investments without overheating domestic economy. Likewise, SWFs can be used to inject resources into the domestic economy when State revenues fall below a certain threshold, for instance, in the case of economies heavily dependent on the exportation of natural resources, because of the sudden fall of the international prices of commodity or because of the depletion of domestic reserves of natural resources.[136] This is the traditional role of commodity SWFs; however also forex SWFs can play such stabilization and inter-generational saving role. In fact, forex SWFs can be used to prevent disruptive devaluation of the domestic currency: this is essentially the task fulfilled also by those foreign exchange reserves which are not transferred to SWFs. More generally speaking, the resources under the management of a SWF could be used in case of economic recession in the State which owns the SWF. They could be used to finance undercapitalised firms, to undertake public investments in order to offset the negative effects of scarce private investments, to finance government budget in order to allow tax cuts which should prompt private investment and consumptions and therefore have expansionary effects on the economy.[137] For instance, it seems that the Russian SWFs, have been largely used during the recent

[135] For instance, it is quite common that SWFs control or finances acomplex networks of State owned companies. On this issue see: L. C. BACKER; *Sovereign Investing in Times of Crisis;* cit.; p. 59-73

[136] See *supra*; chapter 1 paragraph 2.

[137] In this case a SWF could be used to allow an expansionary fiscal policy. For a more detailed analysis of these concepts see: D. BEGG, S. FISCHER, R. DORNBUSCH; *Economia*; Milano; McGraw-Hill, 2001; p. 417-462

financial crisis in 2008-2009[138] even if their potential was partially undermined by the decline of oil prices occurred in that period. In the second half of 2008 foreign capitals were suddenly withdrawn from Russia, stock markets collapsed[139] several bank failures occurred and the Rouble underwent powerful downward pressures. In addition, GDP dramatically collapsed: in 2009 it fell by nearly 8% while in 2008 it was still growing by about 6%. In that occasion the large amount of foreign exchange reserves owned by Russia, also in its SWFs, was used to ensure that the devaluation of the Rouble could be partially prevented and that, in any case, it might occur in an orderly way. In addition the State, also through its SWF, provided loans to domestic firms or even purchased their equity, in order to recapitalise them. A financial and economic disaster tantamount to the one which occurred in Russia ten years before was avoided. Since march 2009 Russian stock markets (like those of most countries) rallied and in less than two years it rose by 250%.[140]

Finally, SWFs can be used not only in periods of economic distress, as they can be more broadly regarded as instruments through which States promote their industrial policy. Therefore their strategies can contemplate foreign and domestic investments, as well as direct and portfolio investments.

If SWFs are meant in this way, and therefore not only as mere instruments for the management of wealth like, for instance, mutual funds, it can be easily understood the role they might have in relation to State subsidies: more precisely, they can be one of the State body entrusted with the task of granting subsidies or of acquiring and managing a vast network of State participations in domestic firms or. At this stage, it is necessary to understand when a transaction made by a SWF can be regarded as a State subsidy. It must be preliminarily stressed that since the GATT and the Agreement on Subsidies and Countervailing Measures only refer to trade in

[138] For more information on the effects on Russia of the last world financial crisis see: S. GURIEV, A. TSYVINSKI; *Challenges Facing the Russian Economy after the Crisis*; cit.; p 16-30.

[139] The RTS index fell from nearly 13300 points in may 2008 to 3540 points in October. Data can be found online on the website of the Russian stock market at: http://www.rts.ru/s690 page visited on 3-1-2011

[140] Data available online at: http://www.rts.ru/en/index/rtsi/ page visited on 18/2/2011

good, subsidies given to firms providing services are excluded. Therefore, the analysis must focus on transactions of SWFs concerning firms producing goods.

Art. 1, 1 a) 1,i of the Agreement on Subsidies and Countervailing Measures includes in the notion of subsidy "a government practice [which] involves a direct transfer of funds" and it specifies that this mean, for instance "grants, loans, and equity infusion." The investments of SWFs in principle consist in purchases of shares ("equity infusion") and of bonds ("loans") and therefore 1, 1 a) 1,i further confirms the applicability of the SCM agreements to the operations of SWFs when they invest in companies based in the same State which owns the SWF itself. However, art. 1,1 b) adds, as a condition for the applicability of the WTO provisions, that such financings also imply a benefit. This concept is clarified by art. XIV of the same agreement. In particular, par. a) specifies that "government provision of equity capital shall not be considered as conferring a benefit, unless the investment decision can be regarded as inconsistent with the usual investment practice (including for the provision of risk capital) of private investors in the territory of that Member". Par. b) adds that "a loan by a government shall not be considered as conferring a benefit, unless there is a difference between the amount that the firm receiving the loan pays on the government loan and the amount the firm would pay on a comparable commercial loan which the firm could actually obtain on the market. In this case the benefit shall be the difference between these two amounts." The practice of the Dispute Settlement Body of the WTO has further clarified such notion.[141] In the case Canada-Aircraft [142] the Appellate Body declared that " that the word "benefit", [...] implies some kind of comparison. This must be so, for there can be no "benefit" to the recipient unless the "financial contribution" makes the recipient "better off" than it would otherwise have been, absent that contribution." The Appellate Body adds that " the marketplace provides an appropriate basis for comparison in determining whether a "benefit" has been "conferred", because the trade-distorting potential of a

[141] P. VAN DEN BOSSCHE; cit.; p. 565-567.

[142] *Canada - measures affecting the export of civilian aircraft*; Report of the Appellate Body of 2 August 1999; WT/DS70/AB/R.

"financial contribution" can be identified by determining whether the recipient has received a "financial contribution" on terms more favourable than those available to the recipient in the market."[143] This approach has been confirmed in subsequent cases. For instance, the Panel in the US- Lead and Bismuth II stated that "the existence or non-existence of "benefit" rests on whether the potential recipient or beneficiary [...] has received a 'financial contribution' on terms more favourable than those available to the potential recipient or beneficiary in the market."[144] In very similar terms, in the more recent Japan - DRAMS case the Panel stated that "although the concept of "benefit" is not defined in the SCM Agreement, it is now well established that benefit is determined by reference to the market. Thus, a benefit is conferred if the recipient receives a financial contribution on terms more favourable than those available to the recipient in the market".[145]

Consistently with the wording of art. XIV of the SCVM agreement and with the reports of the Panels and of the Appellate Body mentioned so far, the issue of the applicability to SWFs of the WTO provisions concerning subsidies can be addressed as follows. If the decision of a SWF to invest in a domestic firm is commercially motivated, i. e. if the SWF carries out such operation because it deems that it will be profitable, in this case the SWF will be acting as any other investor and in this case its operation must be regarded as an investment and not as a state aid. In such a case the SWF will buy equity of a firm at a price comparable to the one that another large and liquid investor would be ready to pay. Likewise, when a SWF demands the same interests paid to other private investors when it lends money to such firm (included when lending is made through the purchase of corporate bonds) then the investment of the SWFs cannot be regarded as tantamount to a State aid. On the contrary, if the investments of SWFs bring financing to invested firms on more favourable conditions than those which would have been applied by other

[143] ibid. par. 157.

[144] *United States - imposition of countervailing duties on certain hot-rolled lead and bismuth carbon steel products originating in the United Kingdom*; Report of the Panel of 23 December 1999; WT/DS138/R; par. 6.66.

[145] *Japan - Countervailing duties on dynamic random access memories from Korea*; Report of the Panel of 13 July 2007; WT/DS336/R; par. 7.256.

commercially driven investors, then it is possible to conceive them as State subsidies. Since they clearly target specific firms, the requirements of specificity is fulfilled, thus enabling the applicability of the WTO discipline.

A contribution of capitals by a SWF into a domestic firm, when it is carried out according to objectives and criteria different from those usually applied by market investors in comparable circumstances, can be motivated in different ways, which nonetheless can be traced back to two hypothesis: lobbying or the implementation of industrial policy. In the first case, a SWF is used as a tool to redistribute wealth from the State to certain firms or groups of people because they are able to influence the government, the parliament, or the public administration, as a result of their connections with them and as a result of lobbying activities.

In the second case, the SWF is used as an instrument for the implementation of the industrial policy. Industrial policy can be defined, in broad terms, as the set of "public actions aimed at guiding and controlling the structural transformation process of an economy"[146] The activities that a State can undertake in order to carry out its industrial policy can range from the definition of the "rules of the game", which means for instance the establishment of a proper legal and economic environment for the development of the economy, to actions which aim at favouring the participation into such competitive game of certain firms and certain individuals. In particular in this second case, the State uses it resources in order to promote the development of certain industries which are expected to become profitable and/or to produce relevant positive externalities but which in the short run need the support of the State. It is for instance the case of sectors which require big initial investments and which become profitable only in the long run. In this case it can be difficult to find private entrepreneurs interested in investing in them: this implies that the only way such industries could rise is with the support of the State. Moreover, it is possible that an industry might produce positive externalities: for instance it can contribute to the

[146] P. BIANCHI, S. LABORY; *From old industrial policy to new industrial development policies*; in: P. BIANCHI, S. LABORY; ed; *International handbook on industrial policy*; Cheltenham; Northhampton; Elgar; 2006; p. 3-27

development and dissemination of technology and know-how in a way that other industries, or the economy as a whole, might obtain a benefit. If however the profitability of the industry is not sufficiently high to encourage private investments in it, its development cannot be achieved without public actions. More in depths studies on industrial policy would fall outside the scope of the present research, [147] however, it is necessary to focus more on a particular aspect: the relation between industrial policy and international trade.

Industrial policy, especially when it consists, as it has been seen before, in an active conduct of a State which "picks winners," can comprise State actions aiming at protecting certain industries from foreign competition (in principle on a temporary base) by means of subsidies as well as the imposition of high tariffs or quantitative restrictions applicable to the importations of foreign competitors. WTO rules, in particular the GATT, the GATS, the TRIP, TRIM and the SCVM agreements severely restrict the possibility of a State to carry out its own industrial policy whenever this distort or jeopardizes international trade.[148]

In conclusion, the legal framework established by the WTO significantly reduces the ability of a State to use its SWF to implement its industrial policy. In fact, it prevents SWFs from being used to invest in firms based in their same State when they provide infusions of capitals (equity or loans) on more favourable terms than market investors do in comparable circumstances.

[147] For a more general discussion on industrial policy and on its multidimensional character see: Irfan ul Haque; Rethinking Industrial Policy; UNCTAD; 2007 and P. BIANCHI, S. LABORY; ed; *International handbook on industrial policy*; Cheltenham; Northhampton; Elgar; 2006; B. BORA, P. J. LLOYD, M. PANGESTU; *Industrial policy and the WTO*; UNCTAD 2000; p. 4-18.

[148] B. BORA, P. J. LLOYD, M. PANGESTU; cit.; p. 19-25; S. MARTIN, P. VALBONESI; *State aid to business*; in P. BIANCHI, S. LABORY; ed; *International handbook on industrial policy*; Cheltenham; Northhampton; Elgar; 2006; p.134-152

10. The impact of the GATS and of the TRIM on the transnational operations of SWFs.

Although the task of the GATT and, since the Uruguay Round, of the WTO, is to govern international trade, its scope has *de facto* become increasingly broad, given the progressive attraction of issues formally distinguished from international trade into the WTO empire. This has been justified by the fact that international trade can be affected, and can in turn affect, a wide array of issues. A review of all the non-trade issues which have somehow been influenced by the WTO would fall outside the scope of the present research. On the contrary, for the purposes of the study of the applicability of WTO law to the operations undertaken by SWFs overseas, it is necessary to focus on the WTO provisions which can apply to international investments.[149] It must be reminded that international law governing transnational investments is mainly provided for in legal instruments other than those concluded within the framework of the WTO, i. e. in International Investment Agreements (IIAs) which will be studied in depths in the following chapter. On the contrary, in this paragraph attention will be paid to the applicability to the investments of SWFs of relevant provisions of the GATS and of the TRIMS.

The General Agreement on Tariffs in services (GATS) was concluded in the Uruguay Round and its aim is to liberalise trade in services. All the members of the WTO must be members of the GATS too. Art. I, 2 of the GATS defines which are the different ways through which services can be supplied. In fact it states that "for the purposes of this Agreement, trade in services is defined as the supply of a service:

(a) from the territory of one Member into the territory of any other Member;

(b) in the territory of one Member to the service consumer of any other Member;

(c) by a service supplier of one Member, through commercial presence in the territory of any other Member;

[149] It must be remarked that in this paragraph the focus will be on the investments that SWFs undertake abroad, while in the previous paragraph attention has been paid to the investments they undertake domestically, as well as to the implications they have from the point of view of international trade.

(d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member."

Mode c) is related to foreign direct investments. In fact, it consists in the supply of services by means of branches or subsidiaries, located in the territory of the host State, which are purchased or created *ex novo* trough foreign direct investments.[150]

However it must be stressed that if on one side art. I 2. c) of the GATS ensures that foreign investments might fall within the empire of the GATS itself, however the applicability of this agreement is limited to foreign direct investments in the service sector. The mere purchase of a non controlling stake in a foreign firm which supplies services cannot fall within the scope of art. I, 2. c). Since the large majority of the foreign transactions of SWFs consist in portfolio investments, the applicability of the provisions of the GATS to them is very limited.

In spite of the limited applicability of the GATS in this case[151], a quick review of the GATS provisions which can affect the operations of SWFs must be made. For the purposes of the applicability of the GATS, it is important to study the criteria adopted by it to define the nationality of suppliers of services in particular in case of supply through commercial presence consisting in the establishment of a branch or a subsidiary. When commercial presence occurs through the establishment of a subsidiary, this implies the creation of a juridical person. In this case, art. XXVIII l) first of a provides that "“juridical person” means any legal entity duly constituted or otherwise organized under applicable law, whether for profit or otherwise, and whether privately-owned or governmentally-owned, including any corporation, trust, partnership, joint venture, sole proprietorship or association".

After having provided a definition of "juridical person", letter m) of art. XXVIII defines what is, for the purposes of the GATT, a “juridical person of another Member”. It is a "juridical person which is either:

[150] T. L. Brewer, S. Young; *Investment issues at the WTO: the architecture of rules and the settlement of disputes*; in *Journal of International Economic Law*; 1998; p. 460; A. Mattoo; *China's accession to the WTO: the service dimension*; in *Journal of International Economic Law*; 2003; p. 300-301.

[151] On this issue see also: F. Bassan; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 173-174

(i) constituted or otherwise organized under the law of that other Member, and is engaged in substantive business operations in the territory of that Member or any other Member; or

(ii) in the case of the supply of a service through commercial presence, *owned or controlled by*:

1. natural persons of that Member; or

2*. juridical persons of that other Member identified under subparagraph (i);"* [emphasis added].

It must be pointed out that in this case a SWF could fall within the notion of juridical person of a member State different from the member State in which the investment is undertaken.

Par. n) of art. XXVIII specifies further how the words "ownership" and "control" must be interpreted. It states that "a juridical person is:

(i) "owned" by persons of a Member if more than 50 per cent of the equity interest in it is beneficially owned by persons of that Member;

(ii) "controlled" by persons of a Member if such persons have the power to name a majority of its directors or otherwise to legally direct its actions;".

Therefore, if a SWF owned by a WTO member owns more than 50% of the shares of a company established in another WTO member which supplies services by mean of commercial presence, the GATS provisions in principle apply. They also apply when the SWF at issue owns less than 50% of the capital but, given the lack of concentration of ownership, the SWF is able to control the company even with a stake of relative majority.

A general obligation upon contracting parties of the GATS is provided for in art. III and it concerns a duty of transparency. In detail, art. III requires that contracting parties shall publish promptly "all relevant measures of general application which pertain to or affect the operation" of the agreements concluded within the framework of the WTO and in particular, the GATS. In addition, art. III,3 lays down an obligation upon contracting parties to inform immediately (and, at least, every year) the Council for Trade in Services "of the introduction of any new, or any changes to existing, laws, regulations or administrative guidelines which significantly affect trade" in those services in relation to which it had undertaken commitments under the GATS. Furthermore, under par. 4 of art. III, if a member of the WTO asks another member State for more specific information on those measures the latter has adopted in relation to issues covered by the GATS, that other State has a duty to provide such information. However, art. III bis provides for a derogation of art. III in case of "confidential information, the disclosure of which would impede law enforcement, or otherwise be contrary to the public interest, or which would prejudice legitimate commercial interests of particular enterprises, public or private."

More relevant for the investments of foreign SWFs is the provision of the GATS which requires contracting parties to ensure the most favourable nation (MFN) treatment[152] to suppliers of services from any other contracting party. To this extent, art. II,1 provides that "[w]ith respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country." Par. 2 of art. II allows a State to maintain a measure inconsistent with paragraph 1 only if such measure is included in a specific annex to the GATS and agreed upon with the other contracting parties.[153] This means that in principle art. II prevents a WTO member State from discriminating between SWFs owned by two different States (provided that both States are members of the WTO) when such SWFs undertake direct investments in the service sector. For instance, in a hypothetical case of two insurance companies based in the US but controlled one by a Chinese SWF and the other by the Norwegian SWF, any advantage included to the latter must be automatically

[152] On this clause see: M. YOKOI-ARAI; *GATS' prudential carve out in financial services and its relation with prudential regulation*; in *International and Comparative Law Quarterly*; 2008; p. 619-621; P. VAN DEN BOSSCHE; cit.; C. DORDI; *Gli accordi sul commercio dei servizi*; in G. VENTURINI; *l'Organizzazione Mondiale del Commercio*; 2nd ed. Giuffrè; 2004; p. 88-89; T. L. BREWER, S. YOUNG; cit.; p. 460-462.

[153] It must be remarked that the possibility to exclude certain sectors from the operations of the MFN clause is a feature of the GATS, while the GATT does not provide such a possibility.

extended to the former, except otherwise provided in the annex referred to at par. 2 of art. II.[154]

However, it must be remarked that art. II of the GATS ensures the MFN treatment only to those investments of foreign SWFs the host State has decided to admit. Likewise, it does not affect issues concerning the right of admission or establishment in the service sector. This means that the MFN treatment is ensured exclusively to those service suppliers which have been granted market access, according to the wording of art. XVI,1 GATS which states that "With respect to market access through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for *under the terms, limitations and conditions agreed and specified in its Schedule*" [emphasis added].

WTO members shall ensure market access to service suppliers of other member States only as far as they undertake to do so as a result of negotiations with other members. Moreover, a State retains the right to decide to grant market access only in relation to certain modes of supply: for instance, a State may decide to allow unbound market access to supply of banking services through commercial presence but to prevent the provisions of such services by means of the other mode of supply listed at art. I,2 of the GATS. Finally, a State can impose further restrictions on market access. The key issue is that all these restrictions, in order to be considered

[154] In addition, since insurance is considered, together as banking, as a financial service under art. 5 c) of the first annex on financial services of the GATS, the special provisions of such annex apply. In particular the host State is allowed, according to art. 2, a) of such annex to take "measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system." However, the same provisions adds that "Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."
The financial sector is not the only one in relation to which additional rules have been developed and included in two annexes of the GATS. In fact there are also the following annexes to the GATS: Annex on Movement of Natural Persons Supplying Services Under the Agreement, Annex on Air Transport Services; Annex on Negotiations on Maritime Transport Services; Annex on Telecommunications; Annex on Negotiations on Basic Telecommunications.
For more information on the liberalization of financial services under GATS see: M. YOKOI-ARAI; p. 613-648; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 177.

as being lawful under WTO law, must be agreed upon with the other member States and included in a document, which is attached to the GATS and which is called schedule of specific commitment. WTO members, in conclusion, remain free to decide the sectors and the mode of supply in relation to which market access shall be granted. The GATS restricts the discretion of States to prevent the provision of services by suppliers of other WTO members only when such States had agreed to ensure market access according to the terms of their schedule of commitments. Only in relation to the sectors and the modalities of service provisions in which commitments have been undertaken as worded in the schedules, State measures limiting market access as those listed in art. XVI,2 GATS are prohibited. Such measures consist in:

"(a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;

(b) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;

(c) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;

(d) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;

(e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and

(f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment."[155]

For the purposes of the present analysis it must be underlined that art. XVI GATS could confer a right to SWFs owned by a member of the WTO to undertake FDIs in the service sector in the territory of the other members of the WTO. In this case, therefore, it seems that it provides rights to SWFs (as well as to any other foreign investor) which go much further than the rights conferred by BITs, which, very often, do not contain provisions obliging contracting parties to admit investments of investors which are national of the other contracting party, or which, even when envisaging such a possibility, actually limit it in several ways.[156] However, in order to assess whether the GATS actually provides foreign SWFs with the right of admission and establishment, it is necessary to study carefully the schedules of commitments of the host States. In particular, attention must be paid to the following elements.

Firstly, it must be studied whether the host State has committed itself to ensure market access in the sector in which SWFs owned by other WTO member States mean to undertake their investments. If, for instance, a State has not included in its schedule of commitments the financial sector (or some of the subsectors pertaining to it), then the GATS cannot be construed as conferring a right upon the foreign SWF to invest in the financial sector of that country.

Secondly, it must be studied whether the host State, even if it has not excluded the sector or the subsector at issue from market access, has however decided to restrict access to some mode of supply only, and in particular to exclude the one envisaged at art. I,2 c) of the GATS, which implies a commercial presence. If this exclusion is provided for in the schedule of commitments, then the GATS shall not be construed

[155] P. VAN DEN BOSSCHE; cit.; p. 476-495; C. DORDI; *Gli accordi sul commercio dei servizi*; cit.; p. 100-101; T. L. BREWER, S. YOUNG; cit.; p. 460-462; M. YOKOI-ARAI; p. 619-621. See also: WTO; *Guide to reading the GATS schedules of specific commitments and the list of article II (MFN) exemptions*; available online at: http://www.wto.org/english/tratop_e/serv_e/guide1_e.htm page visited on 15/01/2011.

[156] see, above, chapter 4 par. 4.

as conferring a right upon foreign investors (included SWFs) to undertake FDIs in the financial sector.

It can occur quite often that supply of services by means of commercial presence is allowed, but subject to further limitations and requirements which, in order to be lawfully adopted by the host State, must be listed in its schedule of commitments. The schedule of commitments of the European Union[157] can be quoted as an example. From its text it emerges that the supply of services in the financial sector by means of commercial presence in the EU is in principle possible, but it is subject to some requirements. For instance, as to services consisting in "Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services" supply by means of commercial presence is allowed, subject to the condition, *inter alia*, of "the establishment of a specialised management company" which might perform "the activities of management of unit trusts and investment companies" in a way consistent with "Articles 6 and 13 of UCITS Directive, 85/611/EEC". In addition, it adds that "Only firms having their registered office in the Community can act as depositories of the assets of investment funds" consistently with "Articles 8.1 and 15.1 of the UCITS Directive, 85/611/EEC". Moreover, the schedule of commitments lays down further requirements which apply when supply of financial service by means of commercial presence occurs in certain member States. For instance, in the case the services of the example are supplied through commercial presence in Italy, the schedule of commitments of the European Union provides for the following requirements. "In the case of collective investment schemes other than harmonised UCITS under the directive 85/611/EEC, the trustee/ depositary is required to be incorporated in Italy or in another Member State of the European Community, being established through a branch in Italy." It is also required, *inter alia*, that "Management companies (closed-end funds and real estate funds)" be "incorporated in Italy".

[157] The document is available online at: http://tsdb.wto.org/simplesearch.aspx page visited on 15/01/2011. For sake of clarity it must be reminded that the EU, jointly with its members, is a member of the WTO. On this issue see, *infra*, chapter 7.

SWFs which mean to undertake FDIs in Italian financial firms operating such kind of business shall have the right to do so provided that their operations comply by with the measures that the EU and Italy have adopted in a manner consistent with the commitments they have undertaken in the above mentioned schedule. Likewise, Italy and the EU would breach the GATS, and more in detail its art. XVI, if they adopted one of the measures envisaged at art. XVI,2 which, whenever they are different from those listed in the schedule of commitments reviewed above.

After having explained the conditions upon which a foreign SWFs shall be entitled to invest in a WTO member and to enjoy MFN treatment, another issue which needs to be studied is whether the GATS also confers it a right to enjoy national treatment. Art. XVII,1 provides that:"In the sectors inscribed in" the schedule of commitments "and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers." National treatment under the GATS, differently from what is provided for at art. III of the GATT, has not general application, since it does not apply generally to all measures affecting trade in services. The national treatment applies only to the sectors and to the modes of supply which WTO members explicitly indicate in their schedule of commitments. Therefore, in the schedule of commitments of every member it is specified, for each subsector and for each mode of supply, not only whether it is granted market access but also whether national treatment is granted.[158] Coming back to the previous

[158] See on this point art. XX of the GATS: "
1. Each Member shall set out in a schedule the specific commitments it undertakes under Part III of this Agreement. With respect to sectors where such commitments are undertaken, each Schedule shall specify:
(a) terms, limitations and conditions on market access;
(b) conditions and qualifications on national treatment;
(c) undertakings relating to additional commitments;
(d) where appropriate the time-frame for implementation of such commitments; and
(e) the date of entry into force of such commitments.
[...]
3. Schedules of specific commitments shall be annexed to this Agreement and shall form an integral part thereof.

example concerning FDIs of SWFs in the financial sector, and especially in the asset management industry, it emerges from the reading of the schedule of commitments of the EU that national treatment is in principle ensured to suppliers of services which have been admitted. No further limitations at the European level are envisaged, however some more restrictions and conditions are possible in case of investments in certain EU members, for instance Sweden. In fact, the schedule of commitments allows Sweden to restrict the possibility for a "branch of a fund management company not incorporated in Sweden" to "operate certain collective investment funds (Allemansfonder), where the investor enjoys certain tax benefits". Companies incorporated in Sweden are on the contrary allowed to operate this kind of collective investment funds. This would be inconsistent with the national treatment principle, but, since such exception is envisaged in the schedule of commitments, it is consistent with art. XVII of the GATS.[159]

Another legal instrument concluded within the framework of the WTO which can affect the investments of SWFs is the trade-related investment measures agreement (TRIM). Such agreement aims at preventing WTO members from adopting measures which, although intended to regulate or promote investments, adversely affect international trade. It must be pointed out that the TRIM applies not only to State measures which target foreign investors, but also to measures concerning domestic enterprises. Therefore trade related investment measures as conceived in the TRIM agreement can apply both to State measures adopted by a State in relation to foreign SWFs investing in their territory and to measures that a State adopts in relation to operations undertaken by its own SWFs.

The TRIM provides in its annex an illustrative list of measures which are often adopted by States in order to promote or regulate foreign investments undertaken in their territory, but which also result into restriction or impairment of international trade or which jeopardize the rights the agreements concluded within the framework of the

For the doctrine see: P. VAN DEN BOSSCHE; cit.; p. 390-395; C. DORDI; *Gli accordi sul commercio dei servizi*; cit.; p. 102-104; T. L. BREWER, S. YOUNG; cit.; p. 460-462.

[159] For a more complete analysis of the schedule of commitments under GATS in relation to financial services see: M. YOKOI-ARAI; cit.; p. 627-630.

WTO confer to the contracting parties. In particular, as it is pointed out in its art. 2, the TRIM aims at defining the trade related investment measures inconsistent with art. III of the GATT, which provides for obligation of national treatment. It also indicates the trade related investment measures which shall be inconsistent with the obligation of general elimination of quantitative restrictions laid down in art. XI GATT.

According art. 1 and art. 2 of the annex to the TRIM, State measures "which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage" can qualify as trade related investment measures. Under art. 1 of the annex, State measures as defined above are inconsistent with the obligation of national treatment when they require:

"(a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production; or

(b) that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports."

Likewise, under art. 2 of the above mentioned annex, measures adopted by the host State are inconsistent with the obligation of general elimination of quantitative restrictions when they require:

"(a) the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports;

(b) the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise; or

(c) the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production."

The TRIM contains other provisions concerning particular treatment for developing country members, (art. 4) the duty upon member States to notify existing trade related investment measures and to abolish them within a certain period of time, (art. 5) the duty of transparency (art. 6). In addition, art. 7 provides for the creation of a Committee on Trade-Related Investment Measures, which shall afford Members the opportunity to consult on any matters relating to the operation and implementation of the TRIM and which shall monitor the operation and implementation of such agreement thus providing the Council for Trade in Goods with a report on an annual basis; the Council for Trade in Goods, in turn shall be entitled to propose amendments to the TRIM according to the mechanisms envisaged at art. 9. Finally, it must be mentioned art. 8, which provides that in case of disputes on the application of the TRIM, the system for the settlement of dispute provided for at art. XXII and XXIII of GATT and in the Dispute Settlement Understanding, shall apply as well.[160]

It must be underlined the limited applicability of the TRIM to the investments of SWFs, which is not the consequence of the peculiar nature of the SWFs but of the kind of investments that they most often undertake. First of all, the TRIM applies to "investment measures related to trade in goods only" as explicitly indicated at its art. 1. Therefore, the TRIM excludes from its scope investments in the service sectors, which represent a relevant quota of the operations undertaken by SWFs. Secondly, from the list contained in the annex, it emerges quite clearly that State measures envisaged can apply in practise to FDIs only.[161]

[160] G. VENTURINI; *L'OMC e la disciplina degli scambi internazionali di merci*; cit.; p. 52-54; T. L. BREWER, S. YOUNG; cit.; p. 462.

[161] The non applicability of the TRIM agreement to SWFs is supported also in F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 172

CHAPTER 4

THE APPLICATION OF INTERNATIONAL INVESTMENT AGREEMENTS TO SOVEREIGN WEALTH FUNDS: PROBLEMS AND (PROPOSED) SOLUTIONS.

Introduction

SWFs present peculiarities which make them different in many respects from any other kind of investor. Therefore, since they represent a new element in the landscape of international economy, it is important to study whether the rules of international investment law which have been developed so far, can adequately apply to them.

In this chapter the wording "international investment law" will refer first of all to international investment agreements (IIAs). The focus will be mainly on Bilateral Investment Treaties (BITs), i. e. on those IIAs which are concluded between two States and which exclusively contain provisions on foreign investments. However, reference will be made also to provisions contained in other international agreements which are multilateral and which govern, together with transnational investments, also other aspects of inter-State relations, for instance trade and environment. [1]

Some references will also be made to those rules of customary international law which can be used to complement or integrate such IIAs or which can autonomously apply to the issue of foreign investments[2]. Provisions having a relevance for foreign investments which are contained in other legal instruments, especially in agreements

[1] In this notion, therefore, Economic Association Agreements, Economic Partnership agreements and even Free trade Areas and Custom Unions may be included.

[2] For an introductory overview of this issue see, for instance: O. K. FAUCHALD; *The Legal Reasoning of ICSID Tribunals – An Empirical Analysis*; in *The European Journal of International Law*; 2008; p. 310-312.

concluded within the framework of the WTO, will not be taken into consideration, since they have already been discussed in chapter 3. Likewise, provisions governing investments which can be found in the Treaty on the European Union (TEU) or in the Treaty on the Functioning of the European Union (TFEU) will be separately analysed in chapter 6 and 7.

As it was discussed above,[3] international investment law has traditionally developed with the aim of providing protection to investments which, in most cases, were undertaken by privately-owned companies and which flowed from developed countries into developing ones. This is explained by the fact that until a few years ago such operations constituted the most common form of transnational investments. However, since the first years of the XXI century a new trend has started to develop, according to which an increasing number of investments are undertaken by State entities (like, in particular, SWFs) which are mainly established in emerging economies and which often direct their capitals to industrialised States. This chapter will therefore analyze whether existing rules of international investment law can apply to investors and in general to circumstances different from those in relation to which they originally developed.

The chapter will be organised as follows.

In the first two paragraphs it will be studied whether SWFs are covered investors, according to the wording of BITs, of the other applicable IIAs and of the ICSID Convention. In particular, it will be discussed whether a dispute between a SWF and the host State should be regarded as an interstate or as an investor-State dispute, depending on the qualification of a SWF respectively as a State or as an investor. This issue is particularly important as only in the latter case recourse to ICSID arbitration is possible. So far no ICSID arbitration has been reported concerning an investment of a SWF. However, an analysis of the relevant ICSID case law will be made in order to understand the criteria elaborated by ICSID tribunals to assess

[3] See also , *supra*, chapter 2 paragraph 1.

whether a foreign investor should be regarded as a State, and therefore as unable to have a dispute with the host State settled by an ICSID tribunal.[4]

In paragraph 3 the focus will be on the operations SWFs usually undertake overseas and it will be discussed whether they are covered investments, according to the wording of BITs, of the other applicable IIAs and of the ICSID Convention.

In paragraph 4, the analysis on the application of BITs to SWFs will focus on the BIT clauses dealing with the issue of the admission of foreign investments and their implications for the regulation of SWFs' transactions will be reviewed.

Then, the chapter will explore the issue of the applicability to SWFs and to their investments of some of the most important provisions of substantive law contained in BITs. In paragraph 5 it will be studied the extent to which the principles of most favoured nation and of national treatment, which are provided for in most IIAs, may limit the possibility of host States to restrict in some circumstances the investments of SWFs in relation to the special concerns they can rise given their particular nature.

In paragraph 6, the focus will be on the fair and equitable treatment clause contained in most BITs. Its extent and its content shall be analysed, also considering the abundant case law developed in this field. It will be studied whether such clause could be construed in a way to take into account not only the interests of the foreign investors but also of the host State and the implications this might have on the limits international law poses upon the host State when the latter regulates the operations undertaken by SWFs in its territory. In paragraph 7 a similar analysis will be carried out with respect to the treaty provisions concerning nationalizations as well as direct and indirect expropriations. Paragraph 7 will also briefly discuss the issue of the applicability of other substantial provisions of BITs, like those concerning the transfers of capitals.

The last three paragraphs will analyze the extent to which national security clauses contained in BITs could enable host States to lawfully impose restrictive measures on

[4] The first two paragraphs will largely reproduce the content of the article: M. BARBIERI; *The settlement of disputes between foreign Sovereign Wealth Funds and host States through international investment arbitration*; in *Diritto del Commercio Internazionale*; 2011; p. 735-766.

SWFs especially in the case they use their investments to pursue undue political objectives. Paragraph 8 will provide an overview of the notion of national security of the host State and of the threats that foreign investments might cause to it. It will underline that the notion of national security could be construed in a very broad way and it will investigate the consequences this might have on the admission and treatment of foreign investments. Paragraph 9 will then study the content and the applicability of the national security clause contained in several IIAs. It will review its interpretation by arbitral tribunals in investor-State disputes and it will investigate whether the notion of national security should be relevant only in relation to military issues or also to situations of severe economic emergency. Finally, it will study the issue of state of necessity, as it is provided for in customary international law, and its relation with the national security clause. Paragraph 10 will study in detail in which circumstances and under which conditions the national security clause and/or rules of customary international law on state of necessity might be used in order to allow the host State to restrict the investments of SWFs.

1. SWFs as covered investors according to the wording of BITs

The first issue to be analysed when studying the application of Bilateral Investment Treaties (BITs) to SWFs is whether they may be regarded as covered investors according to the wording of such international legal instruments.[5] In fact, were SWFs excluded from the definition of covered investors under BITs, then any further discussion on the way the other BIT's provisions may apply to SWFs would become superfluous.

One reason why it could be argued that SWFs should be excluded from the notion of covered investors is that they are State entities and most BITs have traditionally been

[5] For an introduction on the notion of investor in BITs see: UNCTAD; *International Investment Agreements: Key issues*; UNCTAD; 2004; p.126-131 G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*; cit.; p. 310-315; E. SCHLEMMER; *Investment, Investor, Nationality and Shareholders*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press, 2008; p. 49-88

devised as a tool to promote and to protect investments undertaken in the territory of one contracting party by individuals or, more often, private-owned corporations, which are the nationals of the other contracting party. Following this reasoning, existing BITs could hardly be construed to apply to other kind of investors like SWFs.

On the other side, it must be recalled that BITs currently in force have been adopted consistently with a model which dates back to some decades ago, when almost the entirety of foreign investments where actually carried out by privately owned corporations having their seat mainly in developed countries. The rise, in the last few years, of States and State owned entities, like State owned enterprises (SOE) and SWFs as leading global investors, represents a new development in international economics and geopolitics and it could be argued that International Investment law should apply, *mutatis mutandis*, also to new categories of investors.

To solve this question it is necessary to review the definition of investor contained in BITs, focusing on those treaties which have been concluded between the States which own SWFs and the States which are the main recipients of the investments of such State-owned investment vehicles.[6]

The BIT between the United Kingdom and the United Arab Emirates, signed in Dubai on December 8th 1992 and entered into force in 1994, at art. 1 e) defines as investor "any national or company of one of the Contracting parties *or the Government of one of the Contracting Parties, or the Government of any of the Emirates of the United Arab Emirates*" (emphasis added). In addition, it specifies at art. 1 d) ii. that companies, in respect of the United Arab Emirates shall mean:"any entity established in accordance with and recognised as a juridical person by the law of the State, such as public and private companies, corporations, business associations, authorities partnerships, foundations, firms, institutions, establishments, agencies, *development funds...* [emphasis added]". The definition of investor is very broad and it clearly

[6] The texts of the BITs which will be quoted in the present chapter have been downloaded from the UNCTAD database of BITs available online at: http://www.unctadxi.org/templates/docsearch____779.aspx . A survey of BITs concluded between a the main owners of SWFs and the main recipients in their investments mat be found in: F. BASSAN; *The law of Sovereign Wealth Funds*; cit.; p. 118-123, where it is also argued that several States which have established their own SWFs are contracting parties to a limide number of BITs. (Ibid.; p. 128)

allows to include SWFs owned by the United Arab Emirate or by one of the Emirates constituting it, without the need to investigate whether such funds should be regarded as equivalent to State-owned corporations, State-owned funds or as articulations of the State itself. Likewise, the BIT between the United Arab Emirates and Italy, signed in 1995, at art. 1,2 defines investors as "il governo di una Parte Contraente ovvero qualsiasi persona fisica o giuridica di una Parte Contraente che effettui investimenti nel territorio dell'altra Parte Contraente".

BITs concluded by Saudi Arabia are even more explicit in including SWFs in the notion of covered investor. For instance the BIT concluded with Switzereland in 2006 provides at art. 1 par 3 a) that, with respct to Saudi Arabia, the term investor shall mean "toute entité, avec ou sans personnalité juridique, constituée conformément aux lois du Royaume d’Arabie saoudite et ayant son siège social sur le territoire de celui-ci, telles les sociétés de capitaux, les entreprises, les coopératives, les sociétés, les sociétés de personnes, les établissements, les fonds, les organisations, les associations économiques et entités similaires, que leur responsabilité soit limitée ou non" as well as "le Gouvernement du Royaume d’Arabie saoudite et ses institutions financières, telles que l’Agence monétaire saoudienne (Saudi Arabian Monetary Agency), les fonds publics et autres institutions gouvernementales similaires". Art. 1 par 3. a) of the BIT between Italy and Saudi Arabia in 1996 has exactly the same wording.

The BIT between Italy and China of 1985 can on the contrary rise a few more uncertainties as at art. 2 par. 3 it defines investor as: "residente o società di ciascuna delle parti contraenti che effettua investimenti nel territorio dell’altra Parte Contraente" and it adds, at par. 5 that: "Il termine "società" indica ogni persona giuridica costituita nel territorio di ciascuna Parte Contraente in conformità con le sue leggi e regolamenti ed avente la sua sede entro il suo territorio". The lack of an explicit reference to the State or to State owned entities as covered investor can be explained, *inter alia*, by the fact that at the time of the conclusion of the BITs China mainly was a recipient of investments undertaken by foreign privately-owned companies and it would have turned as an investor only later. In particular, at that time China did not have SWFs yet, as the CIC was created only in 2007, differently from SWFs owned by States of the Gulf region which had been established some years or even decades before. However, it could be argued that while governments are not included in the definition of foreign investor (but they are not explicitly excluded) the fact that any company established in one contracting party in accordance with its law can be regarded as a covered investor should entail the applicability of the BIT at least to the China Investment Corporation (CIC), the main Chinese SWFs, which is constituted as a company, although entirely owned by the State and administering resources transferred to it by the Chinese Government. A similar analysis can be made with respect to the BIT China signed with France in 1984, with the United Kingdom in 1986 and with Denmark in 1985. For instance, the BIT between China and France defines investor at art. 1.3 as: "Toute entité économique ou personne morale constituée conformément à la législation de l'une ou l'autre des Parties contractantes et possédant leur siège social sur son territoire [...].. In any case, it can be concluded that the Chinese BITs hereby analyzed, although they do not explicitly refer to SWFs, can apply to the CIC as well; therefore, at least with respect to the definition of investor, a renegotiation of them in order to cover the activities overseas of the main Chinese SWF doesn't seem necessary.

Also Norwegian BITs so far do not provide for a definition of covered investors explicitly including SWFs: for instance the BIT Norway concluded with Poland provides at art. 1 par. 3 that investor shall be "[...] any company, firm, organization and association incorporated or constituted in accordance with the laws of that contracting party with a seat in its territory". If the Norwegian SWF (whose name is Norway Government Pension Fund Global) was constituted as a company, the discussion made above in relation to the Chinese CIC would apply and no problems related to the application of the BIT to the Norwegian SWF would rise. Nevertheless, the Norwegian SWF is run by a branch of the Norwegian Central Bank and it can hardly be regarded as a company or a firm. Therefore it is unclear whether the Norway Government Pension Fund Global could be effectively regarded as a covered investor under most Norwegian BITs. However, the term "organisation" could be interpreted broadly so as to include, if not the Norway Government Pension Fund Global, at least the Central Bank which manages it. As a result the operations undertaken by the Norwegian SWF should be regarded as falling within the scope of applicable BITs.

A similar discussion could be made with respect to BITs concluded by Russia, which is the owner of two big SWFs. For instance, in the BIT concluded with Switzerland in 1990, at art. 1 par. 1 we read " Le terme «investisseur» désigne, en ce qui concerne chaque Partie Contractante, [...] (b) les entités juridiques, y compris les sociétés, les sociétés enregistrées, les entreprises, les sociétés de personnes et autres organisations, qui sont organisées conformément à la législation de cette Partie Contractante et qui ont leur siège, en même temps que des activités économiques réelles, sur le territoire de cette même Partie Contractante." The broad formulation of the term investor, which is far from being limited to companies, should therefore be construed so as to include the two Russian Funds although they cannot be regarded as companies separated by the Ministry of finances of the Russian Federation.

After this brief and necessarily non exhaustive review of relevant BITs, it could be concluded that in most cases SWFs are not excluded from the notion of covered investor contained in BITs.[7] In some cases (for instance as regards funds established and owned by gulf States, which have been the first ones to make use of such investment vehicles) SWFs even are explicitly mentioned in BITs[8]. However, it must be added that in spite of this conclusion not all BITs provisions shall necessarily apply to SWFs. In particular, those BIT provisions concerning the recourse to ICSID arbitration in case of disputes between the foreign SWF and the host State could hardly be applied if the Arbitral Tribunal constituted under ICSID shall deem that SWFs cannot be considered as foreign investors under the ICSID Convention, but for instance that the SWFs should be rather regarded as States. In such a case the dispute between a foreign SWF and the host State should not be regarded as an

[7] This view is shared, inter alia, by L. HSU; cit.; p. 458-459.

[8] UNCTAD; *The protection of national security in IIAs*; UNCTAD; 2009; p. 43.

investor-State dispute but as an inter-State dispute[9], in relation to which ICSID arbitral tribunals do not have jurisdiction. This issue will be explored in the following paragraph.

2. Are SWF covered investors according to the ICSID Convention? The issue of the competence of ICSID tribunal in disputes between SWFs and the Host State.

Most BITs provide for a mechanism for the settlement, by means of arbitration, of those disputes which can arise out of their interpretation and application. The particularity of such clauses is that they not only provide for a mechanism for the settlement of inter-State disputes, i. e. of disputes which rise between the two contracting parties. On the contrary, they also enable the investor to directly initiate arbitral proceedings against the host State, when she deems that she has been adversely affected by a breach, committed by the host State, of one or more of the provisions contained in BITs. A full analysis of this issue would clearly fall outside the scope of the present work and for this reason in this paragraph only a very short overview will be provided, in order to make it clearer the discussion which will be developed below.

BITs can provide for different kinds of investor-State arbitration: they mainly consist in *ad hoc* arbitration and in institutionalized arbitration, the latter being characterised by the fact that it is administered by an organisation which is entrusted with the task of organising the arbitral tribunals, the procedural rules, etc.. Some examples of institutionalised arbitration through which disputes between a foreign investor and the host State may be settled, include commercial arbitration administered by the International Court of Arbitration at the International Chamber of Commerce of Paris, or by the Arbitration Institute of the Stockholm Chamber of Commerce. However, the organisation which exclusively deals with investor-State arbitration is the International

[9] The possibility that disputes between a foreign SWF and the host State might be regarded not as investor-State but as interstate disputes is also envisaged in UNCTAD; *The protection of national security in IIAs*; cit.; p. 23.

Centre for the Settlement of Investment Dispute (ICSID), which has been created pursuant to the entry into force of the Washington Convention of 1965 (ICSID Convention) and which is part of the World Bank Group. The ICSID is therefore the international organisation under which arbitral tribunals can be established and organised, with the task of settling investor-State disputes arising out of the interpretation and the application of IIAs, whenever the parties to the disputes have expressed their consent to do so. Likewise, the ICSID Convention is the international instrument which provides for the basic rules concerning *inter alia* the organisation and the jurisdiction of ICSID Tribunals [10]

In the remainder of the present paragraph it will be studied whether, under the ICSID Convention, ICSID tribunals are competent to settle investor-State disputes when the foreign investor in the case at issue is a SWF. Finally it will be discussed whether other forms of arbitral proceedings could prove more appropriate to settle this particular kind of disputes.

ICSID tribunals are mandated to apply not only relevant BITs, but also the Washington Convention of 1965. Therefore, it must be studied whether the ICSID

[10] For an overview of the mechanism for the settlement of State-investor disputes concerning the interpretation and the application of BITs and, in particular, for more detailed information on the functioning of ICSID tribunals see: UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 347-380; P. BERNARDINI *L'arbitrato nel commercio e negli investimenti internazionali*; 2nd ed.; Milano; Giuffrè; 2008; p. 273-291; G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p 412-454; L. MALINTOPPI, A. REINISCH; *Methods of Dispute Resolution*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press, 2008; p. 691-720; C. SCHREUER; *Consent to Arbitration*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press, 2008; p .830-867; D. WILLIAMS; *Jurisdiction and Admissibility*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press, 2008; p. 868- 931; J.J. VAN HAERSOLTE-VAN HOF; A. K. HOFFMANN: *Relationship between International Arbitral Tribunals and Domestic Courts*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press, 2008; p. 962-1007; G. ZEILER; *Jurisdiction, competence and admissibility of claims in ICSID arbitration proceedings*; in VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford; Oxford university press, 2009; p. 76- 91; P. MAYER; *Contract claims et clauses juridictionnelles des traités relatifs à la protection des investissements. - Lalive Lecture, 22 mai 2008*; in *Journal du droit international (Clunet)* n° 1, Janvier 2009; G. VAN HARTEN, M. LOUGHLIN; *Investment Treaty Arbitration as a Species of Global Administrative Law*; in *European Journal of International Law*; 2006; pp. 121-150; A. DE LUCA; *L'arbitrato internazionale treaty-based sugli investimenti esteri*; in *Comunicazioni e Studi*; 2007; p. 979-1086; P. BERNARDINI; *Specific aspects of State-party arbitration*; in *Diritto del commercio internazionale*; 2007; p. 583- 593.

Convention can be interpreted in a way to consider foreign SWFs as foreign investors and therefore to conclude that disputes they may enter into with the host State can be settled by means of ICSID arbitration. In fact, arbitral tribunals constituted pursuant to ICSID Convention shall not have jurisdiction to settle disputes between two private investors or disputes between two States (or State agencies and instrumentalities), but only disputes between a foreign investor, on one side and the host State, on the other side.[11]

This is confirmed by art. 25 of the Washington Convention, which provides that:"The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State [...]". Art. 25 par. 2 specifies that "National of another Contracting State" means: (a) any natural person who had the nationality of a Contracting State other than the State party to the dispute [...] and (b) any juridical person which had the nationality of a Contracting State other than the State party to the dispute [...]". Therefore arbitral tribunals constituted pursuant to ICSID Convention shall not have jurisdiction to settle disputes between two private investors or disputes between two States (or State agencies and instrumentalities). Therefore, if a SWF is regarded as an investor, and precisely as a "juridical person which had the nationality of a Contracting State other than the State party to the dispute" in this case the jurisdiction of the ICSID tribunals shall be established. On the contrary, if a SWF is to be regarded as a State, recourse to ICSID arbitration shall not be available.

So far, no arbitration concerning a dispute between a foreign SWF and the host State has been reported. Therefore, when trying to assess whether ICSID arbitral tribunal might declare themselves competent to settle disputes to which foreign SWFs are parties, it is necessary to analyse a few arbitral decisions in which Tribunals have been required to settle disputes concerning entities whose qualification as States or as investor was not clear. In other words, it is necessary to study the elements and

[11] A. BROCHES; *The Convention on the Settlement of Investment Disputes between States and Nationals of Other States*; in *Recueil des Cours*; vol. 136; 1972; p. 354-355.

the criteria which have been developed in ICSID case law to decide when an entity must be regarded as an organ of a State or as an entity independent from it, whose conducts therefore could not be attributed to the State. Afterword, an attempt will be made to apply such findings to SWFs.

The first award which deserves mention is the one issued in relation to the Československa Obchodní Banka case. [12] The parties at the dispute were the Ceskoslovenska Obchodni Banka, A.S. (CSOB), which was a credit institution incorporated under the Czech law, and the Slovak Republic. The dispute arose in relation to the financial consolidation of CSOB, which took place in the framework of the process of economic transition of the Czech and the Slovak Republic from a socialist central planned economy to a market economy.[13] In the course of arbitral proceedings, before the discussion of the merits of the dispute, the respondent challenged the jurisdiction of the ICSID Tribunal, insisting that, as Ceskoslovenska Obchodni Banka was an instrumentality of the Czech Republic, the dispute at issue actually was a dispute between two States.[14]

In that occasion, the Tribunal reminded that "[t]he language of Article 25(1) of the Convention makes clear that the Centre does not have jurisdiction over disputes between two or more Contracting States. Instead, the dispute settlement mechanism set up by the Convention is designed to deal with disputes between Contracting States and nationals of other Contracting States." However, the Tribunal also added that "the term “juridical persons” as employed in Article 25 and, hence, the concept of “national,” was not intended to be limited to privately-owned companies, but to embrace also wholly or partially government-owned companies"[15]. It is therefore necessary to understand which are the criteria determining when an entity is a wholly

[12] *Československa Obchodní Banka, a.s. v. Slovak Republic*; ICSID Case No. ARB/97/4; Decision on Objections to Jurisdiction of 24 May 1999.

[13] For basic information on the economic transition in Eastern Europe see: I. W LIEBERMAN, D. J. KOPF; ed. *Privatization in transition economies: the ongoing story*; Amsterdam : Elsevier JAI, 2008; B. DALLAGO; cit.; p. 164-187; T. MORITA; cit.; p. 231-253.

[14] *Československa Obchodní Banka;* cit.; par. 1-15.

[15] *Československa Obchodní Banka;* cit.; par. 16.

or partially government-owned company or a State, as only in the first case jurisdiction of ICSID tribunals may be admitted.

The Tribunal, with the agreement of both of the parties to the dispute, considered that the right test to address the issue is the one which has been suggested by Professor Broche[16], according to which "for purposes of the Convention a mixed economy company or government-owned corporation should not be disqualified as a 'national of another Contracting State' unless it is acting as an agent for the government or is discharging an essentially governmental function."[17]

The application of this test led the arbitral tribunal to deem that at the time of the dispute, the Ceskoslovenska Obchodni Banka, carried out activities which "do not differ in their nature from measures a private bank might take to strengthen its financial position." Although it enjoyed some advantages granted by governmental authorities, in the view of the tribunal this "does not transform the otherwise commercial or private transactions here at issue into governmental acts"[18] For these reasons the Tribunal concluded that the Ceskoslovenska Obchodni Banka could be regarded as an investor under art. 25 of the ICSID Convention and therefore that the Tribunal itself was competent to adjudicate upon the case at issue.

ICSID arbitral tribunals had the occasion to provide further specifications on the issue in the Maffezini case.[19] The claimant was an Argentine national, Mr. Maffezini, who undertook an investment in the production and distribution of chemical products in Spain. He argued that his investment had been seriously affected by the actions and omissions of SODIGA, which in his view was an entity owned and operated by the Kingdom of Spain, thus implying the responsibility of Spain itself and, as a result, the jurisdiction of the ICSID arbitral tribunal with respect to this issue. The respondent, on

[16] A. BROCHES; cit.; p. 354–355.

[17] Entirely quoted in *Československa Obchodní Banka;* cit.; par 17

[18] *Československa Obchodní Banka;* cit.; par. 25.

[19] *Emilio Agustín Maffezini v. Kingdom of Spain*; ICSID Case No. ARB/97/7; Decision on Objections to Jurisdiction of 25 January 2000. For a comment see: K. HOBER; *State Responsibility and attribution*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press; 2008
p. 557-560.

the other side, alleged that "SODIGA is a private commercial corporation established under the commercial laws of Spain and that, consequently, its activities are those of a private entity". Spain argued, therefore, that "[o]wnership of part of the shares of SODIGA by State entities [..] does not alter the private commercial character of the corporation nor does it transform SODIGA into a State agency." As a result, acts or omissions attributable to SODIGA would have not entailed the responsibility of the Kingdom of Spain.[20] The ICSID tribunal had thus to analyze whether SODIGA should be regarded as a State (agency) or as a private company, as only in the first case it will have jurisdiction. The tribunal acknowledged that "[t]he Convention contains no criteria dealing with the attribution to the State of acts or omissions undertaken by such State entities, subdivisions or agencies"[21] . Then it developed an analysis which was more detailed, and (at least apparently) different on some points, than the one made in the Ceskoslovenska Obchodni Banka. The Tribunal in fact considered not only whether SODIGA's "purpose or objectives is the carrying out of functions which are governmental in nature or which are otherwise normally reserved to the State, or which by their nature are not usually carried out by private businesses or individuals". In its view it was also necessary to take into consideration "formal and structural" aspects, as "a finding that the entity is owned by the State, directly or indirectly, gives rise to a rebuttable presumption that it is a State entity."[22] However, as State enterprises, agencies and instrumentalities could take the form not only of public entities which are explicitly controlled and directed by the State, but also they can be constituted as corporations, considering the formal and structural aspects "may not always be a conclusive determination whether an entity is an organ of the State or whether its acts may be attributed to the State." According to the tribunal, this makes it necessary "a functional test, which looks to the functions of or role to be performed by the entity." This approach is consistent with the international law applicable to the issue of State responsibility, as stated at paragraph 2 of article 7 of the International

[20] *Emilio Agustín Maffezini v. Kingdom of Spain*; cit.; par. 72-73.
[21] *Emilio Agustín Maffezini v. Kingdom of Spain*; cit.; par. 74.
[22] *Emilio Agustín Maffezini v. Kingdom of Spain*; cit.; par 77.

Law Commission’s *Draft Articles on State Responsibility*, according to which "the conduct of an organ of an entity which is not part of the formal structure of the State or of a territorial governmental entity, but which is empowered by the internal law of that State to exercise elements of the governmental authority, shall be considered as an act of the State under international law, provided the organ was acting in such capacity in the case in question."[23]

For these reasons, the Tribunal argued that "a private corporation operating for profit while discharging essentially governmental functions delegated to it by the State could, under the functional test, be considered as an organ of the State and thus engage the State’s international responsibility for wrongful acts."[24] It also added that the specific elements which should be considered when applying such a functional test were "difficult to determine *a priori".* In the Maffezini case, the Tribunal considered the facts that SODIGA had been created by a decree issued by the Ministry of Industry and that the preamble of the decree meaningfully declared that one of the purposes for SODIGA’s creation was the promotion of regional industrial development of the Autonomous Region of Galicia. In addition, the Tribunal considered that several functions of SODIGA "are by their very nature typically governmental tasks, not usually carried out by private entities, and, therefore, [which] cannot normally be considered to have a commercial nature." For instance, SODIGA was required to provide subsidies and other inducements for the development of industries in Galicia, it undertook studies for the introduction of new industries into Galicia, it tried to attract such new industries, it invested in new enterprises, it processed loan applications with official sources of financing, it provided guarantees for such loans and technical assistance[25]. For these reasons the Tribunal decided that SODIGA had to be considered as an organ of the State and that SODIGA's acts or omissions entailed the responsibility of the Kingdom of Spain. For this reason the

[23] *Emilio Agustín Maffezini v. Kingdom of Spain*; cit.; par. 78-79
[24] *Emilio Agustín Maffezini v. Kingdom of Spain*; cit.; par. 80.
[25] *Emilio Agustín Maffezini v. Kingdom of Spain*; cit.; par. 84-89.

dispute at issue was an investor-State dispute and competence of the ICSID Tribunal was well founded.

The Salini case[26] provided further insight as to whether a certain conduct towards a foreign investor had to be attributed to a private entity or to an organ of the State, and, as a result, whether a breach of the BIT caused by such a conduct could give rise to a dispute between the foreign investor and the host State. The facts giving rise to the dispute can be summarised as follow: Salini, an Italian company, claimed that its investment, which consisted in the construction of a section of a highway in Morocco, had suffered a serious prejudice as a result of the conduct of the Societé Nationale des Autoroutes du Maroc (hereinafter referred to as ADM). In order to assess its jurisdiction, the arbitral tribunal had to establish whether ADM could have been regarded as an organ of the State of Morocco or as a separate entity, whose acts could have not been attributed to Morocco.

The Tribunal declared that the dispute had to be resolved taking into consideration the international rules governing the issue of State attribution and State responsibility, as well as the previous Maffezzini award. This implied the need to apply both a structural and a functional test.[27]

The structural test provided several, although non decisive, evidences that ADM should have been regarded as an organ of the State. In fact, although it had its own legal personality and it was a "commercial company incorporated as a limited liability company", on the other side it was owned by the Kingdom of Morocco, which through the Treasury or through other entity controlled "at least 89% of ADM". In addition, the president of the company was *de jure* the Ministry of Infrastructure and in the board of directors of ADM sat several government officials, who all depended on the

[26] *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*; ICSID Case No. ARB/00/4; Decision on jurisdiction of 23 July 2001. Award in French available in Journal du droit international 196 (2002); unofficial English translation at: http://ita.law.uvic.ca/chronological_list_if_content.htm . For the doctrine see: K. HOBER ; cit.; p. 560-561.

[27] *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*; cit.; par. 31.

ministry of economy and finance. These elements seemed therefore able to ensure, *de jure* and *de facto* the full ability of the Government to run ADM.[28]

However, it was the functional test which provided the definitive answer. The main task of ADM consisted in fact in building, (by itself or with the support of domestic and foreign inventors) managing and operating infrastructures and other public utilities "responding to the structural needs of the Kingdom of Morocco with regard to infrastructure and efficient communication networks". In the view of the Tribunal, an entity performing such a duty had to be regarded as performing a governmental task, irrespective of the fact it was not formally embedded into the traditional framework of the Government and its subdivisions. The fact that the contract between Salini and ADM was governed not by civil law but by administrative law was a further proof of the correctness of such approach.[29] Since both the structural and functional test led to regard ADM as an organ of the Kingdom of Morocco, the conduct of ADM was to be attributed to the Kingdom of Mororcco itself, thus enabling the qualification of the dispute at issue as an investor-State dispute upon which the ICSID Tribunal has jurisdiction.

A last quotation from the Salini award deserves to be made. The Tribunal argued that "the fact that a State may act through the medium of a company having its own legal personality is no longer unusual if one considers the extraordinary expansion of public authority activity." In fact, the Tribunal added: "in order to perform its obligations [...] the State uses a varied spectrum of modes of organisation, among which are in particular semi-public companies, similar to ADM [...]." Without anticipating the analysis which will be undertaken in the following paragraphs, it cannot be forgone that such a reasoning applies to SWFs very well. SWFs are constituted in different ways, according to the domestic law of the State establishing and owning them. Quite often they are constituted as independent companies with their own legal personality: however this should not be enough to prevent them from

[28] *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*; cit.; par 32.
[29] *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*; cit.; par. 33-34

being regarded as organs of the State, with the consequences on the competence of ICSID Tribunal this might entail.

At the end of this review of awards which should shed light on the possible qualification that arbitral tribunal might give to SWFs, it is necessary to quote the Eureko case[30]. It concerned a dispute between the Republic of Poland and a Dutch investors, who had purchased from the "State Treasury of the Polish Republic" 20% of the shares of PZU, the former State-owned insurance company. Eureko subsequently claimed that its investment had been severely jeopardised by the unlawful conduct of the State treasury and therefore started proceedings before an arbitral tribunal in a view to obtaining a declaration that several articles of the BIT between Poland and the Netherlands had been breached and that proper compensation had to be paid.[31] In order to establish its jurisdiction, the arbitral tribunal was required to assess whether the acts of the State Treasury of the Polish Republic could be attributed to the Polish Republic itself.

The structural test seemed to be unable to provide definitive evidence. On one side, art. 33 of the Polish Civil Code provided that the State Treasury was accorded legal personality and it could enter into legal obligations governed by civil law. However, it could not be forgotten that when it concluded with Eureko the share purchase agreement, it was represented by the Minister of the State Treasury. The deep involvement of a ministry in the activity of a formally independent legal entity could represent an evidence that such entity is tantamount to an organ of the State. Against this argumentation, the Polish Government, argued that the minister of the State Treasury had a dual role, since he exercised State authority in its executive functions but he could also act as a private commercial actor, as it was the case of the share purchase agreement. Therefore, with respect to his relation with Eureko, the Minister, was acting, together with the State Treasury, as a business partner and

[30] *Eureko B.V. v. Republic of Poland*; Ad Hoc award (Netherlands/Poland BIT). Partial Award and Dissenting Opinion, 19 August 2005; available online at: http://ita.law.uvic.ca/chronological_list_if_content.htm . For a comment, see: K. HOBER; cit.; p. 570-571; Z. DOUGLAS; *Nothing if Not critical for investment Treaty arbitration: Occidental, Eureko and Methanex*; in *Arbitration International*; 2006; p. 27-51 and in particular, p. 39-46.

[31] *Eureko B.V. v. Republic of Poland*; cit.; par. 36- 73.

not in the exercise of a governmental authority. Following this reasoning, neither the actions of the minister, nor those of the State treasury would have been attributable to the Republic of Poland.[32] The Tribunal rejected this submission and, also relying on art. 4 of the International law Commission's articles on State Responsibility argued that: "in the perspective of international law, it is now a well settled rule that the conduct of any State organ is considered an act of that State and that an organ includes any person or entity which has that status in accordance with the international law of that State." [33] As the minister was undeniably an organ of the State, the fact that when he represented the State Treasury he was acting as a business counterpart of Eureko (and not as performing a governmental function) became less relevant. In addition, the activities of the minister and of the State Treasures which affected the investment of Eureko, were part of the privatisation process undertaken in Poland in the 1990s, which was decided at the level of the Council of Ministry and which was constituted by a set of clearly political choices, which could not be reduced to mere business transaction made by subjects whose actions could not be attributed to the State. For this reason, the tribunal concluded that the Republic of Poland was responsible for the actions of the State Treasury and therefore that the dispute at issue was an investor-State dispute.[34]

The approach of ICSID tribunals in applying both a structural and a functional test to State entities in order to assess whether they should be regarded as investors or as States, seems consistent with the principles of public international law governing the issue of State responsibility and attribution to States of conducts which are put in place by entities other than State organs. [35] Such principles, which are provided in customary international law, are detailed in the Draft articles on Responsibility of

[32] *Eureko B.V. v. Republic of Poland*; cit.; par. 112-124.
[33] *Eureko B.V. v. Republic of Poland*; cit.; par 127.
[34] *Eureko B.V. v. Republic of Poland*; cit.; par. 128-134.
[35] On these topics see: I. BROWNLIE; cit.; p. 433-454; J. CRAWFORD; *Revisiting the Draft Articles on State responsibility*; in *European Journal of International Law*; 1999; p. 435- 460; C. CHINKIN; *A Critique of the Public/Private Dimension*; in *European Journal of International Law*; 1999; p. 387-395. On the application of the structural and functional test to determine whether SWFs should be regarded primarily as investors or as States for the purposes of the applicability of international investment law see also: F. BASSAN; *The law of Sovereign Wealth Funds*; cit.; p. 142-144.

States for Internationally Wrongful Acts, elaborated by the International Law Commission and whose last version dates back to 2001. The draft articles are not a Convention and they cannot be regarded as constituting international treaty law; therefore, from this standpoint they cannot be considered as legally binding. However, it is broadly held that their content largely reflects customary international law. Therefore they can be consulted, and actually they are broadly consulted, in order to know the content of the rules on this topic provided for in customary international law which, in turn, are legally binding *erga omnes*.

However, it could occur that, in relation to certain articles, the Draft Articles do not limit themselves to a mere reproduction of customary international law, but they also contribute to the progressive development of international law. In this case they could not be used to know the content of customary international law and therefore of the obligation States are mandated to comply with. The assessment of which of the provisions of the draft articles merely reproduce rules of customary international law and which on the contrary contribute to the progressive development of international law and therefore cannot be used in order to know the content of applicable international law needs to be carried out by the international jurisdictions which needs to refer to the Draft Articles. [36]

In the remainder of this paragraph, an effort will be made to apply the principles developed in ICSID awards, which have been studied above, and the principles contained in the draft articles, which will be discussed below, to the issue of the possibility to attribute acts performed by SWFs to the States which own them.

According to art. 4,1 of the draft articles, "The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the

[36] D. BODANSKY, J. R. CROOK; *Symposium: the ILC'sState responsibility articles - Introduction and Overview*; in *The American Journal of International Law*; 2002; pp. 773-791; R. ROSENSTOCK; The ILC and State Responsibility; in *The American Journal of International Law*; 2002; pp. 792-797; D. D. CARON; *The ILC Articles on State Responsibility: The Paradoxical Relationship between Form and Authority*; in *The American Journal of International Law*; 2002; pp. 859-860.

organization of the State, and whatever its character as an organ of the central Government or of a territorial unit of the State."

Art. 4,2 specifies that any person or entity which has the status of State organ in accordance to the domestic law of that State shall be considered an organ of the State for the purposes of the draft articles. This articles, together with their commentaries, provide useful guidance when trying to assess when a SWF could be regarded as a State organ or not. In particular, activities of a SWF should be regarded as activities of the same State which owns it when the SWF at issue is a State organ which exercises legislative, executive or judiciary power, or other functions typically performed by a State. A dispute between such SWF and the host State where it invests should be regarded as interstate disputes, thus precluding the jurisdiction of ICSID tribunals.

Art. 4 of the draft articles seems therefore consistent with what arbitrators have defined as the structural test. However, its application can solve the problem of the attribution of SWFs' conducts to States only in limited cases, and especially when the SWF is a pool of assets without separate legal personality and which is directly owned and managed by the Government or by the Central Bank for the purposes of the conduct of their domestic economic and monetary policies.

However, the protean nature of SWFs, which has been extensively discussed above, rises more interpretative difficulties. In fact, if we exclusively apply what has been called by arbitrators the "structural test" there will be the risk that some SWFs might be regarded as States and other as private investors, exclusively depending on the legal status they have been given by the State creating them, according to their own municipal law. Therefore, SWFs which are constituted as separate legal entity which, although entirely owned by the Government, are mainly governed by common law, could be regarded as separate from States (this is for instance the case of the CIC, the Chinese SWF). On the contrary, SWFs which are created as a division or as a branch of the Government or the Central Bank, or as funds deprived of independent legal personality and consisting in mere pools of assets owned and run by the Government or the Central Bank (as in the case of SWFs of Norway and Botswana) should be regarded as States. It could follow that, pursuant to this approach, a dispute between the CIC and the host State should be qualified as an investor-State dispute in which ICSID Tribunals will have jurisdiction, while in an identical dispute between the SWF of Norway and the same host State, the competence of ICSID Tribunals will be precluded. Such a conclusion would be hardly acceptable. It must be noted that the same commentaries of draft article 4 warn against an excessive reliance on municipal law with respect to the qualification of an entity as an organ of the State. In fact, the commentaries explain that: "the internal law of a State may not classify, exhaustively or at all, which entities have the status of 'organs'". The commentaries continue by underlining that "[i]n such cases, while the powers of an entity and its relation to other bodies under internal law will be relevant to its classification as an “organ”, internal law will not itself perform the task of classification. Even if it does so, the term “organ” used in internal law may have a special meaning, and not the very broad meaning it has under article 4. For example, under some legal systems the term “government” refers only to bodies at the highest level such as the Head of State and the cabinet of ministers. In others, the police have a special status, independent of the executive; this cannot mean that for international law purposes they are not organs of the State." Therefore, the commentaries argue that "a State cannot avoid responsibility for the conduct of a body which does in truth act as one of its organs merely by denying it that status under its own law."[37]

However, even if an entity cannot be formally designated as an organ of a State, its acts could nonetheless be attributed to the State. This possibility is envisaged in draft article 5, which declares that: "[t]he conduct of a person or entity which is not an organ of the State under article 4 but which is empowered by the law of that State to exercise elements of the governmental authority shall be considered an act of the State under international law, provided the person or entity is acting in that capacity

[37] *Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001*; Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission’s report covering the work of that session (A/56/10); available online at: http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9_6_2001.pdf page visited on 8/9/2011. p. 42.

in the particular instance." This approach seems consistent with the functional test developed in those ICSID awards which have been discussed above.

From this discussion, two main conclusions can be drawn.

Firstly, if a State organ is defined as such by the municipal law of that State, then it shall be regarded as such also according to the purposes of the Draft Articles on State responsibility. It follows that if a SWF is defined by the municipal law of the same State which has created it as an organ of that State, then any act or omission of such SWF shall be regarded as acts or omissions of the State which has created it. Under this point of view, the fact whether SWF are performing governmental tasks or commercial acts is irrelevant, because, as it is made clear in the commentaries, the conduct of an organ of a State is always attributable to the State, irrespective of the nature of such a conduct.[38] In this case the investment dispute between a foreign SWF and the host State could hardly be qualified as an investor-State dispute for the purposes of the applicability of art. 25 of the ICSID Convention.

Secondly, even if a State doesn't define a certain entity or body as an organ of its, this does not allow to automatically exclude that such body is not an organ of that State for the purposes of the rules on State attribution. The application of the functional test could in fact lead to the conclusion that a SWF could be regarded as an organ of the State which has created it, also in the absence of a formal qualification of SWF as organ of the State under the municipal law of the latter.

The main issue to be addressed when applying the functional test to those SWFs which by their structure and organisation could not be immediately identified as State organs, consists in answering to the following question: are SWFs empowered by the

[38] ibid. p. 41. See also: C. CHINKIN; cit.; p. 388.
It must be remarked that the issue as to whether the act of a State organ has a governmental or nongovernmental character is on the contrary relevant for the purposes of the assessment of State immunity. However, it is important not to confuse the issue of State immunity and that of State responsibility. In fact, an agency of the government which performs a nongovernmental activity shall determine the responsibility of the State (because in this case what matters is the nature of the organ) but at the same time it will not enjoy immunity (because under this point of view what matters is the nature of the act which is performed). The issue of governmental and nongovernmental acts in relation to the issue of State immunity will be the object of detailed analysis *infra* in chapter 5. See also: J. CRAWFORD; cit.; p. 440.

States which create them to perform functions pertaining to the exercise of the governmental authority?

If we consider the reason why SWFs are created by a State, and the function they perform in the economy of the home State, it can be argued that they essentially perform governmental tasks. In fact, both forex and commodity funds play a governmental function, since they are tools used by States to pursue their macroeconomic policies. With respect to forex funds, they are a tool for the management of official reserves and their creation can be regarded as an integral part of the conduct of the monetary policy of a State. No one doubts that the exclusive management of the monetary policy by the State is a fundamental feature of its sovereignty and for this reason it can be concluded that forex SWFs perform in the home State important governmental tasks and, under the functional test described above, their act should entail the responsibility of the State which owns them.

With respect to commodity funds, it must be reminded that they are created in States rich in natural resources and whose economy is heavily dependent on the proceeds from the sale of such resources; therefore the proper management of the revenues obtained from the exploitation of such natural resources, since it can help to pursue the goals of inter-generational saving and price and revenue stabilization, is a governmental task.

On the other side, it could be argued that, if the focus of this analysis is shifted from the function of SWFs in the economy of the home State to the nature of their operations in the host State, it is possible to reach very different conclusions. In this case the activity of SWs is very similar to the one carried out by non-State institutional portfolio investors, like pension funds or mutual funds and its governmental character could be questioned.[39]. However, for the purposes of the analysis of the issue of State attribution and State responsibility it seems that the

[39] S. KERN; *SWF's and foreign investment policies - an update*; cit; p.6-17; N. FERNANDES; *Sovereign Wealth Funds: Investment Choices and Implications around the World*; IMD working paper series; 2009; p. 11-20; P. ROSE; *Sovereign Wealth Funds: Active or Passive Investors*?; in *The Yale Law Journal pocket part*; 2008; p. 104-108.

focus should be on the macroeconomic functions SWFs perform in the State which establish them and not on the nature of those operations through which SWF accomplish such tasks. It follows that SWFs should be regarded as performing governmental tasks, although they could often achieve their goals through acts, consisting in financial transactions, whose nature is commercial rather than governmental. A more in-depth analysis of the governmental or commercial character of the activities performed by SWFs will be carried out in the following chapter, especially in paragraphs 4 to 6, in relation to the issue of State immunity. It can be anticipated that in that context the elements which will be taken into consideration will be different from those which have been considered in the present chapter and the conclusions reached will significantly differ too.

A last point deserves to be mentioned. According to article 8 of the draft articles, if a person or a group of persons is in fact acting on the instructions of, or under the direction or control of, a State, the conduct of such person or group of persons shall be considered as a conduct of a State. The commentaries to the Draft Articles specifies, although, it seems, incidentally, that the terms "person" and "group of persons" can be construed in a broad way, thus including "group lacking separate legal personality but acting on a de facto basis" as well as legal entities like corporations.[40] The term investment fund or investment vehicle is not explicitly used, however it seems clear that a SWF which is not a State organ for the purposes of draft article 4 would fall within the notion of "legal entity" under the commentaries and therefore of "person" under draft article 8. Draft art. 8 seems consistent with customary international law, whose content, on the issue of State responsibility, has been declared in some judgements of the International Court of Justice. However, it is difficult to determine in practice the degree of control by a State over a person or a group of persons which is needed in order to assess whether the conduct of such person or group of persons is attributable to that State.[41] In my opinion this criterion should be used in order to assess whether the conduct of a SWF should be attributed

[40] *Draft articles on Responsibility of States for Internationally Wrongful Acts*; cit.; p. 49.
[41] *Draft articles on Responsibility of States for Internationally Wrongful Acts*, cit.; p. 47-48.

to a State in a very residual way. In fact the structural and functional tests developed in ICSID case law, duly integrated by customary international law on State responsibility as detailed by the draft articles 4 and 5 and their commentaries, should prove sufficient. In addition determining the actual extent to which a State control and direct its SWF can prove very difficult, especially in the case of those SWFs which are not transparent.

From the discussion undertaken it seems to emerge that the conduct of a SWF should be regarded as tantamount to the conduct of the same State which has created it, also when the SWF is established as a formally independent entity.[42] It follows that SWF should be regarded as States and therefore disputes between a SWF and a foreign State in which it invests should fall within the notion of interstate disputes.

For the above mentioned reasons international arbitration administered by the ICSID is not the most suitable jurisdiction to settle disputes between a foreign SWF, on one side, and the host State on the other. In case such a dispute arises, it could occur that if a BIT confers jurisdictions to an ICSID tribunal in relation to a dispute between a State and a foreign SWF, the ICSID tribunal will decline jurisdiction because of art. 25 of the ICSID Convention, as interpreted consistently with the principles of public international law on State responsibility and with the principles developed in the awards which has been analysed in this paragraph. It follows that *ad hoc* arbitration could prove a more flexible and appropriate instrument than ICSID arbitration, which remains definitely better equipped to deal with disputes not concerning SWFs.[43]

On this aspect, it must be remarked that relevant BITs should provide, as means of settlement of investor-State disputes, also *ad hoc* arbitration and not only ICSID

[42] Such a conclusion is supported by some authors, who has developed a different reasoning. See, for instance: L. C. BACKER; *Sovereign Investing in Times of Crisis*; cit.; p. 5-144 and in particular p.141-142.

[43] It should not be forgotten that when the ICSID Convention was drafted and ratified, investments undertaken overseas by SWFs were meaningless and in general foreign investments of State-owned entities were rarer than they are today. Actually, the main purpose of the Convention was to establish an effective legal framework for the settlement of disputes between foreign investors which mainly were privately-owned corporations originating in developed countries and host States which often were developing countries.

arbitration. Unfortunately, this does not always occur and this could give rise to some uncertainties. For instance, art. 10 of the BIT concluded between Belgium and Saudi Arabia provides in case of State-investor disputes recourse to Courts of the host State or recourse to ICSID arbitration. While the latter, for the reasons investigated above could be unfeasible, also the recourse to domestic Courts of the host State rises two kind of problems. The first one is related to the issue of State immunity, of which a SWF could be entitled. It could be argued that once a SWF starts a legal proceeding before a national Court, waiver of sovereign immunity from foreign jurisdiction is implied. However, if the SWF does not declare to waive its sovereign immunity also with respect to enforcement measures, a judgement of the host State in which the SWF results to be the losing party risks to remain unenforced.[44]

The second problem is more practical than strictly legalistic in character. As international arbitration has been developed in order to give the possibility to foreign investors to have their disputes with the host State settled not by a Court of the same State but by another jurisdiction which is regarded as more independent and less sensible to the interests of the host State, it is unlikely that a foreign investor, who is also a body of the State, might find recourse to the domestic Courts of the host State with which it is in a dispute, more attractive than international arbitration.[45] This statements seem to be contradicted by the recent decision of the Norwegian SWF to sue the big US financial institution Citigroup before the judge of New York, for an alleged violation of the disclosure duties which resulted in severe losses suffered by the sovereign investor of Norway[46]. However it must be remarked that this is a dispute a SWF has entered into not with the host country, but with another private-sector company. Had the dispute been between the SWF and the host State and had

[44] On this issue see *infra* chapter 5

[45] UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 347-380; P. BERNARDINI *L'arbitrato nel commercio e negli investimenti internazionali*; cit.; p. 273-291; G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 412-454; L. MALINTOPPI, A. REINISCH; cit.; p. 691-720; C. SCHREUER; cit.; p .830-867; J.J. VAN HAERSOLTE-VAN HOF; A. K. HOFFMANN; cit.; p. 962-1007.

[46] Few information on this issue are so far available. See, for instance: The Economic Time; September 26th; available online at: http://economictimes.indiatimes.com/news/international-business/Norways-central-bank-sues-Citigroup-Report/articleshow/6630369.cms

the SWF been given by applicable investment agreements the possibility to refer it to international arbitration, it seems more likely that arbitration would have been the preferred mean of dispute settlement.

Coming back to the above mentioned problems related to the arbitration clause contained in the BIT between Saudi Arabia and Belgium, there is therefore the risk that in case of a hypothetical dispute between a Saudi SWF and Belgium, none of the means of settlement of investor-State dispute provided at art. 10 could prove really effective. In this case, the only available solution would consist in the application of art. 9 of the same BIT, which lays down a mechanism for the solution of interstate disputes and which provides for settlement though diplomatic means, through the institution of a Commission or, failing these attempts, through interstate *ad-hoc* arbitration. The BIT provides some guidelines as to the procedures to be followed for the establishment of the arbitral tribunal and for the organisation of the proceedings. In any case recourse to art. 9 would *de facto* imply the determination of the dispute between the Saudi SWF and Belgium as an interstate dispute.

It must be argued that other BITs do not rise such problems. For instance the BIT concluded between Italy and the Russian Federation provides at art. 9 that investor-State disputes shall be submitted either to domestic Courts of the host State, or to international *ad hoc* arbitration consistently with UNCITRAL rules of procedures.[47] In this way a dispute between the Italian republic, on one side, and a Russian SWF investing in Italy, on the other side, could be settled as an investor-State dispute. In other words, the arbitral tribunal will not be prevented by art. 25 of the ICSID Convention (which shall not apply) from refusing to adjudicate because of lack of competence. This argument seems to be confirmed by the fact that in recent times several cases concerning investment disputes between States and foreign State

[47] UNCITRAL rules have been adopted by the United Nations Commission on International Trade Law in 1976 and they have been frequently updated in the following decades. They can be adopted both in investor-State arbitration as well as in arbitration proceedings to which two private entities are parties. Furthermore, UNCITRAL rules may be used in *ad hoc* arbitration or in institutionalised non-ICSID arbitration.

owned enterprises have been settled by means of *ad hoc* commercial arbitration under the UNCITRAL rules.[48]

However, also in this case the suitability of the recourse to international commercial arbitration can be questioned. In fact, if, consistently with the reasoning developed in the previous chapters, SWFs are regarded as tantamount to States rather than as investors, then inter-States arbitration might remain the preferable option.

Further elements seem to support such approach. When a SWF is created as a pool of assets which is controlled, and not legally separate from, the government, the ministry of treasury or the Central Bank, and when a dispute arises between such SWF and the host State, the subjects which would participate to the arbitral proceedings will be the government of the host State and the owner and manager of the foreign SWF, i. e. the government (or possibly the Central Bank) of the State of the SWFs. In this case it is clear that the arbitration at issue should be an inter-State arbitration.

The situation may be more blurred in case of SWFs which have a separate legal personality from the government and in particular when they are created as companies, and subjected, in principle, to company law of the home State. However, in many cases some of the persons responsible for the management of such SWFs are also empowered by municipal law to hold offices at the highest level of the government or at the Central Bank. Moreover, it may occur that the municipal law of the home State empowers certain offices or departments of the Government or of the Central Bank to direct the activity of the SWF and to represent it in case of transnational legal disputes.

Finally, as a decisive argument, it must be stressed that, since the home State of the SWF is the beneficiary and the owner of the wealth under the management of the SWF itself, then a conduct of the host State adversely affecting the SWF, would

[48] See: M. D. NOLAN, F. G. SOURGENS; *State-controlled entities as claimants in international investment arbitration: an early assessment;* Columbia FDI Perspectives, No. 32, December 2, 2010; p. 1. However, it must be remarked that the discussion developed in the article does not necessarily apply to SWFs, because the latter ones should be distinguished from State owned enterprises (see, *supra*, chapter 1 paragraph 1.). Therefore, the disputes between host States and foreign SOEs might have a different nature than disputes between host States and foreign SWFs.

necessarily affect the ultimate owner of the wealth under the management of the SWF, i. e. the State which owns the SWF.

In the above mentioned cases it is likely that the dispute between a SWF and the host state would end up being a dispute between the host State and the State which owns and definitely manages the SWF at issue.

The clauses contained in BITs which specify the circumstances in which inter-State arbitration is available are worded in very broad terms. For instance art. 9 of the BIT concluded by Hungary and China[49] provides that: "disputes between the Contracting States concerning *the interpretation or application* of this Agreement shall, as far as possible, be settled by consultation through diplomatic channel" [emphasis added]. However, it adds in paragraph 2, "[i]f a dispute cannot thus be settled within six months, it shall, upon request of either Contracting State, be submitted to an *ad hoc* arbitral tribunal."

The following paragraphs of art. 9 then lay down some rules concerning the organization of the arbitral tribunal, the number of arbitrators and their appointment, as well as the conduct of the arbitral proceedings. In any case, what needs to be underlined is that this clause never refers to a competence of ICSID, since tribunals organised under this international organisation cannot settle disputes between two States.

Inter-State arbitration clauses are worded in very similar terms in most BITs.

For instance, art. 10 of the Italy-Kazakhstan BIT reads as follows.

"1. Le controversie che dovessero insorgere tra le Parti Contraenti sull'interpretazione e l'applicazione del presente Accordo dovranno essere, per quanto possibile, amichevolmente composte per via diplomatica.

2. Nel caso in cui tali controversie non possano essere composte entro i sei mesi successivi alla data in cui una delle Parti Contraenti ne abbia fatto richiesta scritta all'altra Parte Contraente, esse verranno, su iniziativa di una delle parti Contraenti,

[49] China's prime minister has recently declared that China is considering buying relevant amounts of Hungarian Bonds. It can be expected that such investment may be carried out also through Chinese SWFs and that it will be covered by the above mentioned BIT between Hungary and China.

sottoposta ad un Tribunale Arbitrale ad hoc in conformità alle disposizioni del presente Articolo.[...]"

The article then lays down some rules concerning the way the *ad hoc* arbitral tribunal shall be organised.

Also art. 14 of the France-Kuwait BIT is worded in very similar terms, since it provides that:

"1. Les différends relatifs à l'interprétation ou à l'application du présent accord doivent être réglé, si possible, par la voie diplomatique.

2. Si, dans un délai de six mois à partir du moment où il a été soulevé par l'un ou l'autre des Etats contractants, le différend n'est pas réglé, il est soumis, à la demande de l'un ou de l'autre Etat contractant, à un tribunal d'arbitrage."

Therefore, even though the inter-State arbitration clause does not explicitly provides for a competence of arbitral tribunals over disputes concerning investments undertaken by a *State* (although acting as an investor) in the territory of another State, the broad formulation of the arbitration clause should allow to cover also this particular issue.

Finally, it could be argued that, given the particular nature of SWFs and the political implications of their investments, and even more of the host-State measures applicable to them, inter-State arbitration could prove a more suitable instrument for the settlement of disputes between SWFs and host States.

However it is not for sure that the complex legal problems which have been analysed so far will always rise in practice. In fact, one could reasonably expect that disputes between foreign SWFs and host States might be settled not by judiciary, but by political and diplomatic means, given the undeniable political issues that the investment activity undertaken by state-owned investment vehicles might rise. Nonetheless, applicable provisions of BITs could serve as a useful basis for such political and diplomatic attempts to settle the potential disputes at issue. In other words, the relevant BIT provisions will not need to be applied by a tribunal, but would provide an useful element to diplomacy and politics to solve disputes amicably and in a manner consistent with international law.[50]

3. The operations of SWFs as covered investments

The large majority of investments undertaken so far by SWFs are portfolio investments[51] (also called financial investments), which, differently from foreign direct investments (FDIs), consist in the acquisition of non-controlling shares of foreign companies, as well in the purchase of bonds and of other debt instruments issued by companies or sovereign entities. It is therefore necessary to analyze whether this kind of operations is considered as covered investment according to BITs.

Most BITs adopt a broad definition of investment, often accompanied by an illustrative, non-exhaustive list.[52] Such list often includes shares, bonds and other financial instruments, which are the assets purchased by SWFs when they usually invest abroad. For instance, the BIT between Italy and Saudi Arabia provides at art. 1 that: "con il termine "investimento" si intende ogni bene posseduto o controllato da un investitore di una Parte contraente nel territorio dell'altra Parte Contraente, in conformità alla sua legislazione ed in particolare, ma non esclusivamente, include: [...] b) azioni, obbligazioni e titoli di società ed altri tipi di diritti o interessi in imprese, nonché titoli emessi da una Parte contraente o da qualunque dei suoi investitori[...]". Likewise, the BIT between Switzerland and Saudi Arabia (art. 1) provides that: "Le terme «investissement» désigne toutes les catégories d’avoirs et droits afférents selon le droit applicable, et inclut en particulier, mais non exclusivement: [...] (b) les actions, participations et obligations de sociétés, et tout autre droit ou intérêt dans

[50] For the role of international law in the conduct of diplomatic relations see: B. CONFORTI; *Diritto internazionale*; cit.; p. 10.

[51] See *supra*, chapter 1, paragraph 3. See also: S. KERN; *SWF’s and foreign investment policies - an update*; cit; p. 6-17; N. FERNANDES; cit.; p. 11-20; P. ROSE; *Sovereign Wealth Funds: Active or Passive Investors*?; cit.; p. 104-108.

[52] For a more detailed analysis of this point see: E. SCHLEMMER; cit.; p. 55-62; G. CARDUCCI; *Defining investment in public and private international law and the scope of ICSID, NAFTA and Energy Charter Treaty investment arbitration*; in: A. LIGUSTRO AND G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 649-652.

des sociétés, ainsi que les titres publics émis par une Partie Contractante ou l’une de ses entités; [...]" The BIT concluded between Switzerland and Kuwait uses very similar words, when it provides at art. 1 that "Le terme «investissement» englobe toutes les catégories de biens matériels ou immatériels sur le territoire d’un Etat contractant qui sont détenus ou contrôlés, directement ou indirectement, par un investisseur de l’autre Etat contractant, et en particulier, mais pas exclusivement: [...] (b) les parts de capital, actions, titres d’emprunt de sociétés ou toutes autres formes de participation aux sociétés, ainsi que les titres émis par un Etat contractant ou par l’un de ses investisseurs". The BIT between China and Singapore provides that "the term “investment ” means every kind of asset permitted by each Contracting Party in accordance with its laws and regulations, including, though not exclusively, any [...] (b) share, stock, debenture and similar interests in companies; [...]"

Therefore, from the wording of the agreements reviewed so far, it is evident that portfolio investments undertaken by SWFs are covered investments under BITs.[53]

However, some more difficulties may arise if a dispute between an investor and the host State is brought before an ICSID tribunal, which is mandated to apply not only the BIT but also the ICSID Convention. In fact, it could be argued that the existence in a BIT of a clause providing that disputes concerning alleged breaches of the BIT itself shall be submitted to ICSID tribunals is not sufficient to make ICSID tribunals competent. The requirements laid down at art. 25 of the ICSID Convention must be respected too. The difficulties in this context are similar to those which have been discussed in the previous paragraph in relation to the discussion of the notion of covered investor both under the BIT and under the Washington Convention. While in

[53] For sake of completeness it must be reminded that a few BITs adopt a different approach. For instance, the BIT between Denmark and Poland is applicable to FDIs only, thus excluding portfolio investments. It fact it provides, in article 1 (1) (b), that the term “investment” shall refer “to all investments in companies made for the purpose of establishing lasting economic relations between the investor and the company and giving the investor the possibility of exercising significant influence on the management of the company concerned.” On the contrary, art. 1139 of the NAFTA agreement does not restrict its scope *ratione materiae* to FDIs, but it however excludes some portfolio investments, especially those which concern debt securities whose maturity is lower than three years and which are purchased by entities other than the parent company of the invested company. On the notion of investment in the NAFTA see: G. CARDUCCI; cit.; p. 663-667.

that paragraph it was discussed whether the ICSID Tribunals were competent *ratione personae*, in this paragraph it will be seen whether they have jurisdiction *ratione materiae*.

Art. 25 provides that "the jurisdiction of the Centre shall extend to any legal dispute arising directly out of an *investment* (emphasis added) [...]". This implies that if the dispute submitted to the arbitral tribunal is related to an economic operation other than an investment, the tribunal should declare that it has no jurisdiction. In must be stressed that ICSID convention does not provide for an autonomous definition of "investment". In addition, paragraph 4 of art. 25 provides that "any Contracting State may, at the time of ratification, acceptance or approval of this Convention or at any time thereafter, notify the Centre of the class or classes of disputes which it would or would not consider submitting to the jurisdiction of the Centre". This empowers States to decide, *inter alia*, to exclude certain transaction from the notion of investment for the purposes of the ICSID Convention.[54]

The lack of a definition of investment in the wording of the ICSID Convention could bring to two (opposite) conclusions. On one side, it could be argued that this entails that the definition of "investment" should exclusively depend on the consent of the parties, as it has been expressed in the BIT itself (subjective theory). On the other side, it can be argued that arbitrators have the right (and the duty) to interpret art. 25 consistently with the objective and the spirit of the ICSID Convention and to decide, even beyond the definitions contained in the BIT they are required to apply, what must be regarded as a covered investment (objective theory).[55]

The first solution has been endorsed, *inter alia*, in the Fedax case.[56] In the proceedings on jurisdiction the defendant argued that the dispute concerned

[54] J. LONCLE; *La notion d'investissement dans les décisions du CIRDI*; in *International Business Law Journal*; 2006; p. 319-321

[55] W. BEN HAMIDA; *Two neboulous ICSID Features: the notion of investment and the scope of annulment control*; in *Journal of International Arbitration*; 2007; p. 288-291; G. CARDUCCI; p. 653-654.

[56] *Fedax N.V. v. Republic of Venezuela*; ICSID Case No. ARB/96/3; Decision on Objections to Jurisdiction of 11 July 1997. Text of the award available in; ILM 37 (1998); p. 1378. See also: F. HORCHANI; *Le droit international des investissements à l'heure de la mondialisation*; in *Journal du Droit International (Clunet)*; 2004; p. 377-380.

promissory notes issued by the Government of Venezuela and owned by Fedax, which was a company incorporated in the Netherlands Antilles. In the view of the respondent this could not qualify as an investment under art. 25 of the ICSID Convention and for this reason it argued that ICSID Tribunal was not competent.[57] The Tribunal in that occasion outlined a brief history of the ICSID Convention and it underlined that the decision not to include a definition of investment in its text ensured a high degree of flexibility and discretion of States to determine by themselves what the term investment shall mean.[58] The Tribunal also observed that art. 25 cannot be construed so that to cover foreign direct investment only. In particular, it argued that when art. 25 refers to "dispute arising directly out of an investment", it was clear that "the term 'directly' relates in this article to the 'dispute' and not to the 'investment'". Therefore, the Tribunal concluded that "jurisdiction can exist even in respect of investments that are not direct."[59] Then, the Tribunal carried out an analysis of several international instruments applicable to investments, pointing out that the notion of investment they usually endorse is broad enough to include direct and portfolio investments both. Finally it focused on the BIT in force between the Netherlands and Venezuela, which included also debt instruments and therefore promissory notes in the notion of covered investment. In conclusion, the Tribunal relied on the definition of investment contained in the BIT, which, in its view, could not be regarded as inconsistent with the notion of investment of the ICSID Convention.[60]

The above mentioned approach was confirmed in the Mihaly case, where the Tribunal argued that: "the jurisdiction of the Centre, and consequently of the Tribunal established thereunder, is based on the consent of the Parties to the dispute that have previously agreed to submit the dispute in question to the jurisdiction of ICSID

[57] *Fedax N.V. v. Republic of Venezuela*; cit.; par. 1 and par. 18.
[58] *Fedax N.V. v. Republic of Venezuela*; par. 21-23.
[59] *Fedax N.V. v. Republic of Venezuela*; par 24.
[60] *Fedax N.V. v. Republic of Venezuela*; par. 30-40.

and this Tribunal" [61] In the case at issue the claimant's argument that pre-investment expenditures could qualify as covered investments was dismissed on the ground that it was not possible to assess the existence of a consent of the parties, which should have been expressed *in primis* in the BIT, to include them in the notion of investment.[62]

However, ICSID Tribunals have more often tried to interpret art. 25 of the ICSID Convention in order to develop a notion of covered investment which, while taking into consideration (in different measure, according to the different cases) the wording of applicable BITs, on the other side does not entirely rely on it and it is partially independent from it. This approach would pay more attention to the spirit and to the objectives of the ICSID Convention. In other words, the Tribunal have often found it necessary to adopt a double barrel approach, according to which disputes between a foreign investor and the host State concerning the alleged violation of BITs, could be settled by mean of ICSID arbitration only if they concern an economic operation which can be defined as in investment both under the applicable BIT and under art. 25 of the Washington Convention.[63]

A review of the cases in which ICSID tribunals were required to decide whether a transaction could be defined as an investment allows to find out the following criteria. The investment must entail the establishment of a long lasting economic relations, it must entail a certain level of risk for the investor in the sense that the risk should be shared by the host State and the investor), it must consist in a substantial

[61] *Mihaly International Corporation v. Democratic Socialist Republic of Sri Lanka*; ICSID Case No. ARB/00/2; Award of 15 March 2002; par. 55. See also: F. HORCHANI; p. 379-381.

[62] *Mihaly International Corporation v. Democratic Socialist Republic of Sri Lanka*; cit.; par. 56-62.

[63] This concept is expressed very clearly inter alia in: *Malaysian Historical Salvors, SDN, BHD v. Malaysia*; ICSID Case No. ARB/05/10; Decision on Jurisdiction of 17 May 2007; par. 55. It specifies that: "[u]nder the double-barrelled test, a finding that the Contract satisfied the definition of "investment" under the BIT would not be sufficient for this Tribunal to assume jurisdiction, if the Contract failed to satisfy the objective criterion of an "investment" within the meaning of Article 25." The Tribunal, in that occasion, largely relied on: *Joy Mining Machinery Limited v. Egypt*, ICSID Case No. ARB/03/11; Award on Jurisdiction of 30 July 2004; par. 50, which reads as follows. "The parties to a dispute cannot by contract or treaty define as investment, for the purpose of ICSID jurisdiction, something which does not satisfy the objective requirements of Article 25 of the Convention. Otherwise Article 25 and its reliance on the concept of investment, even if not specifically defined, would be turned into a meaningless provision."

contribution, and the operation should be significant for the development of the host State.[64]

It is not possible to review all the awards concerning this issue and therefore only a few examples could be quoted to support such findings.

In the Salini case the Tribunal argued that it would have been "inaccurate to consider that the requirement that a dispute be 'in direct relation to an investment' is diluted by the consent of the Contracting Parties". It then added that "investment requirement must be respected as an objective condition of the jurisdiction of the Centre". Therefore, the Tribunal concluded that "investment infers: contributions, a certain duration of performance of the contract and a participation in the risks of the transaction". It also declared that "reading the Convention's preamble, one may add the contribution to the economic development of the host State of the investment as an additional condition."[65]

The Saipem case[66], which concerned a gas pipeline project of an Italian investor in Bangladesh confirmed the approach adopted in the above mentioned Salini case. In that occasion, in fact, the Tribunal declared that: "[t]o determine whether Saipem has made an investment within the meaning of Article 25 of the ICSID Convention, the Tribunal will apply the well-known criteria developed by ICSID tribunals in similar cases, which are known as the “Salini test”. According to such test, the notion of investment implies the presence of the following elements: (a) a contribution of

[64] F. YALA; *The Notion of “Investment” in ICSID Case Law: A Drifting Jurisdictional Requirement? Some “Un-Conventional” Thoughts on Salini, SGS and Mihaly. A Drifting Jurisdictional Requirement?*; in *Journal of International Arbitration*; 2005; p. 105-125; and E. SCHLEMMER; cit.; p. 62-69; J. HO; *The meaning of "investment" in ICSID arbitration*; in *Arbitration International*; 2010; p. 633-647; J. LONCLE; cit.;p. 325-328; M. WAIBEL; *Opening Pandora's box: sovereign bonds in international arbitration*; in *The American Journal of international law*; 2007; p. 718-732; P. SALVATI; *Il criterio dello "sviluppo economico dello Stato ospite" come elemento della nozione di investimento: riflessioni a margine del caso Malaysian Historical Salvors v. Malaysia*; in *Diritto Comunitario e degli Scambi Internazionali*; 2010; p. 723-743; W. BEN HAMIDA; *Two neboulous ICSID Features*; cit.; p. 287-306.

[65] *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*; cit.; par. 52.

[66] *Saipem S.p.A. v. People's Republic of Bangladesh*; ICSID Case No. ARB/05/7; Decision on Jurisdiction and Recommendation on Provisional Measures of 21 March 2007.

money or other assets of economic value, (b) a certain duration, (c) an element of risk, and (d) a contribution to the host State’s development." [67]

In the Lesi and Astaldi case[68], the Tribunal argued that. "il paraît conforme à l’objectif auquel répond la Convention qu’un contrat, pour constituer un investissement au sens de la disposition, remplisse les trois conditions suivantes ; il faut

a) que le contractant ait effectué un apport dans le pays concerné,

b) que cet apport porte sur une certaine durée, et

c) qu’il comporte pour celui qui le fait un certain risque.".

However, the same Tribunal held that it was not strictly necessary that the investment "réponde en plus spécialement à la promotion économique du pays, une condition de toute façon difficile à établir et implicitement couverte par les trois éléments retenus."[69]

In the Malaysian Historical Salvors case [70], the ICSID Tribunal stressed the importance of the requirement that the foreign investment might provide an effective contribution to the development of the host State. To support this argument, the tribunal mainly relied on the wording of the preamble of the Washington Convention[71] as well as on the Report of the Executive Directors concerning such Convention[72]. The Tribunal followed "a teleological approach to the interpretation of the ICSID Convention", and this brought it to "interpret the word 'investment' so as to encourage, facilitate and to promote cross-border economic cooperation and development."[73] In the case at issue, the Tribunal had to assess whether the activity of the claimant consisting in the location and salvage of the cargo of a British vessel which sank in

[67] *Saipem S.p.A. v. People's Republic of Bangladesh*; cit.; par. 99.

[68] *LESI, S.p.A. and Astaldi, S.p.A. v. People's Democratic Republic of Algeria*; ICSID Case No. ARB/05/3; Decision on Jurisdiction of 12 July 2006.

[69] *LESI, S.p.A. and Astaldi, S.p.A. v. People's Democratic Republic of Algeria*, cit.; par. 72.

[70] *Malaysian Historical Salvors, SDN, BHD v. Malaysia*; cit.

[71] The preamble of the ICSID Convention starts with a reference to "the need for international cooperation for economic
development, and the role of private international investment therein"

[72] See par. 9 of such report, which stresses that the idea of ICSID was “prompted by the desire to strengthen the partnership between countries in the cause of economic development". These words are quoted in: *Malaysian Historical Salvors, SDN, BHD v. Malaysia*; cit.; par. 66.

[73] *Malaysian Historical Salvors, SDN, BHD v. Malaysia*; cit.; par. 65-68.

1817 could be regarded as an investment, but concluded that it could not. In fact, although this activity may have provided some benefits to Malaysia, however, such benefits would have not been so great to amount to a "significant contribution" to its economic development.[74]

This reasoning was nevertheless rejected by the annulment committee, which found that the Tribunal "failed to take account of and apply the" applicable BIT, when it defined the term "investment" in broad and encompassing terms. In fact, the Tribunal "rather limited itself to its analysis of criteria which it found to bear upon the interpretation of Article 25(1) of the ICSID Convention" and ultimately "elevated them to jurisdictional conditions" This brought it to exclude investments which did not provide relevant contribution to the economic development of the host State. The annulment Committee, in addition, ruled that the Tribunal in the Malaysian Historical Salvors case "failed to take account of the preparatory work of the ICSID Convention and, in particular, reached conclusions not consonant with the *travaux* in key respects". In fact, in the view of the annulment Committee, the drafters of the ICSID Convention decided to leave the term investment undefined and left the States contracting parties to BITs, free to determine the content of such notion. In particular, in the view of the Annulment Committee, drafters of the ICSID Convention, deliberately decided not to state that investments, in order to be regarded as such under the ICSID Convention, needed to reach certain threshold in relation to their size, duration and contribution to development.[75]

The award of the Annulment Committee in the Malaysian Historical Salvors seems to put in question the Salini test, since it strongly limits the ability of Tribunals to infer from the preamble of the ICSID Convention a definition of investment which must be inconsistent with that (usually broader in scope) provided for in the text of applicable BITs. However, it is difficult to conclude whether the award of the Annulment

[74] *Malaysian Historical Salvors, SDN, BHD v. Malaysia*; cit.; par. 113-146. For a comment on these issues see also: P. SALVATI; cit.; p. 724-727.

[75] *Malaysian Historical Salvors, SDN, BHD v. Malaysia*, ICSID Case No. ARB/05/10 (UK/Malaysia BIT).
-Decision on the Application for Annulment, 16 April 2009; par. 80; For a comment see: P. SALVATI; cit.; p. 728-730.

Committee in the Malaysian Historical Salvors case might supersede the Salini test or whether it will have a more limited relevance in future cases.

On the other side, in cannot be denied that the requirement of the existence of a significant contribution to economic development of the host State might create relevant interpretative problems in practise. In fact it is undeniable that it is difficult to establish decently clear and predictable criteria to determine which investment constitute a significant contribution to the development of the host State, and, therefore, which operation can be regarded as covered investment under the ICSID Convention. This would result in greater legal uncertainty and unpredictability. Therefore, it seemed much more reasonable the approach followed by the Annulment Committee in the Patrick Mitchell case.[76] It specified that "the existence of a contribution to the economic development of the host State as an essential – although not sufficient – characteristic or unquestionable criterion of the investment, does not mean that this contribution must always be sizable or successful; and, of course, ICSID tribunals do not have to evaluate the real contribution of the operation in question." It then added that, in order to be regarded as a covered investment under art. 25 ICSID Convention it is sufficient "for the operation to contribute in one way or another to the economic development of the host State, and this concept of economic development is, in any event, extremely broad but also variable depending on the case. "

So far, the focus have been on ICSID awards. However, it must be quickly noted that also non ICSID Tribunals have recently undertaken to apply the double barrel test approach. It could be argued that this could increase the consistency between ICSID and non ICSID awards concerning the notion of covered investment to be applied.[77] However, another problem should not be neglected. It has been stressed that, by

[76] *Patrick Mitchell v. Democratic Republic of the Congo*, ICSID Case No. ARB/99/7, Decision on the Application for Annulment of the Award of 1 November 2006. It must be added that the Annulment Committee in this case did follow in general the Salini test. For a comment see: W. BEN HAMIDA; *Two neboulous ICSID Features*; cit.; p. 291-300.

[77] For a discussion on this topic see: E. CABROL; *Pren Nreka v. Czech Republic and the notion of investment under bilateral investment treaties. Does "investment" really means "every kind of asset"*; in *Yearbook of international investment law and policy*; 2009-2010; p. 217-232.

applying the Salini test, arbitral tribunals partially derogate to the will of States as expressed in BITs as to the issue of the definition of investment. In case of ICSID tribunals, such derogation can been justified with the need to ensure the respect, not only of the applicable BITs but also of the ICSID Convention, which could be regarded as an expression of the will of States as well. Nevertheless, in non ICSID awards, like those which apply UNCITRAL rules, the ICSID Convention is clearly not applicable. Therefore, it should be very questionable to use criteria developed in the context of the interpretation of the ICSID Convention in arbitral procedures which, taking place before non-ICSID tribunals cannot apply the ICSID Convention.[78]

The definition of the investment for the purposes of art. 25 of the ICSID Convention which has been developed in doctrine and in the majority of ICSID case law, seems to be modelled on the notion of the FDI. However, this does not mean that portfolio investments should be excluded in any case from the scope of art. 25. The transactions which are more likely to be excluded from such notion of investment should be those speculative, short-term purchases of financial assets, which are expected to be sold after a short period of time (which in some cases may be a fraction of a second) with the aim of obtaining a capital gain.[79] On the contrary, portfolio investments which fulfil the requirements of the Salini test, as it has been illustrated in this paragraph, must fall within the notion of investment of art. 25.[80] For

[78] This argument is implicitly supported by the French Court of Appeal which was required to set aside the award. See: Court d'Appel de Paris; Pren Nreka v. Czech Republic,-Recours en Annulation, judgement of 25 Septembre 2008; p. 5

[79] In relation to the difficulties in qualifying trading in financial securities, especially when the latter are sovereign bonds, as investments covered by the Washington Convention see: M. WAIBEL; *Opening Pandora's box;* cit.; p. 718-732; P. GRIFFIN, A. FARREN; *How Icsid can protect sovereign bondholders*; in *International Financial Law Review*; 2005; p. 21-24.

[80] On this issue see for instance: *Československa Obchodní Banka, a.s. v. Slovak Republic*; cit.; par. 76-91. In that case debt instruments related to complex financial operations involving the parties to the dispute were regarded as falling within the notion of covered investment under both the applicable BIT and the ICSID Convention. It must be remarked that also in the above mentioned Fedax case debt instruments were regarded as covered investment, but in that case, as already explained, the Tribunal relied to a much greater extent on the wording of the applicable BIT, while reference to criteria similar to those mentioned in the Salini case was limited to a short discussion made at par. 43.

the purposes of the present analysis it is therefore necessary to assess whether the investments of SWFs may in general fulfil the requirements of the Salini test.[81]

It does not seem that the operations of SWFs share the features of short term, "hot money" investments. Therefore, they should be regarded as covered investments under art. 25 of the ICSID Convention even if they do not entail the control of the target company and even if they cannot be considered FDIs. A review of the peculiarities of the investments of SWFs, confirms these findings.

SWFs have so far undertaken long term investments. Their objectives, as they have been described above in the previous chapters, consist in supporting the conduct of the domestic monetary policy, in the macroeconomic stabilisation, in the intergenerational saving. SWFs aim at achieving these goals while pursuing long-term profitability of their investments, while short term profitability is not a the main objective. This necessarily affects the investment strategies adopted by SWFs and makes them different from other institutional investors, for instance certain mutual funds or especially hedge funds, whose transaction on the contrary could sometimes fall outside the notion of investment as specified above.[82]

The fulfilment of the requirement that the operations undertaken by SWFs entail a certain level of financial risk is out of doubt. In fact, many transactions undertaken by

[81] It must be remarked that, given recent developments in ICSID case law, the appropriateness of the Salini test seems to be increasingly questioned. Together to the awards quoted so far, a mention to another recent case must be made: *Abaclat and others (case formerly known as Giovanna Beccara and others) v. The Argentine Republic*; ICSID case No ARB/07/05; award on jurisdiction of 4 August 2011. The analysis as to whether the operation at issue could qualify as investment, and therefore as to whether the Tribunal had jurisdiction, has been developed in par. 343 to par. 371. For the purposes of the present discussion the focus should be on par. 364 where it is argued that the application of the Salini test "would be contradictory to the ICSID Convention‘s aim, which is to encourage private investment while giving the Parties the tools to further define what kind of investment they want to promote". Since the notion of investment covered by the BIT is sufficiently broad so as to cover also sovereign bonds, then art. 25 ICSID Convention should not be interpreted to preclude the applicability of the definition of investment contained in BITs as it was agreed by the parties. The Tribunal, in fact, argued that "the Salini criteria may be useful to further describe what characteristics contributions may or should have. They should, however, not serve to create a limit, which the Convention itself nor the Contracting Parties to a specific BIT intended to create" (Ibid. par. 364).

[82] In particular hedge funds (especially those involved in the so called high frequency trading) buy and sell financial assets thousands times in a few minutes. In this case it is clear that they are speculative, short term investments. For an overview on this issue see: P. ATHANASSIOU; *Hedge fund regulation in the European Union: current trends and future prospects*; Wolters Kluwer Law & business; 2009; F. LHABITANT; *Handbook of hedge funds*; Chichester; Wiley; 2006.

SWFs in the last years consisted in the purchase of shares of companies. As it is well known, investments in equity is risky, and it is undeniable that several SWFs investments have been even riskier if we take into account the period in which they were undertaken (the economic crisis which started in late 2007) and the sectors which have been particularly targeted (the financial one). The large losses (actually, in most cases paper losses) SWFs have suffered from many investments undertaken between 2007 and 2009 provide further evidence of the riskiness on their operations.[83] Also the purchase of bonds and other debt instruments, although less risky than the investment in equity seems to be sufficiently risky for the purposes of the present discussion.

With respect to the requirement of the substantial contribution, the volumes of the transactions of SWFs clearly show that, although the stakes acquired by SWFs in big foreign companies in most cases do not allow to seize control of them, however they represent a very relevant contribution of capital both in absolute and relative terms. The main SWFs operation involve volumes of hundreds or thousands millions USD, corresponding to stakes of more than 1% and up to 9-10% of the target company.[84]

Finally, with respect to the issue of the contribution to the development of the host State, it must be preliminary argued that such requirement can be explained taking into account the pattern traditionally followed by transnational investments in the past and in particular in the period in which the ICSID Convention was drafted. In that time, investments were mostly undertaken by privately-owned corporations, based in developed countries, towards developing economies. Therefore it was though that

[83] For instance, the share in UBS purchased by the Government of Singapore Investment Corporation (GIC) in February 2008 lost 69,87% of its value in about one year, determining a paper loss of more than 10 billion USD. The investment of the Abu Dhabi Investment Authority in Citigroup Inc. undertaken in November 2007 proved even riskier, as in about one year and an half a paper loss of 90.87% was reported.
For a more exhaustive review of the losses suffered by SWFs by 2009 see: W.MIRACKY; B. BORTOLOTTI; ed.; *Weathering the Storm: Sovereign Wealth Funds in the global economic crisis of 2008*; FEEM; 2009; p. 53-58

[84] The biggest deals of SWFs (included those determining the control of the SWF on the invested companies and therefore falling within the category of FDIs) are reported in W.MIRACKY; B. BORTOLOTTI; ed.; *Weathering the Storm: Sovereign Wealth Funds in the global economic crisis of 2008*; cit.; p. 69.

such investments deserved protection and support (and the availability of an effective system for the settlement of State-investor disputes provided by the ICSID must be regarded as a form of support to transnational investments) as far as they not only benefited the foreign investor, but also contributed to the development of the host State.

SWFs operations hardly fit into this conceptual framework, as they originate from State entities often based in emerging economies and as they are directed towards firms established in developed countries. However, if we consider the concept of the development of the host State not in the narrow sense of support to the development of a developing countries, (for instance by means of building basic infrastructures and technology transferring) but more broadly as a support for economic stability and growth of a State, in this case the operation of the SWFs could easily fulfil such criteria. In fact the investments of SWFs, especially during the recent economic crisis have helped to recapitalise western countries companies (and especially banks) which were severely hit by the credit crunch and have contributed to avoid an even worse downturn of the economies of the recipient States.

Finally, it must be remarked that, as it has been pointed out in chapter 1, SWFs have recently increase the volume of their investments towards developing countries. Some of them, for instance the Temasek Holdings of Singapore, in their mission explicitly include the support of the economy and the enhancement of the development of the States where they carry out their investments. In these cases, the requirement of the contribution to the economic development of the host State is fulfilled even more clearly.[85]

The discussion undertaken so far allows to conclude that the operations of SWFs should be regarded as investments both under the BITs and under the ICSID Convention as interpreted by ICSID tribunals.

[85] The possibility that SWFs through their investments may constitute an important tool for the development of the host State has been explored, *inter alia*, in P. J. KEENAN; *The human rights potential of sovereign wealth funds*; cit.; p. 1151-1180.

However it must be reminded that, as explained in the previous paragraph, ICSID tribunals could not be the most suitable forum for the settlement of disputes between foreign SWFs and host States. Therefore it is advisable that such disputes be settled by *ad-hoc* arbitral tribunal, which, inter alia, shall rely for the definition of covered investment exclusively on the wording of applicable BITs. In this way, there will not be the need for such arbitral tribunal to undertake the reasoning carried out above in order to assess the applicability to portfolio operations undertaken by SWFs of the ICSID Convention as interpreted by several ICSID tribunals.

4. The issue of the admission of the investments of SWFS

After having studied that in principle BITs do not exclude neither SWFs from the notion of covered investors nor SWFs' most frequent transactions from the notion of covered investments, the issue of admission or establishment[86] of the investment of SWFs must be addressed. It must be reminded that the majority of the investments undertaken by SWFs are portfolio investments. This means that admission or establishment of such investments actually consists in the possibility to purchase certain financial securities issued by entities located in the host State or by the host State itself, in case for instance of an investment in sovereign bonds.

In many BITs the transnational investments covered are defined as those undertaken by an investor originating from one of the contracting party *into the territory* of the other contracting party.[87] For instance, according to art. 1 of the BIT between Italy and Saudi Arabia: "con il termine 'investimento' si intende ogni bene posseduto o

[86] Some authors tend to distinguish between admission and establishment, as the former would related to short term operations, while the latter to longer term commitments, also involving a commercial presence. For a discussion of this topic see: I. GÒMEZ PALACIO, P. MUCHLINSKI; *Admission and establishment*; in P. MUCHLINSKI, F. ORTINO, FEDERICO and C. SCHREUER, ed.; *The Oxford handbook of international investment law*; Oxford; Oxford University Press; 2008; p. 229-232. Since most investments of SWFs consist in the purchase of minority stakes in listed firms, and not in the establishment of commercial activities through green-field or brown-field FDI, it seems that, when talking abaout the investments of SWF the term admission should be more appropriate than the term establishment.

[87] C. KNAHR; *Investments "in the territory" of the host State*; in VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford : Oxford UP, 2009; p. 42- 43.

controllato da un investitore di una Parte contraente *nel territorio dell'altra Parte Contraente*" [emphasis added]. Likewise, art. 2,1 of the BIT between Kazakhstan and the United Kingdom provides that: "[e]ach Contracting Party shall encourage and create favourable conditions for nationals or companies of the other Contracting Party to invest capital *in its territory* [...]" [emphasis added]. Art. 1 of the BIT concluded between Belgium and Kuwait specifies that "[l]e terme 'investissements' désigne tout élément d'actif ou tout droit quelconque détenu ou contrôlé directement ou indirectement par un investisseur de l'une des Parties Contractantes *sur le territoire de l'autre Partie contractante*".

If the notion of "investment in the territory of the other Contracting Party" is construed in a way to require a physical transfer of capitals from the territory of the home State into the territory of the host State, then all those portfolio investments which consist in the purchase of financial assets issued and traded outside the territory of the host State would be excluded from the notion of investment covered in such BITs. As a result, the applicability of BITs to portfolio investments would be significantly reduced, and this would be contrary to the wording of BITs and to the practice of arbitral Tribunals to consider, in the majority of the cases, portfolio investments as covered investments.

Recent developments in the field of financial investments include the faster circulation of financial assets worldwide, as well as their increased complexity and dematerialization. This inevitably underlines the need to rethink the nature of the territorial nexus between them and the host State. In particular, the focus should not be on the existence of a physical transfer of capitals in the territory of the host State, but on the fact that capitals are made available to a company based in the host State (or to the host State itself, in case, for instance, of investments consisting in the purchase of sovereign bonds) irrespective of the physical place where such capitals are finally held.[88] For instance, if one of the SWF of Kuwait purchases bonds issued by a Belgian company and if such bonds are not directly purchased from the issuer

[88] C. KNAHR; cit.; p. 48- 53.

but by another investor in the secondary market (suppose, for instance, by a French investor operating in the Italian stock market), this transaction should be regarded as an investment covered by the BIT between Belgium and Kuwait. In fact, what matters is the fact that an investor from one of the contracting parties provides capitals which become available to an entity located in the other contracting party, irrespective of the physical place where capitals at issues are finally deposited.[89]

Such conclusions seem to be supported by some ICSID awards. For instance, in the Fedax case the Tribunal argued that while in "some kinds of investments" listed in the applicable BIT "such as the acquisition of interests in immovable property, companies and the like, a transfer of funds or value will be made into the territory of the host country, this does not necessarily happen in a number of other types of investments, particularly those of a financial nature". To the extent, the Tribunal underlined that: "it is a standard feature of many international financial transactions that the funds involved are not physically transferred to the territory of the beneficiary, but put at its disposal elsewhere." [90] Such an approach was endorsed in the CSOB case, when the Tribunal argued that: "while it is undisputed that CSOB's loan did not cause any funds to be moved or transferred from CSOB to the Slovak Collection Company in the territory of the Slovak Republic, a transaction can qualify as an investment even in the absence of a physical transfer of funds"[91]

The recent award Abaclat v. Argentina provides further insight of this issue since it deals with portfolio investments and, more precisely, with bonds issued by one contracting party to a BIT and purchased by investors of the other contracting party. The claimants, i. e. Italian bondholders, had purchased Argentinean bonds from financial intermediaries, which in turn purchased them from a syndicate of underwriters. Therefore, Italian bondholders did not directly make a contribution of capitals to Argentina. Argentina in fact received money from the underwriters, which were a group of international investment banks. For these reasons, the Tribunal was

[89] Finally, it could be argued that the dematerialization and the fast circulation of capitals makes it almost irrelevant to know the exact place where they are deposited.
[90] *Fedax N.V. v. Republic of Venezuela;* cit.; par. 41.
[91] *Československa Obchodní Banka, a.s. v. Slovak Republic*; cit.; par. 78.

required to assess whether the purchase of bonds issued by Argentina by Italian bondholders could qualify as an investment made by an Italian investor in Argentina and therefore as covered by the BIT between Italy and Argentina.[92] The Tribunal argued that the payment of a lump sum to Argentina by the underwriters and the purchase of bonds by bondholders are part of the same economic operation consisting in the issuance of bonds. In particular, "although the payment of the lump sum price for the bonds and the payment of the purchase price by the individual holders of security entitlements happened at different points in time, the latter constitutes the basis for the former". The tribunal added that: "the bonds and the security entitlements are part of one and the same economic operation and they make only sense together: Without the prior insurance to be able to collect sufficient funds from the individual purchasers of security entitlements, the underwriters would never have committed to the payment of the lump sum payment. In other words, the lump sum payment is an advance made by the underwriters to Argentina on the future payments of individual investors".[93]

This brings the tribunal to conclude that the operation at issue qualified as investment by Italian investors undertaken in Argentina since there was "no doubt that the funds generated through the bonds issuance process were ultimately made available to Argentina".[94]

Pursuant to the above mentioned analysis, when in the next pages reference is made to a foreign investment undertaken in the territory of the other contracting party, in case of portfolio investment this will actually mean that the foreign investment consists in the provision of capitals, made by a national of one contracting party, whose final beneficiary is an entity located into the territory of the other contracting

[92] For an analysis of the factual background of the dispute, and in particular of the issuance and distribution of Argentinean bonds, see: *Abaclat and others (case formerly known as Giovanna Beccara and others) c. The Argentine Republic*; cit.; par. 11-51.

[93] *Abaclat and others (case formerly known as Giovanna Beccara and others) c. The Argentine Republic*; cit.; par. 376.

[94] *Abaclat and others (case formerly known as Giovanna Beccara and others) c. The Argentine Republic*; cit.; par. 378.

party, irrespective of the fact that capitals have been physically directed into the territory of the host State itself.

Coming back to the issue of admission and establishment of foreign investments, it must be underlined that the majority of BITs do not contain provisions which create obligations upon the host State in relation to them. On the contrary, in many cases the provisions of BITs exclusively apply to the treatment of the investments after they have already been admitted in the territory of the host State. In other words, most BITs govern the so called post-entry phase, while very few of them contain rules applicable to the pre-entry phase.[95]

The distinction between those BITs which govern also the admission and establishment of foreign investments and those which exclusively refer to the post-admission treatment has a fundamental importance. In fact, in the latter case the discretion of the host State which has concluded a BIT would be limited exclusively with respect to the treatment it means to accord to those foreign SWFs it has previously (and discretionally) decided to admit, while the host State would remain free whether to accept a SWF to invest in its territory. In the first case, on the contrary, BITs may impose upon the host State an obligation to admit the investments of SWFs. This would result into a potential reduction of the ability of the host State to apply screening mechanisms to foreign SWFs in order to preserve its own ability to decide which ones it intends to accept and which ones it prefers not to admit.

The possibility of host States to retain, consistently with the BITs they have concluded, the right to decide whether to admit foreign investments, has a particular importance, given the actual or potential threats that SWFs pose to the national

[95] It must be also noted that States have traditionally reserved to themselves absolute rights with respect to the control of the admission and the establishment of aliens, including foreign investors, on their territory. Also customary international law does not impose any obligation with respect to such issue, while it provides some limits to the discretion of the host State when the latter deals with foreigners it admitted on its territory (although such "limits" in customary international law are far less detailed than those laid down in BITs). Although States have no obligations, deriving from customary international law, with respect to the entry and admission of foreign investors, they can nonetheless commit themselves to admit foreign investments through treaty law instruments, and precisely by entering into BITs which also govern the admission and establishment of foreign investors.

security of the countries where they invest.[96] Such threats have already been described above in chapter 1 paragraph 4 and therefore they will not be repeated. What must be pointed out is that if a State deems that an investment of a SWF rises severe concerns of national security or more generally speaking, that it is absolutely inconsistent with its own interests, it could be better for the host State simply to refuse the admission, instead of admitting the investment and then to stop or impair it after the admission has already taken place (with the risk, *inter alia*, of breaching BITs provisions on the treatment to be afforded to foreign investors and then to be required to pay compensation to them). Nevertheless such an option, which appears to be the most reasonable one, would be available only in the case the applicable BIT does not provide for a duty to admit investments of investors from the other contracting party.

It must also be preliminary noted that under current customary international law States retain their sovereign right in discretionally deciding whether to allow the admission of foreign investments in their territory and, if so, to what extent. They can decide not to admit foreign investments at all (a practice that today is nonetheless very rare) or to admit them selectively, according to criteria of their choice. Customary international law creates obligations upon host States exclusively in relation to the treatment they mean to afford to foreign investors after they have freely decided whether to admit them.[97] Therefore, any legal obligations upon States in relation to the admission of investments and investors originating from other States can be provided for only in treaty law. This implies that, in this paragraph the focus will be on applicable international investment instruments, without the need to further analyse the content of customary international law. In particular, it will be studied whether BITs contain provisions requiring host States to admit foreign investments, included those of SWFs. Like in previous paragraphs, the focus of the present analysis will be on the BITs between States owning SWFs and States which in the

[96] The protection of national security in IIAs and the implication this might have for the investments of SWFs will be the object of paragraphs 8 to 10 of the present chapter.

[97] G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 321-328.

last years have proved to be the main recipients of the investments of such State-owned funds.

Most BITs seem to follow the so-called controlled entry model, which preserves the ability of the host States to regulate and eventually restrict the admission of foreign investments in their territory[98]. When these BITs contain provisions on the entry or even on the promotion of foreign investments, such clauses often are hortatory in their formulation and, even more important, they underline that admission and establishment of the foreign investments shall occur according to the laws of the host State. In practice they seem to regard the promotion of foreign investments not as a legal obligations, but as an objective which should be achieved through the compliance with the provisions contained in the BITs on the treatment and the protection of the investments after their admission[99]. This means that a law of the Host State preventing the admission or the establishment of a foreign investor who is a national of the country with which the host State has entered into a BIT, does not violate the BIT itself. Likewise, the BIT does not restrict the ability of the host State to put in place, according to its municipal law, screening mechanisms allowing it to decide which foreign investments could be granted access. For instance, in the BIT between Libya and Belgium art. 2,1 provides that: "[e]ach Contracting Party shall promote investments in its territory by investors of the other Contracting Party and shall accept such investments *in accordance with its legislation*. (emphasis added)". Likewise, art 2,1 of the BIT between China and Kuwait states that: "[e]ach Contracting State shall encourage and create favourable conditions for investors of the other Contracting State to make investments in its territory and maritime zones and, *in exercise of powers conferred by its laws, shall admit such investments* [emphasis added]."

It seems clear that a State which has entered into a BIT which follows the controlled entry model, fully preserves its ability to prevent any investment undertaken by a SWF if it deems it is inconsistent with its security needs or, more generally speaking,

[98] I. GÒMEZ PALACIO, P. MUCHLINSKI; cit.; p. 240-242.
[99] G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 328.

with its political or economic goals. Of course, in this case the host State could deprive itself of the benefits SWFs' investments may entail (for instance in terms of relevant and useful contribution of capitals in domestic firms) and this can worsen its diplomatic and political relation with the State owner of the SWF; however no breach of the applicable BITs could be invoked.

On the contrary, some BITs adopt a full liberalization model, which significantly reduces the discretion of the host State as to the admission of investors from the States with which it entered into BITs. This kind of BITs provides that those standards of treatment that BITs adopting a controlled entry model apply to the post-entry phase only, shall also apply to the pre-entry phase. In this case screening mechanisms or other limits, imposed by the municipal law of the host State upon foreign investors could prove inconsistent with BITs and therefore their introduction or maintenance would give rise to an international wrongful act. The full liberalisation model is adopted, at least in part, in many FTA agreements containing provisions on investments concluded by the US, as well as in US and Canadian BITs[100]. For instance, the BIT between the US and Kazakhstan provides, at art. 2.1 that "Each Party shall *permit* [emphasis added] and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favorable". Likewise, the BIT between the US and Azerbaijan provides at art. 2.1 that: "With respect to the *establishment, acquisition*, (emphasis added) expansion, management, conduct, operation and sale or other disposition of covered investments, each Party shall accord treatment no less favorable than that it accords, in like situations, to investments in its territory of its own nationals or companies (hereinafter "national treatment") or to investments in its territory of nationals or companies of a third country (hereinafter "most favored nation treatment"), whichever is most favorable (hereinafter "national and most favored nation treatment")[...]"

[100] I. GÒMEZ PALACIO, P. MUCHLINSKI; cit.; p. 242-243.

The BIT concluded by Canada and Trinidad and Tobago (which are both owners of SWFs) reads at art. 2,3: "[e]ach Contracting Party shall permit establishment of a new business enterprise or acquisition of an existing business enterprise or a share of such enterprise by investors or prospective investors of the other Contracting Party on a basis no less favourable than that which, in like circumstances, it permits such acquisition or establishment by: a). its own investors or prospective investors; or b.) investors or prospective investors of any third state".

It seems therefore that States having concluded BITs which adopt the so called full liberalisation approach would be unable to restrict the access to the investments of SWFs. If for instance, the US refused to admit the SWF of Kazakhstan but admitted the SWF of Norway (for instance because it considers that the latter offers more guarantees in terms of transparency and corporate governance) then such a conduct would be inconsistent with the wording of the BIT between the US and Kazakhstan. However, this risk is minimised by the inclusion in the text of the BIT (and often in the same clause on the admission of foreign investments) of a waiver which applies to certain kind of foreign investments, which are listed in an annex of the BIT itself. Therefore, art. 2.1 of the US-Kazakhstan BIT specifies that the national treatment and the MFN treatment apply to foreign investors in the pre-entry phase but "subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty."[101] The basic requirement is that such exceptions are made known to the other contracting party and that they are referred to sectors which are enumerated in the annex itself. In similar terms, the US-Azerbaijan BIT, at art. 2,2 specifies that " A Party may adopt or maintain exceptions to the obligations of paragraph 1 in the sectors or with respect to the matters specified in the Annex to this Treaty.". Therefore, the Government of the US maintains the ability to restrict foreign investments, included those undertaken by SWFs, in a broad number of sectors. For instance, by reading the annex to the US-

[101] P. MUCHLINSKI; *Trends in international investment agreements: balancing investor rights and the right to regulate: the issue of national security*; in *The Yearbook on International Investment Law & Policy*, 2008-2009; p 40.

Azerbaijan BIT, it can be understood that the US could lawfully screen and restrict the access of the SWF of Azerbaijan when the latter means to invest in sectors like banking finance atomic energy, air and maritime transport, broadcasting and communication.

For this reason, also States which have concluded BITs adopting the full liberalisation model substantially preserve their ability to deny the entry of SWFs. On the contrary, when they decide to admit an investment undertaken by a SWF, they will be required to respect the standards of treatment laid down in the BITs. The content of such standards, and the extent to which host States can partially derogate to them in case of investments of SWFs, will be the object of the next paragraphs.

5. The application of the most favoured nation clause and of the national treatment clause to SWFs.

While in the previous paragraphs it has been discussed whether SWFs and their investments might fall within the scope of BITs, in the following paragraphs an analysis will be made on the concrete application to SWFs of substantive provisions contained in BITs. The issue which will be analyzed in depth in the present paragraph is related to the application of the clauses forbidding discriminations against SWFs *vis a vis* domestic investors (National Treatment - NT- clause) or *vis a vis* investors from third countries (most favoured nation -MFN- clause).[102] Such clauses are provided for in virtually all BITs, the main differences residing on whether their applicability is limited to the post-entry phase or also to the stage of the admission and the establishment of foreign investments.[103] Hereafter a very few

[102] F. ORTINO; *Non-discriminatory treatment in investment disputes*; in P-M DUPUY, F. FRANCIONI AND E.U. PETERSMANN; ed.; *Human rights in international investment law and arbitration*; New York; Oxford University Press, 2009; p. 346-348; N. DIMASCIO, J. PAUWELYN; *Nondiscrimination in Trade and Investment Treaties: Worlds Apart or Two Sides of the Same Coin?* in *The American Journal of International Law*; 2008; p. 48- 89.

[103] On this point, see, above, paragraph 4. See also: UNCTAD; *National Treatment*; UNCTAD 1999; p. 18-21; UNCTAD; *Most Favoured Nation treatment*; UNCTAD 1999; p. 14

examples of such clauses contained in BITs concluded by States which own SWFs will be provided.

For instance, the BIT concluded between Libya and Austria provides at art. 3 that: "Each Contracting Party shall accord to investors of the other Contracting Party and to their investments treatment no less favourable than that it accords to its own investors and their investments or to investors of any third country and their investments with respect to the management, operation, maintenance, use, enjoyment, sale and liquidation of an investment, whichever is more favourable to the investor." Likewise, art. 3,1 of the Italy-China BIT reads: "Il trattamento accordato agli Investimenti da parte di residenti o società di ciascuna Parte Contraente nel territorio dell'altra Parte Contraente non sarà meno favorevole di quello accordato agli Investimenti di residenti o Società di ogni Paese Terzo." and art. 3,2 adds that: "Il trattamento accordato alle attività connesse con gli investimenti di residenti o società di ciascuna Parte Contraente non sarà meno favorevole di quello accordato alle attività connesse con Investimenti di residenti o società di ogni Paese Terzo". The BIT concluded between Cile and Argentina provides that: "Ninguna de las Partes Contratantes someterá en su territorio a las inversiones de nacionales o sociedades de la otra Parte Contratante o a las inversiones en las que mantengan participaciones los nacionales o sociedades de la otra Parte Contratante, a un trato menos favorable que el que se conceda a las inversiones de los propios nacionales y sociedades o a las inversiones de nacionales y sociedades de terceros Estados. Ninguna de las Partes Contratantes someterá en su territorio a los nacionales o sociedades de la otra Parte Contratante, en cuanto se refiere a sus actividades relacionadas con las inversiones, a un trato menos favorable que a sus propios nacionales y sociedades o a los nacionales y sociedades de terceros Estados."

A foreign investor which alleges a violation of the NT Clause must prove, firstly, that a domestic investor exists who is in the same economic or business sector and who is undertaking a very similar investment activity; secondly that the domestic investor is receiving a more favourable treatment and, thirdly, that the design and the nature of the measures leading to the difference in treatment have a discriminatory effect.[104] It must be underlined that discrimination can occur as a result of State measures which explicitly deny certain benefits to foreign investors or which explicitly impose upon them particular and burdensome requirements expressly in relation to the fact that they are foreigners. However, discrimination can also occur as far as the host State adopts certain measures which, although not formally discriminatory, in practice impose obstacles to foreign investors, for instance because they made the concession of authorizations and licenses or other benefits subject to certain conditions that, *de facto*, only domestic investors can reasonably fulfil.[105]

In the wording of BITs, some exceptions can be included, so that to enable host countries to exclude certain types of enterprises, activities or industries from the operation of the NT clause. As it can be easily understood, the number and the scope of exceptions determines the practical effect of the NT clause under a BIT.[106] Such exceptions can be based on reasons of public health, public order and morals, as well as national security. They are also called general exceptions and they will be the object of a separate analysis in paragraph 9 and 10 of this chapter. In this case they could entail the non applicability not only of the NT clause, but virtually of several or of all provisions of the BITs.

BITs can also provide for subject-specific exceptions which exempt from the application of the NT clause only those State measures which are adopted in specific fields, predetermined in the wording of the BIT itself. In most cases the measures at issue are those adopted in relation to: intellectual property, taxation, macroeconomic stability, prudential supervision concerning banking or financial services. The

[104] P. MUCHLINSKI; *Multinational enterprises and the law*; 2nd ed.; Oxford; New York; Oxford University Press; 2007; p. 621-625; G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 348.

[105] UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 163-165; UNCTAD; *National Treatment*; cit.; p. 12; F. ORTINO; *Non-discriminatory treatment in investment disputes*; cit.; p. 348-360.

[106] For a classification of such exceptions, see: ibid.; UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 165. It must be noted that the UNCTAD survey mentions a third category, consisting in country-specific exceptions. However the possibility to exclude from the applicability of the national treatment clause one or more contracting parties has a relevance in multilateral agreements and not in BITs, on which the present analysis is focusing.

existence of such exceptions would allow the host State to adopt some measures which might discriminate foreign investors, included foreign SWFs, but only in relation to the subjects specifically listed in the text of the BIT. For instance, in case of existence of an exception clause concerning tax issues, the host State shall not be prevented by the existence of the NT clause to apply to foreign investors tax measures which are less favourable than those applied to domestic investors. It would result that, in such a case, a foreign SWF might be lawfully subjected to higher withholding taxes than a domestic investment fund.[107]

Finally, it is necessary to mention the so-called industry-specific exceptions, which allow the host State to adopt protective measures in order to limit or to monitor more effectively investments undertaken in certain sectors it deems particularly sensitive and strategic, for instance military industry, nuclear plants, but also, in some cases, banking telecommunications, and certain kind of infrastructures.

The other clause contained in BITs and which prevents discriminations against foreign investors is the MFN clause. It implies that a host country must automatically extend to investors who are nationals of the other contracting party the same benefits and advantages it accords to any third-country investor. As in the case of the NT clause, a foreign investor claiming a violation of the MFN clause must prove, first, that a third country investor exists who is in the same economic or business sector and who is undertaking a very similar investment activity; secondly that the third State investor is receiving a more favourable treatment and, thirdly, that the design and the nature of the measures leading to the difference in treatment have a discriminatory effect. The principles emerged in the discussion on general and specific exceptions, which has been carried out above in relation to the NT clause,

[107] In practice, SWFs often enjoy a much more favourable tax treatment than domestic portfolio investors. On this point see: US HOUSE OF REPRESENTATIVES; JOINT COMMITTEE ON TAXATION; *Economic and US income tax issues raised by Sovereign Wealth Fund investments in the United States*; 2008; available at http://www.house.gov/jct/x-49-08.pdf page visited on 10/09/2011. This documents provides a review of the tax treatment of SWFs in several jurisdictions. For a discussion of this issue in literature, which mainly focus on US practice, see: V. FLEISCHER; *A Theory of Taxing Sovereign Wealth*; in *New York University Law Review*; 2009; p. 440-512; M. DESAI, D. DHARMAPALA; *Taxing the Bandit Kings*; in *Yale Law Journal Pocket Part*; 2008; p. 98-103; The issue of the taxation of SWFs shall be analysed more in detail *infra* in chapter 5 paragraph 7.

must apply also to the issue of the MFN treatment and therefore there is no need to repeat them. In addition, it must be reminded that usually BITs provide for a waiver of the MFN treatment clauses when one of the contracting parties to the BIT is also a member of a custom union or of a free trade area. This means, for instance, that the Chinese SWF investing in Italy shall not be entitled, under the MFN provision contained in the BIT between Italy and China, to the same benefits that the Norwegian SWF might enjoy when investing in Italy, whenever such advantages derives from the law of the European Economic Area. Moreover, in case of BITs which lay down obligations upon host States also in relation to the admission of foreign investments, it is possible that an article might be included to exclude the operation of the MFN clause in respect to this last issue.[108]

When the above mentioned exemptions cannot apply, it could be questioned whether and to which extent host States are mandated to treat the investments foreign SWFs undertake in their territory at least as much favourably as any other similar or comparable investment made by a domestic or a by a third country investor, especially if the latter is not a SWF. When assessing the existence of a discrimination, it is indispensable to verify whether two subjects are in a similar or comparable situation and then whether they are treated differently. No discrimination clearly exists when different treatments are accorded to subjects which are in different situations.[109] For instance in the recent case Parkeering vs. Lituania the arbitral Tribunal noted that it was not "in a position to determine if there had been a discriminatory measure against the Claimant as no comparison [was] possible with

[108] Y. RADI; *The Application of the Most-Favoured-Nation Clause to the Dispute Settlement Provisions of Bilateral Investment Treaties: Domesticating the 'Trojan Horse'*; in *The European Journal of International Law*; 2007; p. 757-774; UNCTAD; *Most Favoured Nation treatment*; cit.; p. 14- 40; G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 349-355. On these issues, see also the discussion developed on the regional economic integration organization clause in chapter 7 paragraph 1 of the present research

[109] UNCTAD; *National Treatment*; cit.; p. 28; M. VALENTI; *Gli standard di trattamento nell'interpretazione dei trattati in materia di investimenti stranieri*; Torino; Giappichelli; 2009; p. 139-141; P. ACCONCI; *Most-Favoured nation Treatment*; in P. MUCHLINSKI, F. ORTINO, FEDERICO and C. SCHREUER, ed.; *The Oxford handbook of international investment law*; Oxford; Oxford University Press; 2008; p. 365; T. GRIERSON-WEILER, I. A. LAIRD; *Standards of treatments*; P. MUCHLINSKI, F. ORTINO, FEDERICO and C. SCHREUER, ed.; *The Oxford handbook of international investment law*; Oxford; Oxford University Press; 2008; p. 262.

another investor."[110] In doing so, the Parkering tribunal relied on the findings of the Antoine Goetz award, where it had been ruled that "[u]ne discrimination suppose un traitement différencié appliqué à des personnes se trouvant dans des situations semblables".[111] Likewise, in the Saluka case it was declared the consistency with the principle of non discrimination of "any differential treatment of a foreign investor" which is not "based on unreasonable distinctions and demands" and which is "not motivated by a preference for other investments over the foreign-owned investment."[112] This approach is followed also by arbitral Tribunals interpreting the provision prohibiting discrimination in the framework of the NAFTA.[113] For instance, in the Myers case the arbitral tribunal argued that "[t]he assessment of “like circumstances” must also take into account circumstances that would justify governmental regulations that treat them [i. e. foreign investors] differently in order to protect the public interest." The tribunal further clarified that "the concept of “like circumstances” invites an examination of whether a non-national investor complaining of less favourable treatment is in the same “sector” as the national investor."[114]

[110] *Parkerings-Compagniet as v. Republic of Lithuania*; ICSID Case No. ARB/05/8; award of 11 September 2007; par 290

[111] *Antoine Goetz and others v. Republic of Burundi*, ICSID Case No. ARB 95/3, Award of 10 February 1999; par. 121.

[112] *Saluka Investments BV (The Netherlands) v. The Czech Republic*; arbitration under UNCITRAL arbitration rules; award March 17, 2006; par. 307. It must be remarked that in this case the issue of discrimination was not assessed in relation to an alleged violation of the MFN or national treatment clause, but in relation to the application of the fair and equitable treatment clause. However, the principle provided in this award seems to apply in any case of discrimination. On the issue of the relation between non-discrimination and fair and equitable treatment see below, paragraph 6.

[113] It must be underlined that although the NAFTA is not a BIT, as it is a multilateral agreement whose provisions are not limited to investments, however its section 11 contains provisions governing foreign investments whose wording is very similar to that of BITs. Therefore is has been judged it appropriate to quote it. See: J. J. COE; *Taking Stock of NAFTA Chapter 11 in Its Tenth Year: An Interim Sketch of Selected Themes, Issues, and Methods*; in *Vanderblit Journal of Transnational Law*; 2003; p 1381-1460; A. MILANOVA; *Le règlement des différends dans le cadre de l'ALENA: les atours discrets d'une hégémonie*; in *Journal du Droit International;* 2003; p. 87-100.

[114] See: *S.D. Myers, Inc. v. Canada*, UNCITRAL (NAFTA); -First Partial Award, 13 November 2000; par. 250 However in must be remarked that in this case the investment of the foreign investor is considered comparable with the operations undertaken by a domestic (or a third country) investor when they relate to the same sector, without taking into consideration the characteristics of the investors itself. As it will be analysed in the next pages, an approach which exclusively focuses on this

Therefore, the key issue which allows to understand the issue of the applicability of the NT and of the MFN clause to SWFs is whether an investment undertaken by a SWF can, by its nature, be regarded as comparable or similar to an investment undertaken by a domestic or a third country investor which is not a SWF. This means that, if it is established that a SWF, as it is a State-owned vehicle, because of this specific feature, can never be similar to any other foreign investor, then the applicability of the MFN and of the NT clause to SWF may be always excluded. On the contrary, if it is deemed that the particular nature of SWFs is not sufficient to prevent them from acting similarly to any other non-State- owned investor, then the applicability of the MFN and of the NT clause to SWF would be possible in principle.

In order to consider whether the investments undertaken overseas by a SWF could be comparable to those undertaken by a non-State actor, like, for instance a privately owned mutual fund or transnational corporation, it must first be assessed whether SWFs adopt investment strategies aiming at the maximization of economic and financial returns or whether their investments are also politically motivated. In other words it must be seen whether SWFs, because of their nature, cannot act like market investors but ultimately as States, even when their activities also consist in investing overseas. In this case, an investment of a SWF can never be considered as comparable to an investment undertaken by a domestic or third country investor which is not a SWF, even though the sector or the company targeted, the volume of the transaction and the modality through which the investment is undertaken are very similar.

A non-sovereign investor would be merely interested in achieving economic returns. It could pursue this objective by running and operating an industrial activity (for instance through an FDI in the manufacturing industry) or by means of transactions concerning financial assets (as it is the case of investment funds). Especially in case of a portfolio investor, he can pursue long term strategies, like most pension funds do, or short term strategies, like certain hedge funds. In any case its main objective

aspects is not fully appropriate when discussing the application of the MFN and the National Treatment clause to SWFs.

would be the financial profitability of the investments undertaken. On the contrary, a SWF could be used by the State which has created it in order to pursue also non commercial objectives. Such possibility has been investigated in depth in the first chapter of the present dissertation and therefore only a brief reference to concepts previously explained will be made. It has been argued, for instance, that a SWF might invest in the defence or in other dual-use- technology sectors, thus having access to foreign military technology and perhaps to secret information related to the national security of the host State, with the clear aim of pursuing strategic and military advantages. Furthermore, it is feared that a SWF might attempt to seize control of strategic sectors of the economy of the host States, being capable in such a way to influence the policies of recipient States as well as their economic and social life. Finally, it has been argued that a SWF could make sudden and massive purchases or sales of financial instruments listed in the stock market of a country and/or denominated in the currency of that country in order to disrupt the stability of its stock markets or of its currency. As explained in chapter 1, several studies, mainly pertaining to the field of the political and the economical sciences, have discussed such issues and at least in part they have assuaged most of the anguishes related to the rise of the investments of SWFs. While it cannot be excluded that some investments of SWFs may attempt to achieve goals which are not purely commercial in character, it seems that so far most investments of SWFs have been preponderantly or exclusively economically and financially driven[115].

On the other side, it must be reminded that, as it has been explained in the first three chapters of the present research, SWFs play a particular role in those countries which establish them, as they contribute to the conduct of the monetary policy, to the

[115] E. TRUMAN; *Four Myths about Sovereign Wealth Funds*;cit.; E. M. TRUMAN; *Sovereign Wealth Funds: New Challenges from a Changing Landscape*; cit.; D. SINISCALCO; cit.; p. 75-86; G. LYONS; cit.; p. 4-62; E. C. ANDER; cit.; L. C. BACKER*; The Private Law of Public Law:*cit.; p. 181-1868; G. BAHGAT; cit.; p. 1189-1204; M. BARBIERI*; A new challenge for the European Union*; cit.; p. 272-274; M. BARBIERI; *The International Regulation of Sovereign Wealth Funds. Which Role for the European Union?*; UNCTAD-Virtual Institute Digital Library; 2009; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 165-201; J. BIARD; cit.; S. KERN; *Sovereign Wealth funds; State investments on the rise*;cit; S. KERN; *SWF's and foreign investment policies - an update*; cit; p. 12-17; J. SEZNEC; cit.; p. 97-110; D. K. DAS; cit.; p. 1-15.

management of foreign exchange reserves, to the management of the revenues generated by the exploitation of natural resources and, more generally speaking, to pursue macroeconomic stabilization objectives. From this point of view they are not comparable to other non-State owned institutional investors, which clearly do not perform such tasks.

Against this background, it can be concluded that if SWFs are defined in relation to the activities they undertake in the host State, then it could be argued that they are in principle comparable to other investors, except when it is proved, on a case by case basis, that they are acting consistently with a political and non commercial rationale. On the contrary, if the focus is on the role they play in the domestic economy of the State which establishes and owns them, then it must be concluded that a SWF is clearly always different from any other non-State investor.

Given these elements, it is very difficult to predict what an arbitral tribunal could decide in a hypothetical dispute concerning a claim of a SWF related to an alleged breach of the MFN or NT clause committed by the host State. Two different approaches seem to be possible.

According to the first approach, an arbitral tribunal could decide that the sovereign nature of the SWF would always and necessarily bring it to pursue also political and not only commercial goals.[116] For this reason an investments undertaken by a SWF could be never regarded as being similar or comparable to the investment made by any entity other than a SWF. In practice, this would entail in most cases the impossibility for a SWF to claim that a breach of the MFN or of the NT clause has occurred in relation to their investments. In fact, discrimination would take place only if there is a difference of treatment in similar situations. Given the radical difference of SWFs from any other non-State-owned investor, the requirement of the existence of a similar situation in which a different treatment would have occurred simply can never be fulfilled except in the following specific case. The MFN and the NT clause

[116] In this case political purposes must not be meant exclusively as threats to the national security of the host State, but also as related to the macroeconomic function played by SWFs in the States which establish and own them.

could operate exclusively when an issue of discrimination between two or more SWFs is raised and provided that the SWFs at issue can be regarded as comparable investors and as carrying out comparable operations. For instance, a Chinese SWF which deems that its investment in Italy has been receiving a treatment that is less favourable to the one accorded by Italian authorities to the Libyan SWF could invoke the MFN treatment clause provided for in the BIT between Italy and China. However, the same Chinese SWF would not be allowed to rely on the same provision to claim that its investments are discriminated relative to the investment undertaken in Italy by a Libyan privately owned firm.

An alternative approach consists in a case by case assessment, undertaken by the arbitral Tribunal, of the genuine nature of the investment activity of the SWF. In particular, it could be argued that if the host State is not able to prove that, taking into consideration the SWF's investment overseas, the foreign SWF at issue is acting differently from a privately-owned investor and precisely that the SWF is pursuing political and non commercial goals, in this case the MFN and the NT clause should apply. This implies that the host State shall not afford to foreign SWFs standards of treatment less favourable than those accorded to domestic or third countries investors (irrespective of the fact they are SWFs or not), except otherwise (and explicitly) provided for in applicable BITs.

This second approach seems to be more consistent with the nature and the purpose of the MFN and of the NT clauses. If States mean always to exclude the investments of SWFs from the scope of application of such clauses they should express such intention by including in the wording of BITs a specific exclusion. For instance, they should clearly provide that the MFN clause and the NT clause shall not apply to SWFs and to other State owned vehicles. Lacking such an exclusion, and since BITs and their provisions apply to SWFs and to their investments (as explained above in paragraphs 1, 2 and 3) then also the MFN and the NT clauses should in principle apply to SWFs.

6. The application of the fair and equitable treatment clause to SWFs.

Another provision of substantive law which is contained in BITs and which is related to the standards of treatment that the host State is required to accord to foreign investors consists in the fair and equitable treatment (FET) clause. The MFN and the NT clause provided for *relative* standards of treatment, in the sense that in order to assess whether they are respected it is necessary to consider the treatment accorded to the foreign investor *relative* to the treatment accorded to third country investors or domestic investors respectively. On the contrary, the fair and equitable treatment clause provides for absolute standards.[117] This also means that, in principle, in order to assess the existence of a violation of such a clause, it is not necessary to compare the treatment accorded to the foreign investor with the treatment accorded to other entities. This represents a very important point, since it can help to overcome the difficulties, which have been discussed in the previous paragraph, related to the application to SWFs of the national treatment and of the MFN clause. The fair and equitable treatment clause merely implies that the foreign SWF must be always treated in a fair and equitable way. The assessment of the violation of the fair and equitable treatment in fact does not entail the need to find investors which are in a similar or comparable situation of a SWF but which receive a more favourable treatment by the host State. The fair and equitable treatment clause is provided for in virtually all the BITs, although it could be worded in different ways: for instance the wording "just and equitable” or simply “equitable” could be used as well. In addition, together with the obligation to accord fair and equitable treatment, a reference to the "minimum standard of treatment" and the "full protection and security" could be made. For instance, the BIT concluded between Libya and Austria provides at art. 3.1 that "Each Contracting Party shall accord to investments by investors of the other Contracting Party fair and equitable treatment and full and constant protection and security". Art. 2 of the BIT between Italy and the United Arab

[117] P. ACCONCI; *Most-Favoured nation Treatment*; cit.; p 364-366; T. GRIERSON-WEILER, I. A. LAIRD; cit.; p. 261-263.

Emirates, provides that: "[u]na volta effettuati, gli investimenti godranno in ogni momento di piena protezione e sicurezza, in conformità al diritto internazionale" and specifies that "[c]iascuna Parte Contraente dovrà garantire in ogni momento un trattamento giusto ed equo agli investimenti effettuati dagli investitori dell'altra Parte Contraente." Finally, art. 3 of the BIT between Kuwait and Kazakhstan provides that: "investments by investors of other contracting States shall at all times enjoy fair and equitable treatment and full protection and security in the territory of the other contracting State in a manner consistent with recognised principle of international law and the provisions of this agreement. Neither contracting State shall in any way impair by arbitrary or discriminatory measures the use management conduct operation expansion or sale or other dispositions of the investment." It must be remarked that in this provision, the existence of discriminatory measures adopted by the host State is an evidence of a breach of the fair and equitable treatment clause. However art. 4 provides for the MFN and the NT clause as well. This means that the issue of discrimination is relevant both with respect to the assessment of the violation of the fair and equitable treatment standards and the violation of the MFN or NT clause.

Although the inclusion in the text of BITs of the fair and equitable treatment clause is very common, and although in recent years alleged breaches of such a clause has been increasingly invoked before arbitral tribunals, its exact content remains difficult to know.

Traditionally two possible, theoretical interpretation of the fair and equitable treatment clause have developed.

The first approach consists in considering the fair and equitable treatment as a synonymous with the international minimum standard in international law. This means that arbitral tribunals will have to construe the content of the fair and equitable standard taking into consideration what customary international law provides for as to obligations upon host States related to the treatment of aliens and especially of foreign investors in their territory.

This approach has been followed for instance in the recent model BIT of 2004 adopted by the US, where at art. 5 it is explicitly declared that the notion of fair and equitable treatment must be intended as included into the notion of minimum standard according to customary international law and therefore that the fair and equitable treatment, as well as the expression "full protection and security" do not create upon the host State obligations other than those which already bind it under customary international law. This means that arbitral tribunals summoned to apply BITs concluded in accordance to this model, when interpreting the "fair and equitable treatment" clause shall be required to construe the content of customary international law applicable to the dispute at issue. On the contrary, any interpretation of the fair and equitable treatment clause whose outcome would be the creation of rights or obligations other than those provided for in international law should be inconsistent with the wording of the BIT.[118] It seems, however that when specifications of this kind are not provided in the text of the BIT itself, arbitral tribunals should not be restricted to interpret the notion of fair and equitable treatment as a mere synonym of the minimum standard of treatment provided for in customary international law.

The second approach is referred to as the "plain meaning" or "ordinary meaning" approach.[119] It relies on accepted rules of interpretation in international law as codified in art. 31 of the Vienna Convention on the Law of Treaties of 1969, which

[118] On this issue see: T. GRIERSON-WEILER, I. A. LAIRD; cit.; p. 264-266; SACERDOTI, GIORGIO; *Bilateral Treaties and Multilateral Instruments on Investment Protection*; cit.; p. 347-348; G. MAYEDA; *Playing fair: the meaning of fair and equitable treatment in Bilateral Investment Treaties*; in *Journal of World Trade*; 2007; p. 273-291. For a more in depth discussion of the US model BIT of 2004 see: P. JUILLARD; *Le nouveau modèle américain de traité bilatéral sur l'encouragement et la protection réciproques des investissements*; in *Annuaire français de droit international*; 2004; p. 669-682. See also: M. KANTOR; *The new draft model of US BIT: noteworthy developments*; in *Journal of International Arbitration*; 2004; p. 383-396; S. M. SCHWEBEL; *The United States 2004 Model Bilateral Investment treaty and denial of justice in international law*; in: VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford; Oxford university press, 2009; p. 519-523; W. BEN HAMIDA; *L'arbitrage État-investisseur étranger: regards sur les traités et projets récents; Journal du Droit International*; 2004; p. 419-442; W. S. DODGE; *Loewen Group, Inc. v. United States. ICSID Case No. ARB(AF)/98/3. 42 ILM 811 (2003). Mondev International Ltd. v. United States. ICSID Case No. ARB(AF)/99/2. 42 ILM 85 (2003);* in *The American Journal of International Law;* 2004; p. 155-163; M. VALENTI; *Il trattamento "conforme al diritto internazionale" degli investimenti stranieri nelle convenzioni internazionali*; in *Diritto del commercio internazionale*; 2004; p. 973-990.

[119] UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 212; M. VALENTI; *Gli standard di trattamento nell'interpretazione dei trattati in materia di investimenti stranieri*; cit.; p. 183-188.

reads: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". This approach has been followed, for instance, in the MTD case, when the arbitral tribunal, after having declared it was following the principles of the above mentioned Vienna Convention concluded that "[i]n their ordinary meaning, the terms “fair” and “equitable” used in Article 3(1)62 of the BIT mean “just”, “even-handed”, “unbiased”, “legitimate".[120] It is noteworthy that the tribunal obtained such definitions by consulting "The Concise Oxford Dictionary of Current English, fifth edition."[121]

The plain meaning approach presents certain advantages, in particular in terms of flexibility; however, it is not without its difficulties, which are related to the fact that the notion “fair” and “equitable” are by themselves inherently subjective, and therefore lacking in precision. In principle, the foreign investors and the capital exporting countries will tend to interpret the fair and equitable treatment as capable of affording a particularly high level of protection to foreign investments, while host States will tend to interpret it more restrictively. Risks of irreconcilable interpretations are even higher when parties involved tend to approach the issue with different cultural assumptions and, more specifically, when they have different legal traditions.[122]

The recent increase of treaty based disputes submitted to arbitral tribunal has provided more elements for an analysis of the content of the fair and equitable treatment clause, although it cannot be denied that, since arbitral tribunal interpret it on a case by case basis, their finding are not always very consistent.[123] The legal literature, building upon such a growing number of awards, has attempted to survey when the conduct of the host States implies a breach of the fair and equitable treatment clause. Very briefly speaking, the violation of the fair and equitable

[120] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*; ICSID case No ARB/01/7; Award of 25 May 2004; par. 113

[121] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*; note 63

[122] UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 212.

[123] On the issue of the consistency of arbitral awards in investor-State disputes, both in general and especially in relation to the interpretation of the fair and equitable treatment clause see: O. K. FAUCHALD; cit.; p. 301-364.

treatment clause can be invoked first of all when an active or omissive conduct of the host State, consisting in one only act or in a series of acts related to them provokes a considerable damage to the foreign investor. However this represents only a necessary, although not sufficient condition. In fact, in most cases such acts are adopted by the host State in the legitimate exercise of its sovereign right (and duty) to regulate its internal affairs. It is quite common that such State acts might (also incidentally) modify the condition of doing business and therefore advantage or disadvantage investors, both domestic and foreign. Therefore the legitimate exercise of regulatory powers by the host State doesn't constitute *per se* a violation of the fair and equitable treatment clause even though it adversely affects the foreign investor. However, if the damage to the foreign investor is associated with a conduct of the host State lacking predictability, consistency and transparency, or if a State more generally speaking behaves in bad faith or if it abuses of its right to regulate its domestic affairs, then it is more likely that a foreign investor might successfully invoke the existence of a breach of the fair and equitable treatment clause. Other elements Tribunals may take into consideration when assessing the existence of a violation of the fair and equitable treatment, have been the non respect of the general duty of vigilance and protection of aliens, the denial of due process and of procedural fairness, the coercion and the harassment of the investor by the organs of the host State, protracted failures to implement and enforce national laws in the interest of the foreign investor.[124]

[124] For a more detailed discussion of the content of the fair and equitable treatment clause see for instance: M. VALENTI; *Gli standard di trattamento nell'interpretazione dei trattati in materia di investimenti stranieri*; cit.; p. 183-211; S. FIETTA; *Expropriation and the "Fair and Equitable" Standard. The Developing Role of Investors' "Expectations*" in *International Investment Arbitration;* in *Journal of International Arbitration*, 2006; p. 375- 400; P. MUCHLINSKI; *Caveat Investor? The relevance of the conduct of the investor under the fair and equitable treatment standard*; in *International and Comparative Law Quarterly*; 2006; p. 527-557; T. GRIERSON-WEILER, I. A. LAIRD; cit.; p. 272-290; I KNOLL-TUDOR; *The fair and equitable treatment standard and human rights norms*; in P-M DUPUY, F. FRANCIONI AND E.U. PETERSMANN; ed.; *Human rights in international investment law and arbitration*; New York; Oxford University Press, 2009; p. 310-343; J KROMMENDIJK AND J. MORIJN; *"Proportional" by what measure(s)? balancing investor interests and human rights by way of applying the proportionality principle in investor State arbitration*; in P-M DUPUY, F. FRANCIONI AND E.U. PETERSMANN; ed.; *Human rights in international investment law and arbitration*; New York; Oxford University Press, 2009; p. 422-450; M. POTESTÀ *Il consenso all'arbitrato ICSID contenuto in una legge nazionale dello Stato ospite*

In addition, if the host State through its actions makes the investor legitimately expect a certain treatment or a certain State conduct and if later such legitimate expectations are frustrated by the conduct of the host State acting in bad faith, a further evidence of the violation of the fair and equitable treatment clause is provided. The assessment of the existence and of the subsequent frustration of legitimate expectations is a very important element which is considered by arbitral tribunals. Legitimate expectations can be defined as the expectations that the investor acting in good faith is reasonably and legitimately induced to have by the same conduct of the host State. For instance if governmental authorities provide in a decently consistent and credible way that they will grant permits, licenses, facilities or other form of support to the foreign investors, then the foreign investor will legitimately expect that it will actually obtain such forms of facilitations. Likewise, if the foreign investor is assured by competent host State authorities that the operations related to the investment she means to undertake shall not be hindered, the foreign investor shall legitimately expect that no relevant obstacles will be posed by governmental authorities at least in relation to the issues pertaining to the assurances received, with the exception, of course, of those obstacles which can predictably rise out of the application of domestic laws and regulation. Frustration of such expectations is

dell'investimento; in *Diritto del commercio internazionale*; 2010; p. 375-396; J. Y. GOTANDA; *Renegotiation and Adaptation Clauses in Investment Contract, Revisited*; in *Vanderblit Journal of Transnational law*; 2003; p. 1361-1373; W. BEN HAMIDA; *La prise en compte de l'intérêt général et des impératifs de développement dans le droit des investissements*; in *Journal du droit international (Clunet)*; 2008; p. 999-1034; W. BEN HAMIDA; *L'arbitrage État-investisseur étranger: regards sur les traités et projets récents*; cit.; p. 419-442; M. VALENTI; *Il trattamento "conforme al diritto internazionale" degli investimenti stranieri nelle convenzioni internazionali*; cit.; p. 973-990; F. FRANCIONI. *Access to Justice, Denial of Justice and International Investment Law*; in *The European Journal of International Law*; 2009; pp. 729- 747; G. VAN HARTEN, M. LOUGHLIN; cit.; pp. 121-150.
Among the arbitral decisions which provide useful elements for the analysis of the content of the fair and equitable treatment clause and supporting the finding of the present chapter see, for instance: *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*; ICSID No. ARB(AF)/00/2; award of 29 May 2003; par.152-174; *Metalclad Corporation v. The United Mexican States*; ICSID CASE No. ARB(AF)/97/1; award of 30 August 2000; par. 99; *Occidental Exploration and production company vs. Ecuador*; London Court of International Arbitration; award of July 1, 2004; par.183-185.

therefore an element which could bring arbitral tribunals to assess the existence of a breach of the fair and equitable treatment clause.[125]

Another issue which deserves to be mentioned when discussing legitimate expectations is related to the possibility that a foreign investor might enter into a contract with the competent authorities of the host State. A SWF could conclude an agreement with the host State in which it undertakes to behave in a certain manner, for instance by disclosing certain information and data in relation to its operations[126] or by promising not to adopt certain investment strategies. Such agreements could be concluded at the entry phase and they can lay down the conditions upon which the foreign investment can be admitted. An example is provided by the so called mitigation agreements which are often adopted by the CFIUS within the framework constituted by the screening procedures in force in the US for the admission of foreign investments, which will be described more in detail below. However, contracts between the host State and the foreign investor not only provide for particular obligations upon the investor, as in the example mentioned above, but they more often set a vast array of mutual rights and obligations upon the investor and the host State both. For instance, the host State could undertake to provide certain

[125] For the notion of legitimate expectations and transparency see: A. KOTERA; *Regulatory transparency;* in P. MUCHLINSKI, F. ORTINO, FEDERICO and C. SCHREUER, ed. cit.; p. 617-636; S. FIETTA; cit.; p. 375-400; M. G. PARISI; cit.; p. 383-426; A. REINISCH; cit.; p.432-458. W. BEN HAMIDA; *La prise en compte de l'intérêt général et des impératifs de développement dans le droit des investissements*; cit.; p. 999-1034; J. Y. GOTANDA; cit., p. 1461-1473; K. P. BERGER; *Renegotiation and Adaption of International Investment Contracts: The Role of Contract Drafters and Arbitrators*; in *Vanderblit Journal of Transnational Law*; 2003; p. 1347- 1380. The concept of legitimate expectations has developed from the practise of municipal Courts. For a study of the relation of legitimate expectations in international investment law, on one hand, and in constitutional and administrative law, on the other hand, see: H. A. MAIRAL; *Legitimate expectations and informal administrative representations*; S. W. SHILL; ed.; *International investment law and comparative public law*; Oxford; Oxford U. P.; 2010; p. 413-452.

Several arbitral decisions discussed the role of legitimate expectations of the investors and/or of transparency in order to assess whether an indirect expropriation or a breach of the fair and equitable treatment clause has occurred. See, for instance, the following cases: *Continental Casualty Company v. Argentine Republic*; ICSID case No ARB/03/9; award of 5 September 2008; parr. 257-262; *Técnicas Medioambientales* cit.; par. 122 and 149-174; *Waste Management, Inc. v. United Mexican States*; ICSID Case N° ARB(AF)/ 00/3; award of 30 April 2004; par. 159; *Azurix Corp. v. The Argentine Republic*; ICSID case No. ARB/01/12; award of 14 July 2006; par. 316- 323.

[126] The commitment to a greater disclosure could be particularly important, given the widespread allegation that the main worries related to the investments of SWFs are caused by their lack of transparency.

facilitations to the foreign investor, or to ensure her certain treatments other than those already assured by BITs.

It must be reminded that such a contract (also called agreement between the host State and the foreign investor) is fundamentally different from a BIT, both as to its nature and its purpose. Very briefly speaking, while BITs are governed by public international law, State contracts are usually governed by domestic administrative law of the host State. While BITs provide for basic standards of treatment and facilitations for the investors and the investments of the contracting parties, State contracts provide for additional rights and obligations for individual investors in relation to specific investment projects. It is well established in doctrine and in arbitral decision that a mere breach of a State contract is different from a breach of a BIT[127]. Therefore, if State authorities of the host State do not abide by an investment agreement they previously concluded with a foreign investor, suppose, in this case, a SWF, this, by itself, is not sufficient to enable the SWF to start an arbitration proceeding (especially if before an ICSID tribunal) in accordance with the wording of the BIT at issue and claiming the violation of the BIT itself.

However, agreements with the State could contribute to the formation of legitimate expectations of the investor. If host State authorities enter into a State contract with a foreign investor, they make her legitimately expect that they will support her investments in their territory and that they mean to accord her certain rights and benefits. Therefore an unjustified and sudden breach of such agreements, especially when it is followed by the lack of effective remedies offered to the investor to obtain compensation, can allow the investor herself to claim that the host State is causing a damage to her and that at the same time it is behaving in bad faith, it is frustrating the

[127] For a discussion of the difference between claims arising out of a breach of an IIA and of a State contract see: J. CRAWFORD; *Treaty and contract in investment arbitration*; in *Arbitration International*; 2008; p. 351-374; A. DE LUCA; *L'arbitrato internazionale treaty-based sugli investimenti esteri*; cit.; p. 1018-1045. For a more detailed analysis of the relation between international arbitrators and domestic Judges in investor-State disputes see: J. J. VAN HAERSOLTE-VAN HOF, and A. K. HOFFMAN; cit.; p. 962-1007. For a broader discussion on contracts concluded between the foreign investor and the host State see: UNCTAD; *State contracts*; UNCTAD; 2004; P. MAYER; *Contract claims et clauses juridictionnelles des traités relatifs à la protection des investissements;* cit.*;* p. 71-96.

legitimate expectations of the investor and it is acting in an unpredictable and non transparent manner.[128] As it has been pointed out above, all these elements could constitute a breach of the fair and equitable treatment clause.

The existence of forms of discrimination, although they mainly concern the assessment of the existence of a violation of the MFN and of the NT clause, is also relevant, since a treatment which is discriminatory can hardly be regarded as being fair and equitable.[129]

It is difficult to establish *in abstracto* which of the elements mentioned so far must subsist, and to what extent, so that an arbitral tribunal may decide *in concreto* whether a violation of the fair and equitable treatment clause has actually occurred. While it seems to be excluded that these elements must all be verified, on the other side it is not clear which of them (and eventually with what degree of "intensity") must be observed in order to enable an arbitral tribunal to rule that a violation of the fair and equitable treatment has occurred. This implies that the existence of a violation of such a clause, also because of its vague and broad formulation as well as because of its flexible content, cannot be pre-determined *in abstracto*, but must be assessed on a case-by-case basis, having regard to the peculiarity of each case at issue.[130]

If an attempt is made to apply to SWFs the concepts developed in the present paragraph it must be first of all noted that a SWF which is adversely affected by

[128] J. Y. GOTANDA; cit.; p. 1461-1473; K. P. BERGER; cit.; p. 1347- 1380; P. MAYER; *Contract claims et clauses juridictionnelles des traités relatifs à la protection des investissements;* cit.*;* p. 71-96.

[129] On this point see, for instance: *CMS Gas Transmission Company v. Argentine Republic*, ICSID Case No. ARB/01/08, Award of 12 May 2005; par. 290: " any measure that might involve arbitrariness or discrimination is in itself contrary to fair and equitable treatment".

[130] This concept had been well developed by some ICSID tribunal with respect to the discussion of the elements which must be taken into account when determining the existence of an indirect expropriation. However such reasoning apply to the issue of the assessment of the breach of the fair and equitable treatment clause. See for instance: *Generation Ukraine, inc vs. Ukraine*; ICSID CASE No. ARB/00/9; award of 16 September 2003. At par. 20.29 the tribunal argued that " [i]t would be useful if it were absolutely clear in advance whether particular events fall within the definition of an 'indirect' expropriation. It would enhance the sentiment of respect for legitimate expectations if it were perfectly obvious why, in the context of a particular decision, an arbitral tribunal found that a governmental action or inaction crossed the line that defines acts amounting to an indirect expropriation. But there is no checklist, no mechanical test to achieve that purpose. The decisive considerations vary from case to case, depending not only on the specific facts of a grievance but also on the way the evidence is presented, and the legal bases pleaded. The outcome is a judgment, i.e. the product of discernment, and not the printout of a computer programme."

measures adopted by the host State could claim that a violation of the fair and equitable treatment has occurred only if the conditions described above are fulfilled. On the other side, this implies that a host State which admits on its territory the investments of SWFs but which means to subject them to special controls and regulations given the particular worries SWFs rise, should specify in a transparent way the nature, the extent and the characteristics of the controls and the restrictions it means to apply, preferably before the admission of the investment. Likewise, it should inform the SWFs of changes in its domestic regulatory framework governing the investments of foreign SWFs in its territory. Such changes, in principle allowed, should nonetheless be made in a transparent and consistent way. This should help to enable foreign SWFs to know whether their investments will be welcomed and, more precisely, which will be the sectors and the amount of participation in the companies of the host State which will not meet the opposition of governmental authorities. In other words, this should allow foreign SWFs to reasonably know in advance which kind of treatment they can expect from the host State. Finally, it must be reminded that there is no reason for which the obligation upon the host State not to frustrate the legitimate expectations of foreign investors should not apply to SWFs too.

In concreto, it could be imagined that claims by foreign SWFs for the violation of the fair and equitable treatment could rise when the host State allows foreign SWFs to buy stakes in companies based on its territory and then it starts imposing upon such investments unreasonable, burdensome and prejudicing controls and limitations which the SWFs, acting *in bona fide*, did not legitimately expect as a result of the conduct of the host State itself.

Against this background, those screening procedures which allow recipient States to decide whether or not to admit the foreign investment, have a special importance. In fact it would be better for the host State simply to prevent investments (and especially FDIs) which concern strategic or sensitive sectors and which are undertaken by foreign SWFs, or at least, by those which do not fulfil the basic requirements of transparency or which originate in a country which is regarded by the host State as a strategic competitor. This approach, provided it is consistent with the clauses in BITs concerning the pre-entry phase,[131] should reduce the risk of treaty claims of SWFs which would be much more frequent when the host State admits the investment of the SWF but then subjects it to so many kind of interferences to give rise to a violation of the fair and equitable treatment.

Alternatively, the host State could decide to make the admission of the foreign SWF subject to conditions which are different from those traditionally applied to other investors which, given their non-sovereign nature, rise less concerns than SWFs do. In principle this should be lawful, provided that such "special conditions" are detailed out and agreed upon with the SWFs themselves well before the admission of their investments, and not after their admission and when the SWFs had been reasonably made to expect that any "special" (which actually means more burdensome) condition and treatment would have not been applied to them.

The practice of the US authorities to conclude mitigation agreements with foreign investors which require to be admitted in the US seems consistent with the approach proposed in this paragraph and therefore it deserves to be quickly outlined.

In the US, according to the Foreign Investment and National Security Act (FINSA) as implemented by the Executive Order (E.O. 13456), a Committee on Foreign Investment in the US (CFIUS) is established, whose task is to provide advice to the President in relation to the decision the latter is responsible to make on the admission of investments by foreign entities (included, clearly, foreign SWFs). The CFIUS or another State agency which is allowed to act on its behalf, may negotiate and enter into a mitigation agreement which imposes particular conditions and obligations upon a foreign investor in order to mitigate any threat to national security which might arise in connexion to her operations. It seems evident that this increases the transparency and the predictability of the conduct of the host State *vis a vis* the foreign investor who is enabled to know well in advance which are the particular

[131] As it has been explained before at paragraph 4, most BITs do not provide for an obligation upon the host State to admit foreign investments on its territory. Also those BITs which contain provision in this sense (e. g. many BITs concluded by the USA) provide for some restrictions, concerning for instance certain sectors of the domestic economies.

requirements she should fulfil to be allowed to invest in the US and to safeguard to value of the investments she undertakes here.[132]

In the last years some interesting developments in the field of the fair and equitable treatment clause have occurred, which can have a relevance for the possibility of the host State to adopt certain measures which although they adversely affect the foreign investors, must nonetheless be deemed consistent with the fair and equitable treatment clause since they are somehow justified by the conduct of the foreign investor herself. In the last part of this paragraph such developments will be briefly described and then it will be assessed whether they can provide the host State with new instruments to control and eventually interfere with the investments SWFs undertake in their territory, in a way consistent with the BITs of which they are contracting parties.

The key issue consists in taking into consideration, when assessing the existence of a breach of the fair and equitable treatment, the conduct not only of the host State, but also of the investor. To this purpose, the fair and equitable treatment should be interpreted in an innovative way, in which the equity should be conceived as a counterweight to fairness, thus allowing to assess the conduct of the host State no more in absolute terms, but also considering whether it could be regarded as a necessary and legitimate response to the conduct of the investor. According to this approach "fair" should mean consistent with the domestic law of the host State which in turn must be consistent with IIAs and other applicable sources of international law.

[132] For more information on the mitigation agreements, as well as on the screening procedures adopted by the US and applicable, inter alia, to SWFs see: G. SUD; *From Fretting Takeovers to Vetting CFIUS: Finding a Balance in U.S. Policy regarding Foreign Acquisitions of Domestic Assets Note*; in *Vanderblit Journal of Transnational law*; 2006; p. 1304-1331; A. GUTLIN; *Regulating Sovereign Wealth Funds in the U.S.: A Primer on SWFs and CFIUS*; in *FIU Law Review*; 2010; p. 765-780; J. F. F. CARROLL; *Back to the future: redefining the foreign investment and national security act's conception of national security*; in *Emory International Law Review*; 2009; p. 178. See also: L. HSU; cit.; p. 451-477 and in particular p. 455-456; J. COOKE; cit.; p. 729-782; J. O'BRIEN; *Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds*; in: *The international Lawyer*; 2008; p. 1242- 1244; S. T. ANWAR; *CFIUS, Chinese MNC's outward FDI, and globalization of business*; in *Journal of World Trade*; 2010; p. 419-466; Z. FENG; cit.; p. 501-507. A. WONG; cit.; p. 1088-1090. For a review of the screening procedures put in place by other main recipients of SWFs investments see also: S. KERN; *SWF's and foreign investment policies - an update*; cit; p. 24-38. These issues will be dealt with more carefully in the last paragraph of the present chapter, in relation to the discussion of the issue of national security.

"Equitable" should mean that all the interests at stake, both those of the investors and of the host State, must be adequately taken into consideration, together with all relevant circumstances which are specific of the case at issue.[133] This means, first of all, that the notion of legitimate expectations must not be understood as an absolute concept, but rather in relative terms and precisely in relation to the situation of the host State. This has a particular relevance when an assessment must be made by arbitral tribunals on the frustration of legitimate expectations of the foreign investors whose importance has been stressed above. If an investor has unrealistic and unreasonable expectations on the business environment of the host State or if she unconsciously and unjustifiably expects she will receive certain favourable treatment, then she cannot claim that the host State should have not frustrated its expectations, since such expectations were neither reasonable nor legitimate[134]. In this case the investor would hardly be able to successfully claim that she has not been accorded fair and equitable treatment. Based on this interpretation, if a SWF decides to invest in a country in which transactions carried out by State-owned entities are traditionally not welcomed and subjected to unfavourable treatment, then it cannot claim that his legitimate expectations have been frustrated, as it should have been aware of the hostility reserved in the recipient State to investments undertaken by SWFs. To give proof of its good faith the foreign SWF should have at least tried to seek some

[133] D. CARREAU, P. JUILLARD; cit.; p. 463-466; M. VALENTI; *Gli standard di trattamento nell'interpretazione dei trattati in materia di investimenti stranieri*; cit.; p 185-211; M. VALENTI, Il *contributo dei trattati in materia di investimenti stranieri allo sviluppo del paese ospitante*; in G. VENTURINI, ed.; *Le nuove forme di sostegno allo sviluppo nella prospettiva del diritto internazionale*; Torino; Giappichelli; 2009; p. 83-94; P. MUCHLINSKI; *Caveat Investor? The relevance of the conduct of the investor under the fair and equitable treatment standard*; cit.; p. 527-557. W. BEN HAMIDA; *La prise en compte de l'intérêt général et des impératifs de développement dans le droit des investissements*; cit.; p. 999-1034. Among ICSID arbitral decision which deal with these issues and which deserve to be quoted we remind: *Alex Genin and others v. Republic of Estonia*; ICSID case No. ARB/99/2; award of 25 June 25 2001; par. 352-363; *International Thunderbird Gaming Corporation v. The United Mexican States*; Arbitral award In the matter of a NAFTA arbitration under the UNCITRAL Arbitration Rules; award of 26 January 2006; par.148-166; *Saluka Investments BV (The Netherlands) v. The Czech Republic*; cit.; par. 297-306; *Parkerings-Compagniet as v. Republic of Lithuania*; cit.; par: 320-346.

[134] P. MUCHLINSKI; *Caveat Investor? The relevance of the conduct of the investor under the fair and equitable treatment standard*; cit.; p. 542-547.

assurances from the relevant authorities of the recipient States, for instance by entering into State contracts in the way indicated above.

The second important implication of the interpretation of the fair and equitable treatment clause mentioned above is that, if a conduct of a State which adversely affects the activity of the investor is a consequence of a previous conduct of the investor herself, in this case the latter cannot claim the existence of a violation of the fair and equitable treatment clause. This is particularly important when a foreign investor claims that she has not been accorded fair and equitable treatment because she has been damaged by an active or omissive conduct of the investor, for instance in the case of the decision of State authorities to withdraw or not to renew a license as a result of failure of the investor to comply with applicable laws and regulations of the host State. This includes both State measures adopted with a view to sanctioning violations of applicable domestic provisions committed by the investor herself and measures whose adoption is made necessary to cope with a situations which have been determined entirely or in part by the investor herself. Such State measures however, need to be decided and implemented in a lawful, consistent and non discriminatory way. [135]

The interpretation of the fair and equitable treatment according to which the lawfulness of the conduct of the host State must be judged in the light of the behaviour of the investor could provide host States with more effective means to govern the operations of SWFs in their territory and minimise the potential threats they may entail. In fact, such an interpretation could allow to consider as compatible with the fair and equitable treatment clause any measure adopted by the host State in order to tackle the effects of a conduct of a foreign SWF whenever the latter means to use its investments in order to pursue political objectives in a way detrimental to the interests of the host State. Therefore, in an hypothetical dispute between a foreign SWF and the host State, concerning the alleged violation of the fair and equitable treatment clause, the host State could claim that the measure it

[135] On this point see, *inter alia*, P. MUCHLINSKI; *Caveat Investor? The relevance of the conduct of the investor under the fair and equitable treatment standard*; cit.; p. 540-543.

has adopted, although it damages the foreign SWF does not represent a breach of the applicable BIT since it constitutes an appropriate response to the conduct of the SWF itself.

Another aspect of the investments of SWFs which causes worries in the recipient countries is related to the alleged lack of transparency of many SWFs. Such opacity has several dimensions: it can relate to the legal framework and to the structure of the SWF, as well as to its corporate governance, its objectives and strategies. Reluctance of a foreign SWF to disclose relevant information to competent State authorities can trigger host State measures which might severely affect its investments; however these measures should not amount to a breach of the fair and equitable treatment.

Municipal law of most host States usually require investors (in many case not only foreign but also domestic) to provide information to competent market and financial authorities when they carry out investments and especially when they acquire a stake in a listed company, something that SWFs usually do when they invest overseas. In principle such duties of disclosure and information serve the purpose of enhancing the transparency and the integrity of financial markets and of providing all investors with adequate information about the ownership of listed companies. In the case of the investments of SWFs the need for disclosure and transparency is even more important. In fact, as already discussed in the present chapter, SWFs are often feared to pursue political and strategic goals: only if they provide appropriate information, the competent authorities of the recipient State will be able to assess whether the investments undertaken by a SWF on its territory should need particular attention as they would be regarded as politically driven.[136]

Such a conclusion is supported by the finding of an ICSID tribunal in the Genin case[137] in which an American investor was adversely affected by the decision

[136] On the issue of transparency of SWFs see, *inter alia*, chapter 1 paragraph 4. The issue of transparency has been addressed in soft law instruments which have been recently adopted and which are dedicated to SWFs. For an analysis of the importance of transparency in these instruments see, *infra*, chapter 8 paragraph 1.

[137] *Alex Genin and others v. Republic of Estonia*; cit.; par.352-363.

adopted by authorities of the Republic of Estonia entrusted with the task of financial supervision to revoke his license as a result of his failure to disclose those information the host State authorities needed in order to be able to carry out their supervisory tasks. The tribunal, when asked to decide whether the revocation of the license was tantamount to an expropriatory act and therefore whether it gave rise to an obligation to pay compensation argued that: "[...] the reluctance of Mr. Genin to divulge the beneficial ownership of Eurocapital which would have enabled the Bank of Estonia's Banking Supervision department to understand the relationship of the various entities associated with him, was the cause of legitimate concern and cannot be considered to have been a mere excuse, or pretext, to revoke EIB's license. Mr. Genin's failure to disclose the true ownership of the companies in question was one of the very reasons for the Bank of Estonia's suspicions regarding EIB—even if the central bank was unable, at the time, to identify precisely the cause of its unease or to confirm its suspicions regarding self-dealing among EIB's shareholders and affiliated entities."[138] The tribunal therefore argued that "the Bank of Estonia acted within its statutory discretion when it took the steps that it did, for the reasons that it did, to revoke EIB's license. Its ultimate decision cannot be said to have been arbitrary or discriminatory against the foreign investors in the sense in which those words are used in the BIT [...][139] Although these finding are related to an issue of indirect expropriation and not of a alleged violation of the fair and equitable treatment standards, it seems that they can apply to the latter as well.[140]

The discussion undertaken so far in the present paragraph allows to conclude that a foreign SWF cannot successfully claim that it has not been accorded fair and equitable treatment if the SWF itself has not in turn behaved in a fair and transparent

[138] *Alex Genin and others v. Republic of Estonia*; cit.; par. 363.

[139] *Alex Genin and others v. Republic of Estonia*; cit.; par. 364

[140] *Alex Genin and others v. Republic of Estonia*; cit.; par: 366-373. It must be stressed that in recent ICSID awards the elements which have been considered by arbitral tribunals when assessing the existence of indirect expropriation and of violation of the fair and equitable, are very similar. For this reason some of the principles which have emerged in relation to the discussion of the issue of indirect expropriation seems to be applicable also in the analysis of the notion of the fair and equitable treatment, and *vice versa*. For a more in-depth analysis of this point see the following paragraph.

way. On the other hand, it can be argued that if a State is left free to determine when a foreign SWF has behaved in a way so as to deserve to be treated fairly and equitably, this might introduce an excessive level of arbitrariness on behalf of the host State. This would ultimately result in depriving the fair and equitable clause of its utility.

For this reason, it would be desirable to develop mutually agreed and predictable criteria concerning the conduct of SWFs. If the SWFs fail to respect such standards, then there would be a presumptions that they are behaving in a way which could in turn justify the host State to adopt some measures which would have been otherwise inconsistent with the fair and equitable treatment clause.

In the last few years, some documents, like, for instance, the so called "Santiago Principles", have been adopted concerning the way SWFs should be managed and the way they should carry out their investments overseas. These documents will be the object of in-depth analysis in chapter 8 paragraph 1 of the present research. However, it is important to stress in these pages that, although they are not legally binding, nonetheless the host State, or, in a second stage, the arbitral tribunals could refer to them when it assesses whether a foreign SWF is acting fairly. Conduct of a SWF resulting into failure to respect the Santiago Principles would not amount to a breach of a legal obligation; however it would give rise to a strong presumption that measures adopted by the host State as a response to the conduct at issue would not constitute a violation of the fair and equitable treatment clause.

7. The provisions on expropriations and transfers of capitals in IIAs and their implications for the investments of SWFs

Usually BITs contain several other provisions, other than those dealing with standards of treatment which have been discussed in the previous paragraphs. The purpose of this paragraph is to review them and their applicability to the investments of SWFs.

First of all, BITs attempt to govern expropriations and nationalisations of foreign investments located in their territory. It must be remarked that BITs do not prohibit host States from expropriating foreign assets, but they make the lawfulness of expropriation subject to the fulfilment of certain requirements and to the payment of a compensation which, in the wording of most BITs must be prompt, adequate and effective. For instance, the BIT concluded between Italy and the United Arab Emirates declares at art. 6.1 that "Gli investimenti [...] non saranno soggetti a sequestro, confisca o misure analoghe che possano limitare permanentemente o temporaneamente i connessi diritti di proprietà, possesso, controllo o godimento, salvo i casi in cui ciò sia specificamente disposto per legge o sulla base della decisione di un tribunale competente emanata in conformità alle leggi in vigore." With respect to nationalisations it adds at art. 6.2 that" Gli investimenti di persone fisiche o giuridiche di ciascuna delle due Parti Contraenti non saranno direttamente o indirettamente nazionalizzati, espropriati, congelati o sottoposti a misure aventi effetti equivalenti alla nazionalizzazione o all'esproprio nel territorio dell'altra Parte Contraente, ivi compresi l'imposizione di tasse, la vendita obbligatoria di tutto o parte di un investimento o l’impedimento o la privazione della sua gestione e del suo controllo. Tutte queste azioni fanno riferimento all'esproprio [...]" After having prohibited direct and indirect forms of expropriation and nationalization of assets owned by investors of the other contracting State, art. 6 continues specifying the conditions which must be respected by an act of the host States which completely deprives the foreign investor of the value of his investment in order not to be tantamount to expropriation. A State act, although it destroys the value of the investment of the foreign investor, is not prohibited provided that: "sia compiuto a fini pubblici o interesse nazionale; sia compiuto in conformità a tutte le disposizioni e procedure di legge e non sia discriminatoria; non violi alcuna specifica disposizione e o clausola contrattuale o espropriazione contenute nell'Accordo di investimento fra le persone fisiche e giuridiche interessate e la parte che effettua l'esproprio; sia effettuato in conformità a regolamenti e sentenze emesse da corti o tribunali competenti."

The BIT concluded between Saudi Arabia and Austria is more concise, since it provides at art. 5 that: A Contracting Party shall not expropriate or nationalize directly or indirectly an investment of an investor of the other Contracting Party or take any measures having equivalent effect such as freezing or blocking of assets (hereinafter referred to as expropriation) except:

a) for a purpose which is in the public interest,

b) on a non-discriminatory basis,

c) in accordance with due process of law, and

d) accompanied by payment of prompt, adequate and effective compensation in accordance with paragraphs (2) and (3) below [...]"

As it is clear from the wording of the BITs quoted above, expropriation can be direct or indirect. While direct expropriation consists in an outright seizure of foreign assets, indirect expropriation is more difficult to assess.[141] However, in the last years an increasing number of disputes has concerned indirect expropriations, which occurs when the alleged deprivation of the foreign investor of its assets or, more often, the deprivation of the foreign investor of the possibility *to dispose* of its assets and to use them, is the consequence of State acts whose character and nature are not in principle expropriatory, but which simply consist in regulatory and administrative acts the host State adopts in the exercise of its sovereign functions within its territory. Arbitral tribunals, when required to assess whether an indirect expropriation has taken place, need to evaluate measures adopted to implement policies decided by a sovereign State in the exercise of its duty and its right to govern its internal affairs, included the conduct of economic operations on its territory. Arbitral tribunals, in an increasing number of awards, have provided some elements which could be taken into consideration in order to assess whether the conduct of a State exclusively consists in a legitimate regulatory act or whether it is also tantamount to expropriation

[141] G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*; cit.; p. 379-383.

and therefore whether it gives rise to the obligation upon the host State to pay compensation to the adversely affected investor.[142]

As already mentioned, the first evidence of indirect expropriation is the existence of one or more active or omissive conducts (or a combination of them) referable to the host State authorities, whose actual or apparent aim may be to regulate certain aspects of the economic or social life of the State but whose outcome is also a complete loss of value of the foreign investment although the latter, differently from what occurs in the case of the direct expropriation, formally remains in the foreign investor's ownership [143].

However, this is a necessary but not a sufficient condition; further conditions must be fulfilled so that it is possible to assess that certain State acts can fall within the notion of indirect expropriation. A list of such condition could be drawn from an analysis of the "case law" of arbitral tribunals which have been required to settle investor-State disputes.

First of all, if State measures at issue are adopted not to pursue a public purpose, this may constitute evidence that their real aim is not to regulate certain activities but just to deprive the investor of its property. It must be remarked that also in case of direct expropriation the assessment of the existence of a public purpose is extremely

[142] On this issue, and on the problems that this might entail for the sovereignty of the host State and for its ability to carry out its domestic policies in accordance with its own objectives see: P. MUCHLINSKI; *Trends in international investment agreements: balancing investor rights and the right to regulate*; cit.; p. 35-78; M. BARBIERI; *Economists and Lawyers Working Together. A Multidisciplinary Approach for Policy Orientated Researches in the Fields of Foreign Investments and Economic Development*; UNCTAD- Virtual Institute Digital Library; 2010; p. 4-7; A. DE LUCA; *L'arbitrato internazionale treaty-based sugli investimenti esteri*; cit.; p. 1050-1070.

[143] A. REINISCH; cit.*;* p. 432- 458; G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 382 seq.; J. R. MARLLES; *Public Purpose, private losses: regulatory expropriation and environmental regulation in international investment law*; in *Journal of Transnational Law & Policy*; 2007; p.276-336; B. KUNOY; *The Notion of Time in ICSID's Case Law on Indirect Expropriation*; in *Journal of International Arbitration*; 2006; p. 342-349; R. DOLZER; *The impact of international investment treaties on domestic administrative law*; in *New York University Journal of International Law and Politics*; 2005; p. 953-972; Y. L. FORTIER; S. L. DRYMER; *Indirect Expropriation in the Law of International Investment: I know It When I See It, or Caveat Investor*; in *ICSID Review*; 2005; p. 293-327; M. G. PARISI; M*oving towards transparency? An examination of regulatory takings in international law*; in *Emory International Law Review*; 2005; p. 383-426; E. SAVARESE; *In margine al caso Saipem: tra allargamento della nozione di espropriazione e coordinamento successivo di giurisdizioni*; in *Diritto del commercio internazionale*; 2007; p. 933-959; W. BEN HAMIDA; *L'arbitrage État-investisseur étranger: regards sur les traités et projets récents*; cit.; p. 419-442.

important.[144] However, while in case of direct expropriation the absence of a public purpose affects the legitimacy of the expropriation, but not the existence of the expropriation itself, on the contrary in case of indirect expropriation the absence of a public purpose of the regulatory act at issue is an evidence of the existence of an indirect expropriation.

In addition, in order to amount to indirect expropriation, host State measures must also be disproportional, arbitrary and discriminatory, they must be adopted pursuant to a process which does not ensure a minimum level of predictability, transparency, consistency and respect for the law, they must determine the frustration of the legitimate expectations of the investor.[145]

In their decisions, Arbitral Tribunals have referred to the above mentioned elements in very different ways. In some cases they took into consideration only some of them. Therefore the list provided above is neither exhaustive, nor the elements quoted must necessarily occur simultaneously.[146]

It must be underlined that the elements determining the existence of an indirect expropriation and those providing evidence of a breach of the fair and equitable treatment clause are very similar. Actually, in most treaty-based disputes, investors tend to simultaneously claim both the violation of the BIT provisions on expropriation and those on the fair and equitable treatment, the main difference between the two

[144] On the issue of the public utility of a lawful measure of expropriation see, *inter alia*, G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 386.

[145] The assessment of the existence and of the subsequent frustration of legitimate expectations is a very important element which is considered by arbitral tribunals. legitimate expectations can be defined as the expectation that the investor acting in good faith is reasonably and legitimately induced to have by the same conduct of the host State. For the notion of legitimate expectations and transparency see: A. KOTERA; *Regulatory transparency;* in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford; Oxford University Press, 2008; p. 617-636; S. FIETTA; cit.; p.375-400; M. G. PARISI; cit.; p. 383; REINISCH; cit.; p.432-458. Several arbitral decisions discussed the role of legitimate expectations of the investors and/or of transparency in order to assess whether an indirect expropriation or a breach of the fair and equitable treatment clause has occurred. See, for instance, the following cases: *Técnicas Medioambientales* cit.; par. 122 and 149-174; *Waste Management, Inc. v. United Mexican States*; cit., par. 159; *Azurix Corp. v. The Argentine Republic*; cit.; par. 316- 323.

[146] For a more detailed and analytical analysis of the elements taken into consideration when assessing the existence of an indirect expropriation, as well as for a survey of the relevant arbitral awards, see: A. REINISCH; cit.; p. 432- 458; Y. L. FORTIER; S. L. DRYMER; cit.; p. 293-327; M. G. PARISI; cit.; p. 383-426; R. MARLLES; cit*.;* p.276-336; B. KUNOY; cit.*;* 342-349; S. FIETTA; p. 375- 395.

notions residing in the extent to which the value of the investment is impaired. A complete annihilation of the value of the investment shall amount to indirect expropriation, while a State act determining a severe but not complete loss of the value of foreign assets shall entail a violation of the fair and equitable treatment clause.[147] For this reason, several considerations which have been carried out in the previous paragraph in relation to the application of the fair and equitable treatment clause to SWF will be valid also in relation to the application of BIT's provisions governing indirect expropriation, hence they will not be repeated in this paragraph. Therefore, it can be concluded that States acts which in principle aim at regulating either the specific investments of the foreign SWF, or a number of investments of different entities included those of the SWF at issue, could potentially be tantamount to acts of indirect expropriation against the SWF, whenever they completely destroy the value of its investment. Likewise, State measures formally governing matters which are distinguished from investments, for instance environment health, or military issues but which are nonetheless able to affect the operations of SWFs, could fall within the notion of measures tantamount to expropriation.[148] For this to occur it is also necessary for these State measures to be disproportional, arbitrary, discriminatory, opaque, inconsistent and susceptible to frustrate the legitimate expectations of the investor. In any case, State measures which annihilate the value of SWF's investments but which are adopted as a result of the conduct of the SWF (which, for instance fails to ensure a sufficient level of disclosure about its operations or uses its the investments to achieve political aims and in order to threaten the national security of the host State) could hardly be regarded as tantamount to indirect expropriation and therefore as giving rise to an obligation upon the host State to pay compensation.

[147] F. HORCHANI; cit.; p. 367-418.

[148] W. BEN HAMIDA; *L'arbitrage État-investisseur étranger: regards sur les traités et projets récents;* p. 419-442; P. MUCHLINSKI; *Trends in international investment agreements: balancing investor rights and the right to regulate*; cit.; p. 35-78; J. WAINCYMER; *Balancing property rights and human rights in expropriation*; in P-M DUPUY, F. FRANCIONI AND E.U. PETERSMANN; ed.; *Human rights in international investment law and arbitration*; New York; Oxford University Press, 2009; p. 275-308.

Another important clause contained in most BITs and which can have a relevance for the operations of SWFs, is the one which provides for the removal of restrictions on capital transfers which are made in relation to covered investments. In many cases, it provides for a general obligation upon contracting parties not to restrict capital transfers and then it adds a non exhaustive list of transfers of funds.[149] For instance, the BIT concluded between China and Australia provides at art. 10 that: "A Contracting Party shall, when requested, permit, subject to its law and policies, all funds of a national of the other Contracting Party related to an investment or activities associated with an investment in its territory, and earnings and other assets of personnel engaged from abroad in connection with an investment, to be transferred freely and without undue delay. Such funds include the following:

(a) the initial capital plus any additional contributions used to maintain or expand the investment;

(b) returns;

(c) fees, including payments in connection with intellectual and industrial property rights;

(d) receipts from the whole or partial sale, divestment or liquidation of the investment;

(e) payments made pursuant to a loan agreement; and

(f) capital accretions."

Likewise, the BIT concluded by Italy and the United Arab Emirates provides at art. 7 that: "Ognuna delle Parti Contraenti garantirà, senza indebito ritardo e dopo che siano stati adempiuti tutti gli obblighi fiscali, ivi compresa l'imposta sul reddito, il trasferimento all'estero in qualsiasi valuta liberamente utilizzabile" in relation to a) profitti netti, dividendi, royalties, [...] interessi ed altri utili derivanti da investimenti effettuati da investitori dell'altra Parte Contraente; b) redditi derivanti dalla totale o

[149] For an introduction to the clause of IIAs which provides for free capital transfers, as well as its relations with other clauses of IIAs see: R. DOLZER; *Transfer of Funds; investment rules and their relationship to other international agreement*; in M. GIOVANOLI, D. DEVOS; *International monetary and financial law: the global crisis*; Oxford; Oxford University Press; 2010; p. 533-544.

parziale vendita o dalla totale o parziale liquidazione di un investimento; c) fondi destinati al rimborso di prestiti; [...][150]

In principle, the clause providing for the abolition of restrictions to transfer of capitals connected to covered investments has two dimensions. First of all, it refers to the possibility of the investor to move funds from the home State to the host State. Under this point of view the capital transfer clause allows to start the investment, to develop it and to make all the payments which might be necessary for its continuation and management. Secondly, it lays down the possibility for the investor to move capitals back from the host State to the home State. This enables the investor to repatriate a part or the totality of profits, or even to divest and to repatriate the proceeds from sale of the assets she holds abroad. Finally, this could ensure that in the case the host State is required to pay compensation to the investor because of breaches of other BIT provisions, no obstacle will exist which prevents the transfer of capitals related to the payment of the compensation itself.[151]

When BITs contain a capital transfer provision of this kind, they turn from instruments imposing certain obligations to host States in relation to the treatment of foreign investor into instruments which also pushes host States to liberalise their capital account.[152] In some cases they contain some exceptions, for instance related to the possibility to introduce restrictions to capital transfers in order to temporarily address problems of the balance of payments or otherwise related to monetary issues, or in order to ensure compliance with tax provisions, or to enforce creditor rights or, finally, in order to ensure proper regulation of the banking and financial system.

One of the most sophisticated example of balance of payment safeguard in an International Investment Agreement is constituted by art. 2104 of NAFTA. Given its complexity, its completeness in its attempt to address the issue and finally, since all

[150] In quoting art. 7 of the Italy-United Arab Emirates BIT I reported only the paragraphs relevant for financial investments undertaken by SWFs.

[151] A. NEWCOMBE, L. PARADELL; *Law and practice of investment treaties: standards of treatment*; Kluwer Law International, 2009; p. 407-411; UNCTAD; *Transfer of funds*; UNCTAD; 2000; p. 4-7 and p. 28-32.

[152] M. WAIBEL; *BIT by BIT;* cit.; p. 497-518.

the members of NAFTA own SWFs and especially one of them, the US, is one of the main recipients of SWFs investments, it is worth to quote it in full.

"1. Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining measures that restrict transfers where the Party experiences serious balance of payments difficulties, or the threat thereof, and such restrictions are consistent with paragraphs 2 through 4 and are:

(a) consistent with paragraph 5 to the extent they are imposed on transfers other than Cross-Border trade in financial services; or

(b) consistent with paragraphs 6 and 7 to the extent they are imposed on Cross-Border trade in financial services.

General Rules

2. As soon as practicable after a Party imposes a measure under this Article, the Party shall:

(a) submit any current account exchange restrictions to the IMF for review under Article VIII of the Articles of Agreement of the IMF;

(b) enter into good faith consultations with the IMF on economic adjustment measures to address the fundamental underlying economic problems causing the difficulties; and

(c) adopt or maintain economic policies consistent with such consultations.

3. A measure adopted or maintained under this Article shall:

(a) avoid unnecessary damage to the commercial, economic or financial interests of another Party;

(b) not be more burdensome than necessary to deal with the balance of payments difficulties or threat thereof;

(c) be temporary and be phased out progressively as the balance of payments situation improves;

(d) be consistent with paragraph 2(c) and with the Articles of Agreement of the IMF; and

(e) be applied on a national treatment or most-favored-nation treatment basis, whichever is better.

4. A Party may adopt or maintain a measure under this Article that gives priority to services that are essential to its economic program, provided that a Party may not impose a measure for the purpose of protecting a specific industry or sector unless the measure is consistent with paragraph 2(c) and with Article VIII(3) of the Articles of Agreement of the IMF.

Restrictions on Transfers Other than Cross-Border Trade in Financial Services

5. Restrictions imposed on transfers, other than on cross border trade in financial services:

(a) where imposed on payments for current international transactions, shall be consistent with Article VIII(3) of the Articles of Agreement of the IMF;

(b) where imposed on international capital transactions, shall be consistent with Article VI of the Articles of Agreement of the IMF and be imposed only in conjunction with measures imposed on current international transactions under paragraph 2(a);

(c) where imposed on transfers covered by Article 1109 (Investment - Transfers) and transfers related to trade in goods, may not substantially impede transfers from being made in a freely usable currency at a market rate of exchange; and

(d) may not take the form of tariff surcharges, quotas, licenses or similar measures.

Restrictions on Cross-Border Trade in Financial Services

6. A Party imposing a restriction on Cross-Border trade in financial services:

(a) may not impose more than one measure on any transfer, unless consistent with paragraph 2(c) and with Article VIII(3) of the Articles of Agreement of the IMF; and

(b) shall promptly notify and consult with the other Parties to assess the balance of payments situation of the Party and the measures it has adopted, taking into account among other elements

(i) the nature and extent of the balance of payments difficulties of the Party,

(ii) the external economic and trading environment of the Party, and

(iii) alternative corrective measures that may be available.

7. In consultations under paragraph 6(b), the Parties shall:

(a) consider if measures adopted under this Article comply with paragraph 3, in particular paragraph 3(c); and

(b) accept all findings of statistical and other facts presented by the IMF relating to foreign exchange, monetary reserves and balance of payments, and shall base their conclusions on the assessment by the IMF of the balance of payments situation the Party adopting the measures."

Some elements of this article must be pointed out. Firstly, it governs capital transfers related to trade (in goods and services) and investment both, consistently with the broad scope *ratione materiae* of the NAFTA. It distinguishes between transfers associated with financial services, which are regarded as more volatile, and other transfers. In relation to the former ones, the possibility for member States to restrict transfers consistently with the NAFTA is made relatively easier. Finally, the NAFTA provides for cooperation with the IMF, which is regarded as the most authoritative organization in the field of balance of payments issues.[153]

However in the majority of cases BITs do not specify such exceptions and therefore the capital transfer clause contained in their texts could severely reduce the ability of the host State to adopt measures aiming at achieving one of the objectives mentioned above in a way which does not result into a breach of the BIT itself.[154]

The provision concerning capital transfers is important both in relation to FDIs and to portfolio investments. In the first case, it must be pointed out that multinational corporations need to be able to transfer funds across the parent company, the branches and the subsidiaries for a vast array of reasons, for instance to finance certain productions, to compensate losses incurred in relation to certain economic activities they carry out, to improve their tax planning. In the case of portfolio investments, which are particularly important for the purposes of the present analysis since they constitute the majority of the investments of SWFs, the possibility

[153] M. WAIBEL; *BIT by BIT;* cit.; p. 506-507; UNCTAD; *Transfer of funds*; cit.; p. 4-7 and p. 37-38. For more information on the role of the IMF in issues concerning balance of payments see, *supra*, chapter 3.

[154] M. WAIBEL; *BIT by BIT;* cit.; p. 497-518; UNCTAD; *Transfer of funds*; cit.; 2000; p. 32- 38.
It must be remarked that provisions concerning possible restrictions imposed by the host States to transfers of capitals, especially in relation to monetary and financial issues can be found in other international agreements, especially in the IMF and in the GATT and the GATS. A discussion on these topics has been made in the previous chapter and therefore it shall not be repeated in this context.

for the investor to freely transfer capitals related to covered investments can be an even more sensitive issue. In fact, foreign portfolio investments consist in the purchase of securities issued by States or by entities based in States other than the State of which the investor is national. If capital transfers from the home State to the host State are prohibited, then it could be argued that it may be impossible to purchase such securities and, therefore, to undertake the investment itself. On the other side, it must be argued that, given the worldwide circulation of financial assets and their tradability in trading venues located also outside the territory of the host State, it is possible to make a portfolio investment without the need for direct transfer of capitals from the territory of the home State of the investor to the territory of the host State. This concept could be better clarified by the following example. Suppose that a Chinese SWF purchases shares of a British company from an American investor and pays the latter with USD which are deposited in a bank account at a bank located in the US. In this case although the Chinese SWF has undertaken an investment in the UK, no direct transfer of capitals from China to UK has occurred. Such a portfolio investment could have occurred independently from the existence of any provision liberalising capital transfers between the UK and China.

The relation between transfer of funds clauses and provisions which govern payments and other capital transfers which are contained in other international instruments having a multilateral character, can give rise to some difficulties. For instance, if a State, acting consistently with the IMF Articles of Agreement adopts measures which restrict capital transfers in a way which jeopardises the rights of the foreign investors, then violation of a BIT might occur. In principle, the fact that some measures can be authorised under the IMF Articles of Agreement should not preclude their incompatibility with BITs. The only exception could be represented by the case in which the BITs at issue contain a provision expressly subordinating their application to the respect of the IMF Articles of Agreement.[155]

[155] For a more detailed discussion of the relation between BITs and the Articles of Agreement of the IMF see: A. KOLO; *Transfer of funds*; cit.; p. 355-374.

Other provisions contained in BITs seem to have less relevance in governing the investments of SWFs. It is for instance the case of those provisions on performance requirements or on restrictions of movements or on hiring of key personnel working for the foreign investor[156]. Such provisions, although they have a great importance in case of FDIs, have nevertheless a little impact in case of portfolio investments, which, as explained above, are by large the most frequent kind of operations undertaken so far by SWFs. Therefore an analysis of such clauses and of their applicability to SWFs does not seem to be necessary for the purposes of the present paragraph.

8. The issue of the protection of national security of the host State: introductory remarks.

As broadly discussed in the previous pages, the investment undertaken by SWFs rise several concerns in recipient countries. In particular, it is feared that such State-owned investment vehicles might represent a threat to the national security of the host State.

For this reason, in order to complete the review of the applicability of international investment law provisions to SWFs, it is necessary to study whether there are provisions in BITs or in customary international law which can be used in order to allow the host State to adopt measures which can adversely affect the foreign SWF but which do not constitute a breach of international investment law since they are adopted with a view to protect the national security of the host State.

In the next paragraphs an analysis of this issue will be undertaken. First of all, a very general review of what could be meant as national security shall be made; in this first stage the considerations which shall be made will also have a political, economical and "pre-legal" character. Then, it will be studied the content of the rules of international law applicable to the relation between the protection of national security of the host State and transnational investments. To this extent, due attention will be

[156] On this issues, see: G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.;p. 356 seq.; UNCTAD *international investment agreements: key issues*; cit.; p. 144.

paid to provisions contained in IIAs, to the relevant arbitral awards interpreting and applying them, as well as to the applicable rules of customary international law. Finally, the applicability of such rules to the operations of SWFs will be studied.

As a first step of the present analysis, it must be understood that the determination of what represents a situation in which an investment of a foreign SWF may endanger national security, depends on the determination of the notion of national security itself, as well as of the sensitive economic sectors in which foreign investments can rise an issue of national security.

In principle, national security can be related first of all to the sovereign right of a State to adopt measures necessary to prevent imminent military aggressions, terroristic attacks, severe riots and civil war, as well as the right to adopt measures to respond to such events when they have already started to occur.[157] In this case the notion of national security is strictly intertwined with military and police issues. If this notion is construed more broadly, it can be used to adopt measures which aim at preventing a loss of relative military power, especially *vis à vis* possible military competitors.[158] This means that any event which reduces the relative military power of a State and which determines a loss of its strategic advantages compared to other States can constitute an issue of national security. It follows that also restrictions on foreign investments in the military sector or in the so called dual use sectors should be envisaged,[159] in order to prevent foreigners, especially when they are sovereign

[157] Several BITs do not provide for a duty upon the host State to pay compensation to foreign investors affected by such events, but they only require it to respect the principle of national treatment and MFN when if it decides to provide compensations to domestic investors or to third country investors. For an example see art. 5,1 of the BIT stipulated by Kazakhstan with Kuwait.

[158] On the issue of relative power in international relations see, for instance: R. POWELL; *Absolute and Relative Gains in International Relations Theory*; in *The American Political Science Review*; 1991; pp. 1303-1320.

[159] The word dual use sector refers to those industries which develop technologies primarily devised to be used for civil purposes, but which could be also used and applied, with minor changes, also for military purposes. Several electronic equipments like those produced for aircrafts constitute an example of double use technology, since they could be initially developed to be installed on civil aircraft, but then used also in order to improve the performance of military planes. Also researches in molecular biology could develop dual use technologies, which can be used to care diseases but also to create biological weapons. On this last issue see, for instance: Federation of American Scientists; Case studies in dual use biological research; available online at: http://www.fas.org/biosecurity/education/dualuse/index.html

foreigners, from profiting of their status as "insiders" in the host State military industries to obtain information related to military issues and often having confidential characters. In addition, a foreign investor might have access to military technologies which, if divulgated, would deprive the military sector of the host State of a strategic advantage, thus weakening the position of the host State as an actor of the international relations. If foreign investments in the military industry are undertaken not by private sectors companies, but by State entities like SWFs, the risk they might entail for the national security of the host State is even greater. It could be legitimately suspected that a SWF may use its status as insider in the invested company in order to acquire military secret know-how from the host State and then to forward it to the government of the State which has created it. This would actually transform SWFs in instruments of the home State for the conduct of industrial and military spying activities. However so far SWFs' investments in the military sectors have been extremely limited and they have always involved meaningless stakes. This would exclude any concrete possibility for SWFs to acquire a position as insiders in the target company, with the risks for the national security of the host State described above.

However, national security could be construed in a broader sense and it can be linked to any event which might threaten a State or its population in such a serious way so that to put in danger the existence of the State itself or of a substantial part of its population: it is the case, for instance, of spreading of severe diseases or of serious food shortages which result in famines. The host State could therefore consider as necessary to preserve national security all the facilities and the assets which can be used to prevent or to stop these calamities. As a result, it could be invoked that investments involving these assets and facilities could rise issues of national security.

Virtually, this approach could bring the host State to regard an exterminate number of industries as indispensable to preserve its national security: from the entire farm and agricultural sector, to the food industry, to the distribution and retail sector as they are the channel to which processed food can be conveyed to the population. Likewise, the need to preserve the population from massive diseases would not only lead to consider hospitals as related to national security, but also the pharmaceutical industry and services like waste management. Also disruptive shortages of water and energy supply as well as blockades of means of transport might endanger national security of the host State.

Finally, a State could be severely threatened also by economic and financial events. In principle an extremely severe economic crisis could put in question the survival of a State and of its population, it can destroy social cohesion, provoke riots and unrests. Under this point of view, at least in principle, disruptive economic crisis would justify the adoption of measures adopted in order to preserve national security. Some economic sectors play a particularly delicate role in the economy of the State. It is the case of the banking and financial sector, which, *inter alia*, play an indispensable task in relation to the effectiveness and implementation of the monetary policy decided by the Central Bank, the collection and the management of saving, the financing of the economy as a whole, from the investments in the fixed capital made by firms to consumptions of households.[160] Therefore the activities of banks, exchanges and, to a certain extent, financial firms could be meant as related to the national security of a State. It would follow that foreign investments in these sectors may be regarded as giving rise to issues of national security.

Finally, the notion of "economic" national security could be construed in an even broader way so that to comprise all measures undertaken in order to preserve the competitiveness of domestic firms. In fact, a severe reduction of the competitiveness of the industries of a State could determine, *inter alia* and at least in the long run, the erosion of the tax base, the deterioration of the trade balance (with a deterioration also of the balance of payment) the growth of unemployment, with negative effects not only on the domestic economy as a whole but also on social cohesion and

[160] In this specific sentence, the term investment is meant as one of the items constituting the aggregate demand according to the macroeconomic science (see: D. BEGG, S. FISCHER, R. DORNBUSCH; cit.; p. 338 and p 356-358 and R. BREALY, S. MYERS, S. SANDRI; cit., p. 3-10) and not in the sense which is given in international investment law and which has been used in the present chapter.

political stability. Such an interpretation of the notion of national security could justify any measure by which State authorities intervene in the economy with the objective of improving the competitiveness of its firms and to protect them from foreign competition.[161]

It could be noted that in the analysis which has been made above, the notion of national security has been progressively broadened to include, in its most extreme and overarching formulation, virtually every economic activity of the host State. On one side it could be argued that the last interpretation of national security which has been provided should be rejected, especially because it is absolutely irreconcilable with the current globalisation of the economy and because today it could be applied maybe in a few closed economies like North Korea. On the other side, it is clear that it is very difficult to find an objective notion of national security. It is not possible to review all the actual or potential problems which can be related to this situation of uncertainty about the content of the notion of national security. In this chapter the focus will be on the implications this might have on the issue of the applicability of national security exceptions in international investment law.

It must be stressed that in concrete cases host States, and not only those which have traditionally been more sceptical as to the liberalisations of trade and investments, might be in favour of a broad interpretation of the notion of national security, in order to retain more discretion in adopting or maintaining measures possibly inconsistent with BITs provisions but consistent with their own interests. On the contrary, foreign investors would be in favour of a restrictive interpretation of the national security exception, because they do not want that the standards of treatment and protection afforded to them in BITs might be easily restricted or circumvented anytime the host State believes that an issue of national security has arisen. It is likely that home State would tend to favour the approach of the investor. Of course, in case of investments

[161] As to the issue of strategic firms and national security see, for instance: OECD; *Freedom of Investment, National Security and "Strategic" Industries: An Interim Report*; in OECD; *International Investment Perspectives: Freedom of Investment in a Changing World*; OECD; 2007; p. 53-63; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 190.

of SWFs, since the home State of the investor is at the same time the investor itself, the overlapping of the interests of the foreign investor and of the home State is complete.

If the notion of national security is construed and applied in an excessively broad sense, then the existence of a violation of BITs and of the duty to pay compensation will be excluded for virtually all State measures inconsistent with one or more BIT provisions but which allow the host State to safeguard what it claims to be its national security. Nevertheless, this would deprive the BITs of their utility. In fact, their provisions could be waived whenever a State deems it necessary to pursue its own interests and whenever it decides that such interests pertain to its national security . In other words, BITs would be prevented *de facto* from achieving their primary task, which is to ensure a certain level of stability of the rights of the foreign investors.[162] An excessively broad interpretation of the national security clause would be contrary to the same purposes of BITs, or, at least to several of its provisions on the treatments to be afforded to foreign investor.[163] It would result into a deprivation of BITs of their utility and this would be inconsistent, inter alia, with the principle of *effet utile.*[164]

[162] In particular, it can be argued that BITs have been conceived in order to ensure a certain degree of stability to foreign investments in host Countries whose investment environment, being regarded as not sufficiently stable, was hardly able to attract investments. It follows that in principle the provisions contained in BITs should apply and should be respected also in cases in which the host State experiences relevant difficulties. On this point see, for instance: *Sempra Energy International v The Argentine Republic*; ICSID case no. ARB/02/16, award of 28 September 2007; par. 373 which reads as follows: "In weighing this discussion, the Tribunal must first note that the object and purpose of the Treaty" [in this case a BIT between the US and Argentina] "is, as a general proposition, for it to be applicable in situations of economic difficulty and hardship that require the protection of the internationally guaranteed rights of its beneficiaries"

[163] For a broader discussion of these issues see P. MUCHLINSKI; *Trends in international investment agreements: balancing investor rights and the right to regulate*; cit.; p. 68-74.

[164] The *effet utile* principle, or principle of effectiveness implies that a legal instrument, or a provision contained in its wording, shall not be interpreted in a way such as to deprive the legal instrument at issue or some of its provisions, of their meaning and their utility. Several ICSID tribunals supported and applied the principle of *effet utile*. See for instance: *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Hashemite Kingdom of Jordan*; ICSID Case No. ARB/02/13; Decision of the Tribunal on Jurisdiction of 29 November 2004; par. 95; *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*; cit.; par. 156; *Emilio Agustín Maffezini v. Kingdom of Spain*; cit.; par 36, *Československa Obchodní Banka, a.s. v. Slovak Republic*; cit.; par 39 and 67; *SGS Société Générale de Surveillance SA v. Islamic Republic of Pakistan*; ICSID Case No ARB/01/13; Decision on jurisdiction of 6 August 2003;

After this general introduction it is possible to analyse more in detail the content of international law on such an issue. In principle a State might be allowed not to comply with the international obligations it previously undertook, provided that certain circumstances or situations occur. In order to ensure a proper level of stability and predictability of law, it is necessary to determine with a sufficient level of precision which are such circumstances. They can be determined first of all in international treaties. In this case, one or more clauses are included in the text of the treaty, which specify when failure to comply with one or more of its provisions does not amount to a violation of the treaty at issue and does not entail the invocation of the international responsibility of the State. BITs sometimes contain such kind of clauses, which often consist in so-called national security clauses. They enable the host State not to respect other provisions of the BIT when national security or essential security issues are at stake.[165]

Before starting to review and to analyse some examples of clauses of this kind which are included in the BITs concluded between owners and recipients of the investments of SWFs, it must be reminded that, provided certain circumstances occur, international wrongfulness of a State conduct could be excluded also in the absence of a national security clause of a BIT. In fact, in this case it is still possible to apply customary international law. The Draft Articles on Responsibility of States for Internationally Wrongful Acts, which have already been analysed above in this chapter in paragraph 2, constitute a useful tool to understand which are such circumstances.

par. 172; *Noble Ventures, Inc v. Romania*; ICSID Case ARB/01/11; Award of 12 October 2005; paras 50 – 54.

[165] Some international instruments use the term "national security", others refer to "essential security", others to "vital interests". Although it could seem that the notion of “essential security interests” – by including the expression “essential” should be regarded as narrower than the more general term “national security”, it is not obvious that Contracting Parties, by choosing one of these alternatives, actually intended to introduce such a distinction. On this issue see: UNCTAD; *The protection of national Security in IIAs*; cit.; p. 73. In this paragraph it will not be studied further neither the extent to which such terms can be regarded as synonyms nor the differences existing between them. In addition, hereinafter, only the term "national security" will be used in this paragraph and it will be meant as encompassing also the notions of "essential security" or that of "vital interests".

Building upon the discussion developed in the present paragraph, in the next pages it will be studied the content of national security clauses provided for in several BITs, then it will be studied the content of customary international law concerning State of necessity and it will be investigated the relations and the interactions existing between these two notions. Finally, it will be assessed the impact this may have on the ability of host States to properly govern the investments of SWFs undertaken in their territory in order to prevent them from threatening their national security.

9. The notion of national security in IIAs and in customary international law. The interpretation of arbitral tribunals

As anticipated above, some BITs contain clauses providing for derogations of all or some of their provisions when such derogations prove necessary for the host State in order to protect its national security. For instance, art. 2,3 of the BIT between Hungary and the Russian Federation provides that it "shall not preclude the application of either Contracting Party of measures, necessary for the maintenance of defence, national security and public order, protection of the environment, morality and public health." Art. 4,4 of the BIT Kuwait concluded with Lithuania provides that "measures that have to be taken for reasons of public security and order, public health or morality shall not be deemed "treatment less favourable" within the meaning of this Article". The peculiarity of such provision is that the national security exception seems to apply not to all the provisions of the BIT, but only in relation to the non-discrimination clauses. This means that if a foreign investor is discriminated (i. e. treated less favourably) *vis a vis* a domestic investor or a third country investor but if the discriminatory measures are adopted for reasons of "public security and order, public health or morality", then no duty to pay compensation to the foreign investors will arise.

While most BITs fail to detail out what "national security" shall mean, on the other side more insight about the content of such notion can be found in other international instruments containing also, but not exclusively, provisions governing transnational investments between contracting parties,[166] like economic integration or economic cooperation agreements. The analysis of the wording of such instruments has a relevance not only with respect to investments undertaken by SWFs between the States which are parties to such IIAs, but also to the purpose of the interpretation of the national security clauses contained in BITs. Although arbitral tribunals, when they are required to interpret the notion of national security contained in BITs, are not mandated to consider the wording of other international instruments which may provide for some definitions or precisions of the notion of national security, they are not prevented to do so. In other words, although the provisions contained in another international instrument in principle must not be applied by an arbitral tribunal which is settling a dispute concerning a BIT, however they could provide the arbitrator useful guidance in his autonomous reasoning for the purposes of the interpretation and the application of the national security clause.

To this purpose, it is possible to quote first of all the Treaty of 1992 on the North America Free Trade Area, since its art. 2102 provides that none of its provisions shall be construed:

"b) to prevent any Party from taking any actions that it considers necessary for the protection of its essential security interests

(i) relating to the traffic in arms, ammunition and implements of war and to such traffic and transactions in other goods, materials, services and technology undertaken directly or indirectly for the purpose of supplying a military or other security establishment,

(ii) taken in time of war or other emergency in international relations, or

(iii) relating to the implementation of national policies or international agreements respecting the non proliferation of nuclear weapons or other nuclear explosive devices; or

(c) to prevent any Party from taking action in pursuance of its obligations under the United Nations

[166] UNCTAD; *The protection of national security in IIAs*; cit.; p. 85.

Charter for the maintenance of international peace and security."

"The Closer Economic Partnership Agreement between New Zealand and Singapore" of 2000, provides further insight on the notion of national security and of the measures which can lawfully adopted to protect it. Its art. 76 in fact provides that:

"Nothing in this Agreement shall be construed:

(a) as preventing either Party from taking any action which it considers necessary for the protection of its essential security interests, including but not limited to action relating to traffic in arms,

ammunition and implements of war and to such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment, and any action taken in time of war or other emergency in domestic or international relations".

According to art. 193 of the Economic Partnership Agreement between Chile and Japan of 2007, national security implies the adoption of measures "[...](i) relating to the traffic in arms, ammunition and implements of war and to such traffic in other goods and materials, or such supply of services, as is carried on directly or indirectly for the purpose of supplying or provisioning a military establishment; (ii) taken in time of war or other emergency in international relations; or (iii) relating to fissionable and fusionable materials or the materials from which they are derived"

For the purposes of the brief and non exhaustive review of provisions contained in international instruments governing also, although not exclusively, transnational investments, it is possible to quote art. 6,12 of the Economic Cooperation Agreement between India and Singapore of 2005. Since it contains a broad and rather overarching notion of, inter alia, national security, it deserves to be quoted in full.

" Nothing in this Chapter shall be construed:

(a) to require a Party to furnish any information, the disclosure of which it considers contrary to its essential security interests; or

(b) to prevent a Party from taking any action which it considers necessary for the protection of its essential security interests

(i) relating to fissionable and fusionable materials or the materials from which they are derived;

(ii) in time of war or other emergency in international relations;

(iii) relating to the production or supply of arms and ammunition; or

(iv) to protect critical public infrastructures, including communication, power and water infrastructures, from deliberate attempts intended to disable or degrade such infrastructures; or

(c) to prevent a Party from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security."

It emerges therefore that national security exceptions are mainly intended as pertaining to the military and security sphere. Therefore, arbitral tribunals relying on these provisions when interpreting the national security clause in BITs, would consider lawful those host State measures which, although inconsistent with other BIT provisions, are nonetheless necessary to limit and control trade and investments in the military and in the dual sector industry, to prevent nuclear proliferation, or which are adopted in case of war or serious internal disturbances involving the host State, or in order to comply with actions undertaken by competent international organization with a view to maintaining international peace and security (as in the case, for instance, of host State measures adopted in order to implement sanctions against a State adopted by the UN Security Council)[167]

National security exceptions, especially when they are not interpreted in a narrow sense, can provide a powerful tool in the hands of the host State to avoid compliance with the provisions of the IIAs. In order to minimise the risk of such kind of abuses, the same text of IIAs could contain some additional requirements that the host State must fulfil in order to be entitled to claim a security-related exception. One requirement is that measures adopted in order to protect national security exceptions

[167] UNCTAD; *The protection of national security in IIAs*; cit.; p. 85-89.

must not be arbitrary or constitute an unjustifiable discrimination.[168] The requirement that measures for the protection of national security be not adopted in an arbitrary way is detailed out in other IIAs, when they clarify that such measures must be adopted in accordance with the domestic laws of the host States.[169] In addition, it could be required that national security exceptions be not used as disguised restrictions of international investments.[170]

National security clauses can be self-judging or not self-judging. In the first case, they would in principle allow the host State to autonomously and discretionally judge what is necessary for the protection of its national security. Therefore, in principle, the only condition for the invocation of the self-judging national security exception is that the relevant Contracting Party consider the measure at issue "necessary", thus excluding any kind of review by arbitral tribunals or other organs in relation to this issue. On the contrary, if the clause is not self-judging, the host State cannot decide on its own if the measure adopted is necessary for the protection of its national security[171]. Non-self judging clauses provide arbitral tribunals, or other organisms in charge of settling investor-State disputes, with a greater power in assessing whether State measures are actually adopted in a view to protect national security. Non self-judging clauses clearly provide a higher degree of stability and protection to investors, since they reduce the risk of abusive application of the national security clause by the host State. On the other side, they entrust an organ like an arbitral tribunal with the task to assess what is necessary for the protection of the national security of the host State.

[168] UNCTAD; *The protection of national security in IIAs*; cit.; p. 81. For an example of IIA providing for such a requirement see, for instance, art. 99 of the Economic Partnership Agreement between Japan and the Philippines of 2006. It provides that measures adopted for the protection of national security are lawful:"[s]ubject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination against the other Party, or a disguised restriction on investments of investors of the other Party in the Area of a Party".

[169] For instance, art. 12 of the BIT of 2003 between Hungary and India provides that "nothing in this Agreement precludes the host Contracting Party from taking action for the protection of its essential security interests or in circumstances of extreme emergency in accordance with its laws normally and reasonably applied on a non-discriminatory basis".

[170] UNCTAD; *The protection of national security in IIAs*; cit.; p. 83-84.

[171] UNCTAD; *The protection of national security in IIAs*; cit.; p. 91-96; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 193.

This means that a jurisdictional body, which in principle is mandated to apply international law and therefore to have primary an expertise in this field, is *de facto* required to undertake an in-depths political, economic and social analysis of the situation of the host State. Definitely, arbitrators would be given the power to assess what constitutes "national security" for the host State, which events or situations might pose a threat to it, which State measures are appropriate and proportional to the purpose of protecting national security. Under this point of view it is difficult to believe that an arbitral tribunal could be better equipped to understand what the host State needs for its national security than the host State itself. Without going further into a discussion of the pros and cons of self-judging and non self-judging clauses, which would fall outside the scope of the present analysis, it is necessary to explain how to distinguish between a self-judging and a non self-judging clause. Only the former is worded so as to make it clear that it will be the host State to be entitled to decide what it deems to be necessary.[172] For instance, art. 14 of the BIT concluded between the US and Bahrain provides that "This treaty shall not preclude a Party from applying *measures which it considers necessary* [emphasis added] for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests."

On the contrary, non-self judging clauses do not specify which is the subject entrusted with the right to decide what is necessary for the protection of national security. For instance, art. 10 of the US-Kazakhstan BIT provides that: "This Treaty shall not preclude the application by either Party *of measures necessary* for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests." [emphasis added]. In this case, it will be the arbitral tribunal to interpret and apply the provision and, as a result, to assess if a measure

[172] A. K. BJORKLUND; *Economic Security Defenses in International Investment Law*; in *The Yearbook on International Investment Law & Policy*; 2008-2009; p. 498-500; UNCTAD; *The protection of national security in IIAs*; cit.; p. 49-55.

adopted by one of the contracting parties is really necessary to protect its national security.

Therefore, when an IIA fails to specify the exact content of the notion of national security, it will be the task of the arbitral tribunal to do so, especially in case of non self-judging clauses. What deserves particular attention, especially in the context of the present research, is the issue whether also events pertaining to the sphere of economic and financial issues could fall within the notion of national security. As it has been seen above, in many cases they are not explicitly included in the wording of the national security clause, but they are not explicitly excluded; to solve this problem it is therefore necessary to refer to ICSID case law, and especially to some recent awards issued in relation to disputes opposing Argentina to some US investors.

The disputes at issue arose in relation to the damages suffered by foreign investors as a result of the emergency measures adopted by Argentina in order to cope with the severe economic crisis of 2000-2001. In these cases Argentina claimed that economy emergency measures, although inconsistent with some provisions contained in the BIT between the US and Argentina, did not entail a breach of international law because they fell within the scope of the national security clause provided for in art. 11 of the BIT at issue.[173] Art. 11 provided that the BIT "shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests".

When interpreting and applying art 11, arbitral tribunals firstly had to decide whether the national security clause should be meant as referring exclusively to military and

[173] For an analysis of the UCSID awards issued in relation to these disputes see: J. E. ALVAREZ, K. KHAMSI; *The Argentine Crisis and Foreign Investors: A Glimpse into the Heart of the Investment Regime*; in *The Yearbook on International Investment Law & Policy*; 2008-2009; p. 379-478; M. VALENTI; *Lo stato di necessità nei procedimenti arbitrali ICSID contro l'Argentina: due soluzioni contrapposte*; in *Rivista di Diritto Internazionale*; 2008; p. 114-135; M. F. ORZAN; *Il caso CMS Gas Transmission Company e lo stato di necessità economica nel diritto internazionale*, in *Diritto del Commercio internazionale*; 2007; p. 237-272; A. K. BJORKLUND; *Economic Security Defenses in International Investment Law*; cit.; p. 479-504.

security issues or whether, at least in principle, it could also encompass situations of severe economic stress. Secondly, they had to decide the degree of seriousness that an economic crisis must attain in order to be regarded as a threat to national security and therefore to trigger the possibility to invoke the national security exception in order to exclude the existence of an international wrongdoing.

With respect to the first issue, the arbitral tribunal in the CMS case argued that there is "nothing in the context of customary international law or the object and purpose of the Treaty that could on its own exclude major economic crises from the scope of article 11."[174] The tribunal then added that "if the concept of essential security interests were to be limited to immediate political and national security concerns, particularly of an international character, and were to exclude other interests, for example, major economic emergencies, it could well result in an unbalanced understanding of article 11"[175] Likewise, in the LG&E case, the Tribunal, "rejected the notion that Article XI is only applicable in circumstances amounting to military action and war."[176] Also in the Sempra case it was declared that: "there is nothing that would prevent an interpretation allowing for the inclusion of economic emergency in the context of Article XI." In fact, "[e]ssential security interests can eventually encompass situations other than the traditional military threats for which the institution found its origins in customary law"[177] Finally, in the Continental Casualties the tribunal Stated that, when interpreting the notion of essential security interests "it is necessary to recall that international law is not blind to the requirement that States should be able to exercise their sovereignty in the interest of their population free from internal as well as external threats to their security and the maintenance of a peaceful domestic order." Then it adds that "[i]t is well known that the concept of international security of States in the Post World War II international order was

[174] *CMS Gas Transmission Company v. Argentine Republic*; cit.; par. 359.

[175] *CMS Gas Transmission Company v. Argentine Republic*; cit.; par. 360. See also: See also: P. MUCHLINSKI; *Trends in international investment agreements: balancing investor rights and the right to regulate;* cit.; p. 56-58.

[176] *LG&E Energy Corp./LG&E Capital Corp./LG&E International Inc. v The Argentine Republic*, ICSID case no. ARB/02/1, award of 3 October 2006; par. 238.

[177] *Sempra Energy International v The Argentine Republic*; cit.; par. 374.

intended to cover not only political and military security but also the economic security of States and of their population" at to this extent the tribunals also quotes the Preamble to the Charter of the United Nations and the Article of Agreement of the International Monetary Fund.[178]

From the awards mentioned above, it emerges that there is a certain degree of consent on the issue that, at least in principle, economic events could constitute a threat to national security and therefore that national security clauses contained in BITs should apply also in case of economic emergency[179], save otherwise provided for in an explicit way in the wording of the BITs at issue.

However, the main difficulties arise when arbitrators need to assess in practise which is the degree of severity that an economic crisis must attain in order to be regarded as a real and actual threat to national security. In fact it is agreed that not every economic crisis rises issues of national security, but only those which reach a particular level of gravity so that to put in danger the existence and the integrity of the affected State.

On this point arbitral tribunals seem unable to agree on the features an economic crisis should have in order to threaten domestic national security.[180] In fact, the LG&E Tribunal, after having provided in the text of the award a description of the severe situation of economic disruption and related social disaster and civil unrests of the period in which Argentina adopted the emergency measures at issue,[181] concluded that the economic crisis in Argentina constituted a threat to its national security. In fact, it argued that "the conditions in Argentina in December 2001 called for immediate, decisive action to restore civil order and stop the economic decline. To conclude that such a severe economic crisis could not constitute an essential

[178] *Continental Casualty Company v The Argentine Republic*; cit.; par. 175.

[179] P. MUCHLINSKI; *Trends in international investment agreements: balancing investor rights and the right to regulate*; cit.,p. 54-55; J. E. ALVAREZ, K. KHAMSI; cit.; p. 431; L. HSU; cit.; p. 472-475

[180] A. H. QURESHI; *The economic Emergency defence in Bilateral investment treaties; A development perspective*; in VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford; Oxford university press, 2009; p. 631-635.

[181] *LG&E Energy Corp./LG&E Capital Corp./LG&E International Inc. v The Argentine Republic*; cit.; par. 231-237.

security interest is to diminish the havoc that the economy can wreak on the lives of an entire population and the ability of the Government to lead. When a State's economic foundation is under siege, the severity of the problem can equal that of any military invasion."[182] Likewise, in the Continental Casualty case, the Tribunal found that "it is impossible to deny" that a [...] crisis like the one which hit Argentina "does not qualify as a situation where the maintenance of public order and the protection of essential security interest of Argentina as a state and as a country was vitally at stake." The Tribunal briefly summarized the main elements of the Argentina crisis whose combination was able to put in question the national security of Argentina: "the near collapse of the domestic economy; the soaring inflation; the leap in unemployment; the social hardships bringing down more than half of the population below the poverty line; the immediate threats to the health of young children, the sick and the most vulnerable members of the population, the widespread unrest and disorders; the real risk of insurrection and extreme political disturbances, the abrupt resignations of successive Presidents and the collapse of the Government, together with a partial breakdown of the political institutions and an extended vacuum of power". The Tribunal therefore deemed that the level of crisis attained was sufficiently severe to qualify as a threat to national security of Argentina and it added that "the protection of essential security interests recognized by Art. XI does not require that "total collapse" of the country or that a "catastrophic situation" has already occurred before responsible national authorities may have recourse to its protection".[183]

However, the CMS Tribunal did not support this approach and stated that "the Argentine crisis was severe but did not result in total economic and social collapse."[184] Also in the Sempra case the Tribunal was of the opinion that although "there was a severe crisis, and that in such a context it was unlikely that business could have continued as usual," however "the argument that such a situation

[182] *LG&E Energy Corp./LG&E Capital Corp./LG&E International Inc. v The Argentine Republic*; cit.; 238.
[183] *Continental Casualty Company v. Argentine Republic*; cit.; par. 180.
[184] *CMS Gas Transmission Company v The Argentine Republic*; cit.; par. 355.

compromised the very existence of the State and its independence, and thereby qualified as one involving an essential State interest, is not convincing." [185] From this discussion it emerges that, while there is consensus that national security of a State can be put in question also by economic and not merely military events, however it seems impossible to determine in practice which is the degree of severity that a situation of economic hardship might have in order to be actually regarded as posing a real threat to national security, with the consequences this entails from the point of view of international law.[186] As a result, the awards mentioned above are unable to provide definitive and consistent answers.

The discussion carried out so far has focused on the application of national security clauses contained in BITs. As it was described in the beginning of the paragraph, several BITs do not contain such a clause. Nevertheless, this does not mean that a State, which is part of a BIT whose text does not include a national security exception clause, is unable to make recourse to national security in order to exclude that its conduct, whenever inconsistent with one or more provisions of the BIT, does not amount to an international wrongdoing. In fact, customary international law still applies and it provides for the circumstances precluding wrongfulness of a conduct of a State.[187] Such circumstances are listed in the Draft Articles of State Responsibility (articles 20 to 25) and consist in the followings: consent, self-defence, countermeasures in respect of an internationally wrongful act, force majeure, distress, necessity.

Very briefly speaking, consent by a State to a conduct by another State, which otherwise would constitute an international wrongdoing against the consenting State, precludes the wrongfulness of that conduct in relation to the consenting State, provided the consent is valid and to the extent that the conduct remains within the limits of the consent given. Self-defence implies that the wrongfulness of an act of a State is precluded if the act constitutes a lawful measure of self-defence, which *inter*

[185] *Sempra Energy International v The Argentine Republic*, cit.; par. 348.
[186] L. HSU; cit.; p. 472-475
[187] For an overview of these circumstances see, for instance: I. BROWNLIE; cit.; p. 465-467.

alia must be taken in conformity with the Charter of the United Nations and especially with the articles of such treaty governing the use of force. The possibility to adopt countermeasures means that acts adopted by a State not in conformity with an international obligation towards another State do not constitute an international wrongful act when they are adopted as a response to wrongdoings committed by the latter State towards the former State. Force majeure occurs when an irresistible force or an unforeseen event, beyond the control of the State, occurs, making it materially impossible for the State in such circumstances to perform the obligation. Distress applies when the act of a State, which would be otherwise inconsistent with an international obligation, is undertaken "in a situation of distress" in order to save the life of the author of the act or lives of other persons entrusted to the author's care. Finally, necessity can be invoked by a State when its conduct is the only way to safeguard an essential interest of the State itself against a grave and imminent peril, provided that such conduct does not seriously impair an essential interest of the State or of States towards which the obligation exists, or of the international community as a whole. Therefore “necessity” refers to "those exceptional cases where the only way a State can safeguard an essential interest threatened by a grave and imminent peril is, for the time being, not to perform some other international obligation of lesser weight or urgency"[188]. If State of necessity is lawfully invoked, the host State could act inconsistently with international obligations it undertook when entering into IIAs, thus causing a prejudice to the foreign investors, and nonetheless it could be held not responsible for committing an international wrongdoing.

For the purposes of the present analysis, the focus should be on the issue of necessity. Necessity is distinguished from other circumstances precluding wrongfulness, like consent, self-defence and countermeasures because it does not depend on the prior conduct of the injured State. It also differs from force majeure, because the latter involves conduct which is involuntary or coerced, while in case of

[188] *Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries.;* cit.; p. 80.

necessity the State willingly decides to undertake certain actions in order to protect certain interests. Finally, necessity is different from distress because it is not related to the existence of a danger to the lives of individuals in the charge of a State official but to a grave danger either to the essential interests of the State or of the international community as a whole. In other words, necessity operates in a context where there is an irreconcilable conflict between an essential interest of the State and an international obligation binding upon that State and whose respect would prevent it from pursuing that essential interest, which would result into a severe prejudice of the State.[189] Given the broad formulation of the notion of State of necessity, it seems clear that it should not be construed in a way to exclude economic necessity from its scope. Therefore, state of necessity in principle could be validly used to exclude wrongfulness of a conduct of a State inconsistent with the international obligations which are binding upon it.[190]

After having analyzed the content of the notion of national security contained in BITs and of the notion of necessity provided for in customary international law, it is necessary to study their relations, especially in the case they are invoked in relation to the same disputes. If a BIT does not contain a national security exception empowering it to waiver other provisions of the Treaty, in this case such a waiver can be provided for by customary international rules precluding wrongfulness of a State conduct. However, even when a national security clause is provided in a BIT, this does not exclude the applicability also of the rules of customary international law mentioned above. In fact, it seems that the national security exception contained in a BIT and the customary rule of necessity should be meant as complementary and partially similar as to their object and purpose, rather than as identical or alternative

[189] *Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries.;* cit.; p. 80-82. For an overview of the state of necessity see also: P. PUSTORINO; *Lo stato di necessità alla luce della prassi recente*; in *Rivista di Diritto Internazionale*; 2009; p. 411-442; A. K. BJORKLUND; *Economic Security Defenses in International Investment Law*; cit.; p. 479-504.

[190] M. VALENTI; *Lo stato di necessità nei procedimenti arbitrali ICSID contro l'Argentina*; cit.; p. 114-135 ; M. F. ORZAN; cit.; p. 237-272; A. K. BJORKLUND; *Economic Security Defenses in International Investment Law*; cit.; p. 479-504.

(in the sense that they would exclude each other).[191] This interpretation is consistent with the findings of the Annulment Committee of ICSID in the CMS case. The *ad hoc* committee[192] had to assess the relation between art. XI of the BIT between the US and Argentina, which, as already discussed above, provided for a national security exception, and art. 25 of the Draft Article on State Responsibility which dealt with State of necessity as a circumstance precluding wrongfulness of a conduct of a State. The committee recognised that "there is some analogy in the language used in Article XI of the BIT and in Article 25 of the ILC’s Articles on State Responsibility", in particular since "[t]he first text mentions 'necessary' measures and the second relates to the 'state of necessity'." However, it continued, "article XI specifies the conditions under which the Treaty may be applied, whereas Article 25 is drafted in a negative way: it excludes the application of the state of necessity on the merits, unless certain stringent conditions are met. Moreover, Article XI is a threshold requirement: if it applies, the substantive obligations under the Treaty do not apply. By contrast, Article 25 is an excuse which is only relevant once it has been decided that there has otherwise been a breach of those substantive obligations".

The committee then continued its analysis by explaining why "Article XI and Article 25 are substantively different". It pointed out that "[t]he first covers measures necessary for the maintenance of public order or the protection of each Party’s own essential security interests, without qualifying such measures. The second subordinates the plea of necessity to four conditions. It requires for instance that the action taken 'does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole', a condition which is foreign to Article XI. In other terms the requirements under Article XI are not the same as those under customary international law as codified by Article

[191] For an analysis of the difficulties of arbitral tribunals in reaching this conclusions and for a more in-depth study of the issue see: C. BINDER; *Changed circumstances in investment law: interfaces between the law of treaties and the law of State responsibility with a special focus on the argentine crisis*; in VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford; Oxford university press, 2009; p. 631-635; J. E. ALVAREZ, K. KHAMSI; cit.; p. 379-478.

[192] The terms "ad hoc committee" and "annulment committee" are used as synonyms.

25".[193] Such findings were confirmed by the decision of the Annulment Committee in the Sempra case, which declared that "[b]y equating Article XI of the BIT with ILC Article 25, and assuming they were on the same footing, the Tribunal committed manifest errors of law."[194]

It can therefore be concluded that a measure adopted by the host State, which is inconsistent with one or more provisions of an applicable BIT, would not constitute a violation of international law if one of the following circumstances occurs.

First, the State measure is consistent with the national security exception contained in the applicable BIT. In this case there would be no need to make recourse to customary international law. In any case, customary international law on State responsibility should not be construed in a way to prevent the application of the national security clause contained in a BIT.[195]

Second, there is not a national security exception contained in the applicable BIT, but the measure is consistent with rules of customary international law, as "codified" in art. 25 of the Draft Articles on State Responsibility, which provide for the circumstances precluding wrongfulness of a State act. Third, the emergency measure adopted by a State cannot fall within the scope of the national security exception contained in the applicable BIT (for instance because such clause explicitly refers exclusively to military emergencies, while the measure is adopted by the State to cope with a situation of economic emergency) but it is consistent with those rules of customary international law mentioned above.

[193] On this point see: *CMS Gas Transmission Company v The Argentine Republic*, ICSID case no. ARB/01/08; Decision of the Ad Hoc Committee on the Application for Annulment of the Argentine Republic; 25 September 2007, para. 128–131.

[194] *Sempra Energy International v. Argentine Republic*; ICSID Case No. ARB/02/16; Decision on Annulment of 29 June 2010.

[195] Such a finding seems to be consistent with art. 55 of the Draft Articles, which provides that "[t]hese articles do not apply where and to the extent that the conditions for the existence of an internationally wrongful act or the content or implementation of the international responsibility of a State are governed by special rules of international law." In the case at issue, the national security clause contained in a BIT should be regarded as *lex specialis*, while art. 25 of the draft articles should be regarded as *lex generalis*. As a result of the application of the principle *lex specialis derogat legi generali*, in case of inconsistency between the national security clause and the draft articles, the former should be applied. On this issue see also commentaries; p. 140 and. In literature see: J. CRAWFORD; *The ILC's Articles on Responsibility of States for Internationally Wrongful Acts: A Retrospect*; in *The American Journal of International Law*; 2002; p. 879-880; C. BINDER; cit.; p. 620-624; J. E. ALVAREZ, K. KHAMSI; cit.; p.427.

Finally, it is necessary to address the issue of compensation when the state of necessity exception or of the national security clause apply.[196]

As to the issue of state of necessity, art. 27 of the draft articles provides that "[t]he invocation of a circumstance precluding wrongfulness in accordance with this chapter is without prejudice to: [...] (b) The question of compensation for any material loss caused by the act in question." The commentaries to the draft articles explains that the aim of art. 27,b) is to avoid that "the State whose conduct would otherwise be unlawful might seek to shift the burden of the defence of its own interests or concerns onto an innocent third State."[197] In fact it could be argued that when a State breaches a provision of a Treaty because of state of necessity, while it would be unfair to force it to pay compensation as if state of necessity would have not applied, on the other side it would be equally unfair not to provide for some form of compensation at all for the other contracting State. In fact, complete lack of compensation would imply that the other contracting State has to bear entirely the costs of the violation committed by the offending party. In the case of BITs the costs of the breach of BITs' provisions by the host State would be borne directly by foreign investors but indirectly also by the host State and therefore the principles outlined above must apply as well.

The commentaries also note that such principle has been supported in the Gabˇcíkovo-Nagymaros Project case, where the Court noted that also the respondent "expressly acknowledged that, in any event, such a state of necessity would not exempt it from its duty to compensate its partner."[198]

However, as the commentaries note, art. 27, b) "does not attempt to specify in what circumstances compensation should be payable." In fact, they argue that "the range of possible situations covered by chapter V is such that to lay down a detailed regime for compensation is not appropriate."

[196] For an analysis of this issue in doctrine see: A. K. BJORKLUND; *Economic Security Defenses in International Investment Law*; cit., p. 500-502; J. E. ALVAREZ, K. KHAMSI; cit.; p. 401-402.

[197] *Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries*; cit.; p. 86.

[198] ICJ; *Gabčíkovo-Nagymaros Project (Hungary/Slovakia);* Judgment of 25 September 1997; par. 48.

It seems therefore that, while in principle the existence of a duty to compensate should not be excluded in case of one or more circumstances precluding wrongfulness, on the other side the amount of such compensation should be calculated taking into account that the wrongfulness of a conduct of a State is precluded because of occurrence such circumstances. As the commentaries point out, "[i]t will be for the State invoking a circumstance precluding wrongfulness to agree with any affected States on the possibility and extent of compensation payable in a given case.[199]

If such principles were applied in an investor-State dispute, they would imply that the host State which has breached one or more provisions of the relevant BIT should not be allowed to refuse to pay compensation if, for instance, the existence of state of necessity is assessed. On the contrary, it would have the duty to agree with the investor a certain form of compensation, whose amount could be calculated taking into consideration that the breach occurred in a state of necessity.

The ICSID awards which adjudicated upon disputes between US companies and Argentina and which have been quoted above, should be taken into consideration also in order to better analyse this issue. The Enron tribunal[200] supported the approach which has been suggested above, when it declared that although art. 27. b) of the Draft Articles "does not specify the circumstances in which compensation should be payable because of the range of possible situations, it has also been considered that this is a matter to be agreed with the affected party, thereby not excluding the possibility of an eventual compensation for past events." The Tribunal also argued that "[i]n the absence of a negotiated settlement between the parties, this determination is to be made by the Tribunal to which the dispute has been submitted."[201] The CMS Tribunal was even clearer when it supported the view of the claimant and declared that "the plea of state of necessity may preclude the

[199] *Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries*; cit.; p. 86.

[200] *Enron Corporation Ponderosa Assets, L. P v. Argentine Republic*; ICSID Case No. ARB/01/3; award of 22 May 2007.

[201] *Enron Corporation Ponderosa Assets, L. P v. Argentine Republic*; cit.; 345.

wrongfulness of an act, but it does not exclude the duty to compensate the owner of the right which had to be sacrificed"[202] To this extent, it argued that art. 27 of the Draft Articles "establishes the appropriate rule of international law on this issue"[203]

However, in the LG&E case another ICSID Tribunal reached the opposite conclusion. In fact, it declared that "Article 27 of the ILC Draft Articles, as well as Article XI of the Treaty, does not specify if any compensation is payable to the party affected by losses during the state of necessity". Therefore, it concluded that "the damages suffered during the state of necessity should be borne by the investor".[204]

The Annulment Committee in the CMS case shared the same view expressed by the LG&E tribunal as to the issue that if state of necessity is effectively invoked, no duty to pay compensation to the adversely affected investor arises. The Committee pointed out that the declaration in the CMS award that Argentina would have had the duty to pay compensation in spite of the existence of the state of necessity was not indispensable for the purposes of settling the dispute, since "the Tribunal [had] rejected Argentina’s defense based on state of necessity". Therefore, paragraphs of the CMS award relating to that issue were "obiter dicta which could not have any bearing on the operative part of the Award".[205] However, as the Committee observed that such reasoning of the CMS award contained a "manifest error of law", it decided to attempt to provide further elucidation on the content of international law on this issue. It argued that "Article 27 concerns, inter alia, the consequences of the existence of the state of necessity in customary international law, but before considering this Article, even by way of obiter dicta, the Tribunal should have considered what would have been the possibility of compensation under the BIT if the measures taken by Argentina had been covered by Article XI. The answer to that question is clear enough: Article XI, if and for so long as it applied, excluded the

[202] *CMS Gas Transmission Company v. Argentine Republic;* cit.; par. 388.

[203] *CMS Gas Transmission Company v. Argentine Republic;* cit.; par. 390.

[204] *LG&E Energy Corp./LG&E Capital Corp./LG&E International Inc. v The Argentine Republic*; cit., par. 264.

[205] *CMS Gas Transmission Company v The Argentine Republic*, ICSID case no. ARB/01/08; Decision of the Ad Hoc Committee on the Application for Annulment of the Argentine Republic; 25 September 2007; par 145.

operation of the substantive provisions of the BIT." Therefore, the Committee concluded that "there could be no possibility of compensation being payable during" the period in which the state of necessity occurred.

The Annulment Committee in the Enron case partially supported the view of the Annulment Committee in the CMS case. In fact, it recalled that "Article XI of the Treaty differs significantly from the 'state of necessity' under customary international law, which is substantially contained in Article 25 of the ILC Articles" and then argued that "when Article XI of the BIT is applicable

no compensation is payable, while Article 25 of the ILC Articles is expressed by virtue of Article 27 of the ILC Articles to be without prejudice to the question of compensation." Therefore, while the Annulment Committee in the Enron case did not explicitly declare that effective invocation of the state of necessity excluded the duty to pay compensation, on the other side the effective invocation of the national security clause could entail this consequence. It thus concluded that the Tribunal in the Enron case "made manifest errors of law in equating Article XI of the BIT with Article 25 of the ILC Articles and in applying the rule of Article 27 of the Articles on State Responsibility to Article XI of the Treaty".

In conclusion, the analysis of ICSID decisions and of the ILC Draft Articles is unable to provide definitive answers to the issue of compensation to investors adversely affected by measures adopted by the host State to cope with a situation of economic emergency which in turn has brought to the invocation by the latter of the national security clause or of the state of necessity or of both. It could be argued that State could be required to agree with the investor the amount of the compensation to be paid even in case of successful invocation of the state of necessity. On the contrary, this possibility could be excluded in case of applicability of the national security clause.

10. SWFs and the protection of national security of the host States in international investment law

The fact that a State might deem that its national security, defined in a way such as to include also economic national security, is threatened by the investments of SWFs targeting its firms, has a relevance both in relation to the pre-admission and to the post-admission phase. Considerations of the host State concerning its national security can affect both its decision to admit the investments of foreign SWFs and the way such investments shall be regulated and eventually subjected to special controls and limitations after their admission. As international investment law impacts on the discretion of the host State to regulate these two aspects in very different ways, also for this reason the host State should carefully evaluate the pros and cons of each investment policy it can adopt relative to SWFs. In other words the host State, in an attempt to strike a balance between the need to retain sufficient discretion to intervene to preserve national security and the importance of complying with BITs it previously concluded, must undertake a careful analysis as to whether it is more feasible and desirable simply not to admit certain investments of SWFs or to admit them and then subject them to particular regulatory measures.

The most straightforward response to the risks that SWFs might pose to the national security of the host State would simply consist in preventing SWFs from undertaking any kind of investment in its territory. As it has already been explained above in paragraph 4, most BITs do not provide for legal obligations upon contracting parties as to the admission of foreign investments and also those international instruments which adopt a full liberalization approach, contain nonetheless some exceptions which can allow States to restrict admission of certain investors or of certain investments especially if they target sensitive sectors.[206] Therefore, in most cases the mere decision of a State not to allow SWFs to invest in its firms should not

[206] G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p. 321-328; I. GÒMEZ PALACIO, P. MUCHLINSKI; cit., p. 240-242; UNCTAD; *Admission and establishment*; 2002; UNCTAD; p. 17-26.

constitute a breach of the BITs the State at issue has previously concluded. Likewise, customary international law does not impose any obligation upon States as to the admission of aliens on their territory.

In conclusion, the host State is not required to justify its refusal to admit the foreign investment by proving that the latter would have endangered its national security, since the ability of the State to decide on the admission of foreign investments is not significantly restricted neither by the BITs of which it is party, nor by customary international law. A State does not need to invoke the national security clause, because the latter precludes wrongfulness in case of breaches of other BIT provisions but in most cases of refusal to admit the investment, simply no provision of applicable BITs is actually breached.

However, it cannot be denied that the operations of SWFs, not differently from those of many non-State-owned foreign investors, can also bring several benefits to the host State economy. For this reason a State might find it more reasonable to admit the investments of SWFs, while retaining the ability to control and to subject them to certain requirements, in order to mitigate the potential risks their operations might entail for its national security. For instance, the host State might require SWFs to provide particular information about their operations, or it could impose SWFs not to increase their stakes in certain companies beyond a predetermined thresholds, in order to be sure that the SWFs will remain unable to seize control of the invested companies thus remaining minority investors. Such controls and limitations could be different and more burdensome than those imposed upon other foreign investors. Although they result into a differential treatment for SWFs, they are not regarded inconsistent with the NT and the MFN clauses contained in BITs provided one of the two following circumstances occur.

First of all, difference treatment relative to other non sovereign investor involved in similar business transaction is due to differences between the conduct of the SWF and the conduct of the other non sovereign investor, for instance because the former uses its investments to pursue political objectives.

Secondly, restrictive measures applicable to SWFs and justified by the particular nature of such investors or of their operations, are applied in a way not to discriminate between domestic and third country SWFs on one side and SWFs of the other contracting party of the BIT on the other side.

In conclusion, a breach of the NT or of the MFN clause could occur only in the specific case discrimination against a SWF takes place because of its nationality and when the host State is unable to prove that the conduct of the SWF and the features of its operations are not comparable to those of domestic non-sovereign investor (in the case a breach of the NT clause is invoked) or of a third country non-sovereign investor (in the case a breach of the MFN clause is invoked).[207] Only in these relatively limited cases recourse to national security clause could be necessary for a State which has adopted measures which adversely affect the investments of foreign SWFs in a way inconsistent with the MFN or the NT clause.

A similar discussion could be made as to the applicability of the national security clause in order to assess whether the host State might be allowed not to respect the fair and equitable treatment clause provided for in a BIT. As it has been studied above, in paragraph 6, measures adopted by the host State in order to regulate the investments of foreign SWFs might not amount to a breach of the fair and equitable treatment even if they determine a partial or even complete loss of the value of the foreign investment, provided that those conditions which have been underlined in paragraph 6 are fulfilled.

In addition, at least if we rely on the findings of some recent awards, the conduct of the foreign SWF too should be taken into consideration when assessing the lawfulness of the conduct of the host State. In fact, when risks to national security of

[207] On the issue of non discrimination and in particular on the interpretation of the MFN and national treatment clause see: P. MUCHLINSKI; *Multinational enterprises and the law*; cit.; p. 621-625; G. SACERDOTI; *Bilateral Treaties and Multilateral Instruments on Investment Protection*, cit.; p.348 - 355.
UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 163-165; UNCTAD; *National Treatment*; cit.; p. 12; F. ORTINO; *Non-discriminatory treatment in investment disputes*; cit.; p. 348-360.
N. DIMASCIO, J. PAUWELYN; cit.; p. 48-89; Y. RADI; p. 757-774; UNCTAD; *Most Favoured Nation treatment*; cit.; p. 14- 40; P. ACCONCI; *Most-Favoured nation Treatment*; cit.; p. 365; T. GRIERSON-WEILER, I. A. LAIRD; cit.; p. 262.

the host State arise after the investment has already been admitted, when such risks are determined by the illegal and unconscious conduct of the foreign SWF, in this case measures adopted by the host State as a response to them in principle should not be inconsistent with the provisions of the BITs even when they result into a loss suffered by the SWF. If the prejudice to the foreign investor is the result of measures legitimately and lawfully adopted by the host State as a result of an unconscionable or illegal conduct of the foreign investor, no violation of the BIT occurs. In fact foreign investors, included, of course, SWFs, are mandated to respect any applicable law and regulation of the State in which they invest. BITs clearly cannot be construed as authorizing foreign investors not to abide by applicable laws and regulations of the host State, nor BITs must be meant as preventing host States from sanctioning foreign investors who breach its laws and regulations.

If the host State adopts necessary, proportional, non discriminatory and non arbitrary measures whose aim is to prevent foreign SWFs from posing threats to its national security, and if threats to national security are the result of an unconscionable or illegal conduct of the foreign SWF, in this case, the host State shall not be liable of having breached of the fair and equitable treatment clause.[208]

In this case it would be unnecessary to invoke the national security clause or the state of necessity. In fact, they allow to preclude wrongfulness of a conduct inconsistent with the fair and equitable treatment clause but in this case simply there is no breach of the FET clause.

On the contrary, if risks to the national security are related to a legal conduct of the SWF, in this case host State regulatory measures could be inconsistent with the fair and equitable treatment clause. In this case, invocation of the national security clause by the host State could be necessary, in order to justify the measures the latter has adopted and which adversely affect the operations of foreign SWFs. On the

[208] P. MUCHLINSKI; *Caveat Investor? The relevance of the conduct of the investor under the fair and equitable treatment standard*; cit.; p. 527-557; D. CARREAU, P. JUILLARD; cit.; p. 463-466; M. VALENTI; *Gli standard di trattamento nell'interpretazione dei trattati in materia di investimenti stranieri*; cit.; p. 185-211. M. VALENTI, Il *contributo dei trattati in materia di investimenti stranieri allo sviluppo del paese ospitante*; cit.; p. 83-94; W. BEN AMIDA; *La prise en compte de l'intérêt général et des impératifs de développement dans le droit des investissements*; cit.; p. 999-1034.

other side, it should be remarked that if a State admitted a foreign SWF because it did not deem that the latter might have posed threats to national security, if later it changed its mind and it regarded the foreign SWF as a threat (and as a result adopted restrictive measures against it), then the host State would fail to ensure a minimum of stability and predictability of the legal framework governing investments in its territory. In addition, this would result in frustration of legitimate expectations of the foreign SWF, at least if the SWF was brought to legitimately rely on the fact that the host State did not consider its investment as a threat to its national security. In this case a breach of the FET clause would occur and the host State should try to invoke the national security clause or the State of necessity. In any case, it must be remarked that a host State acting in good faith is expected to be able to assess if an investment of a SWF represents a threat to its national security before such investment is made and not after the host State has already admitted it.[209]

In order to minimise legal uncertainties on this issue it could be reasonable and useful for both the host State and the foreign SWF to agree the nature, the scope and the extent of such special restrictions and controls before the admission of the investment itself. In other words, the host State can make its decision to admit the investment of the foreign SWF subject to the undertaking of the SWF itself to accept particular kinds of controls and restrictions to its operations. This reciprocal undertakings could be formalised in a state contract or in another kind of agreement. The mitigation agreements concluded by the CFIUS and foreign investors and which have been reviewed above in paragraph 6 represent a good example of the utility of the approach proposed. The violation of such agreements, when it is committed by the authorities of the host State, should not be regarded as a breach of the applicable BITs but should nonetheless be considered as providing evidence of the frustration of

[209] A. KOTERA; cit.; p. 375-400; M. G. PARISI; cit.; p. 383-426; A. REINISCH; *Expropriation*; cit.; p. 432-458; W. BEN HAMIDA; *La prise en compte de l'intérêt général et des impératifs de développement dans le droit des investissements* cit.; p. 999-1034; J. Y. GOTANDA, cit., p. 1461-1473; K. P. BERGER; cit.; p. 1347- 1380.

the legitimate expectations of the investors for the purposes of an assessment of a violation of the fair and equitable treatment clause.

The discussion undertaken so far in this paragraph shows that in most cases in which SWFs, because of their conduct, constitute a threat to the national security of the host State, recourse to the national security clause or to state of necessity is not necessary, since a proper interpretation of substantial provisions of a BIT is sufficient to exclude that they have been breached by the host State in its attempt to protect its national security.

In order to complete the analysis undertaken in the present chapter, it must be mentioned the case in which, irrespective of the operations of the foreign SWFs, a threat to the national security of the host State arises, which obliges it to adopt emergency measures which in turn are able to prove detrimental to the interests of the foreign SWFs. It must be noted that emergency measures adopted by the host State in order to protect its national security, although they would otherwise be inconsistent with international investment law, could in some cases be allowed. To this extent, it is necessary that the relevant BITs contain a national security clause or that the conditions for the invocation of the State of necessity are fulfilled, according to the analysis developed above in paragraph 9. However, in this case there is no element suggesting that provisions of international law governing measures adopted by the host State in order to protect its national security, should apply in a different way in case of investments of SWFs. Therefore, in case of circumstances whose occurrence is independent of the conduct of the SWFs and in which national security of the recipient States is put in danger, there is no evidence that SWFs should be treated differently from other investors.

SWFs, like any other investor, will be affected by the applicability of the national security exception, which would operate whenever it is included in relevant IIAs, or by the plea of necessity provided in customary international law, which is always applicable. Therefore, arguments developed above in paragraph 9 should apply to SWFs without relevant changes.

After the discussion undertaken so far in the present paragraph, the following conclusions could be drawn. In several cases a proper interpretation of the clauses of BITs allows the host State to adopt measures which are needed to protect its national security but which adversely affect the foreign investors, without this constitute a breach of the provisions of the BITs at issue and therefore without recourse to the national security clause or to state of necessity be necessary to preclude wrongfulness of the State measures at issue.

On the contrary, the national security clause could become relevant after the host State has decided to admit the investment of the foreign SWF and when at least one of the two following circumstances occurs. First, the investment of the SWF represents a threat to the national security of the host State and this is not the consequence of an illegal activity of the SWF itself. Second, a situation of danger to national security occurs, which does not depend on the conduct of the foreign SWF, but which obliges the host State to undertake emergency measures which are necessary to protect its national security and which are able to prove detrimental to the interests of the foreign investor.

CHAPTER 5

SWFS AND THE PRINCIPLE OF STATE IMMUNITY

Introduction

Since SWFs engage in financial transactions within the jurisdiction of other States, it is in principle possible that they, like any other investor, might be convened before the Courts of those States. In addition, it is possible that such Courts adopt pre-trial or post-trial measures of constraint which affect the assets owned by the SWFs.

Since SWFs are State entities, it is important to know whether they should be entitled to State immunity or whether Courts of the States where they carry out their operations could be allowed to convene them and to adopt measures of constraint against them. If SWFs were regarded as entitled to enjoy State immunity from adjudicating and enforcing jurisdictions of the States where they invest, the practical consequences would be extremely important. The possibility for the host State to ensure the compliance of SWFs with its own laws and regulations, and in particular with those concerning for instance financial markets and banking, which are particularly sensitive sectors, could be reduced. In addition, since in many transactions the counterparts of SWFs are private investors, the immunity of SWFs could provide them with an unfair advantage in their relations with other market participants. Moreover, the issue of immunity of SWFs is connected to the problem of the taxation of the income SWFs earn on their investments overseas. If SWFs are regarded as entitled to immunity from taxation, this clearly provides them with a competitive advantage relative to any other investor and can finally determine distortions in the worldwide allocation of capital.[1]

[1] For an overview of the applicability of the law of State immunity to SWFs see also: F. BASSAN; *The law of Sovereign Wealth Funds*; cit.; p. 89-115.

The objective of the present chapter is to address all the above mentioned issues concerning the applicability of the principle of State immunity from adjudication, enforcement and taxation to the transnational investments of SWFs. The chapter will be framed as follows.

In paragraph 1 and 2 a review of the existing provisions governing the issue of State immunity respectively from jurisdiction to adjudicate and to enforce will be made. It should be remarked that the study of such provisions rises particular difficulties, because of the limited applicability of relevant treaties and because the content of customary international law on this issue is far from being clear. Therefore, it will be necessary also to study in depths also the practice of States (i. e. their law and case law governing the issue of State immunity), which is quite inconsistent, despite the development of converging trends in the last decades.[2] It will be demonstrated that the same notion of law of State immunity is rather controversial, and its contents can be defined only referring to a plurality of different sources: international conventions, international custom, municipal laws of certain States, practice of domestic tribunals.[3] Given these caveats, it emerges quite clearly that in the present chapter it would be impossible to provide a complete study of the provisions applicable to State immunity and in particular it would be impossible to critically and systematic review all relevant legislation and case law. For this reason the discussion of the principles of State immunity will largely rely on the findings of existing doctrinal studies on this topic; when provisions of domestic law and relevant sentences dealing with State immunity will be quoted, this will be made essentially with a view to providing examples and not to attempting a systematic reconstruction of the case law.

Paragraph 1 and 2 will also explain the development of the law of State immunity and of its sources, highlighting the distinction which is currently drawn between the public activities of a State (*acta jure imperii*) and the State activities which do not entail the

[2] R. LUZZATTO; *La giurisdizione sugli Stati stranieri tra Convenzione di New York, norme internazionali generali e diritto interno*; in *Comunicazioni e Studi*; 2007; p. 4-16.

[3] A. DICKINSON; *State immunity and State owned enterprises*; in *Business Law International*; 2009; p. 101-102; I. PINGEL; *Observations sur la convention du 17 janvier 2005 sur les immunités juridictionnelles des Etats et de leurs biens*; in *Journal du Droit International*; 2005; p. 1045-1056.

exercise of sovereign powers and which can be assimilated to commercial activities which can be performed by non-State actors too (*acta jure gestionis*). It will be studied which of them enjoy immunity from foreign jurisdiction to adjudicate and to enforce.

Paragraph 3 will study the notion of "State" and of "State entity" or "State agencies and instrumentalities" for the purposes of the application of the law of State immunity and therefore it will investigate whether SWFs could fall within one of these notions. It could be argued that the issue as to whether SWFs might be regarded as tantamount to States has already been addressed in the previous chapter. However, in paragraph 3 of the present chapter it will be explained that the elements to be considered in an analysis which focuses on the issue of State immunity may be different than those which are relevant for the purposes of the study of the issue of State responsibility and State attribution.

Paragraph 3 will also explain why the attempt to answer to the question as to whether SWFs should be regarded as organs of the government of the States or as other State entities or as State owned enterprises is not determinant for the purposes of the issue of immunity of SWFs. What is determinant is to understand whether, firstly, the creation and, secondly, the investment activities of SWFs could be regarded as *acta jure imperii* or *acta jure gestionis.* This discussion will be carried out in paragraphs 4 and 5 respectively. As SWFs, with respect to their source of financing, the reasons why they are established and the functions they are required to perform, can be divided between commodity funds and non commodity (foreign exchange or “forex”) funds, it will be necessary to undertake such analysis for both categories of SWFs.

Paragraph 6 will explore the relation between State immunity and enforcement of awards (and especially of ICSID awards) issued at the outcome of investor-State arbitration. In particular, it will try to answer to the question as to whether the assets under the management of SWFs, which are invested abroad and which therefore constitute wealth owned by a State but located in the jurisdiction of other States, could be the object of measures of constraint related to the enforcement of an award rendered against the same State which is the owner of the SWFs at issue. It will also study whether the principle of State immunity might effectively prevent from doing so. It will be discussed the impact that an affirmative answer to the above mentioned question might have on the possibility to facilitate the enforcement of investor-State awards and finally to enhance the compliance with them.

Paragraph 7 will turn the attention to the issue of immunity from taxation. After having provided an introduction of the principle of immunity from taxation and of its relation with immunity from adjudication and enforcement, a review will be made of international instruments and domestic legislation dealing with it, as well as to their applicability to SWFs. In addition, a few considerations will be made on the economic consequences that granting immunity from taxation to SWFs might involve.

Finally, paragraph 8 will study whether exemption of SWFs from taxation could be granted not on the basis of the doctrine of State immunity, but taking into consideration the macroeconomic and developmental role played by these investment vehicles especially in certain developing countries. It will be investigated whether certain tax exemptions in these cases could be meant as an alternative form of aid to development.

1. The immunity of States from adjudicative jurisdiction and the distinction between *acta jure imperii* and *acta jure gestionis*.

Most doctrinal studies on State immunity have focused on immunity from adjudication (the right not to be sued before the Courts of another State) and from enforcement (the entitlement not to have one’s properties attached by enforcement measures adopted by another State). It should be preliminarily observed that the concept of immunity depends on that of jurisdiction. If State A is entitled to affect the right of persons by means of legislative, judicial and administrative activities, this implies that State A has the jurisdiction to prescribe, to adjudicate and to enforce over such persons. Immunity of State B from the jurisdiction of State A means that B shall not be judged by the Courts of State A and shall not be affected by enforcement measures adopted by the authorities of State A.[4] However, with respect to the jurisdiction to prescribe, it can be denied that there is immunity. In fact, in their activities within the territory of a State, foreign States do not operate outside the local law and immunity is therefore not from the power of the forum to prescribe, but from the power to enforce the rules so prescribed. To exercise substantive jurisdiction over a foreign State is not to prescribe the rule, but it consists in applying such rule, even through the use of coercion, when necessary.[5]

The sources of public international law providing for the principle of State immunity are the European Convention on State Immunity signed in Basle on 16 may 1972 and the United Nations Convention on Jurisdictional Immunities of States and Their Property, adopted by the United Nations on 2 December 2004. So far, the latter has not come into force yet, while it has been ratified only by a very limited number of States. Therefore it could not be regarded as a treaty source *strictu sensu*, as until its entry into force its provisions are not legally binding and also in case of entry into force it could bind only the few States which have ratified it. However, the Convention can be regarded as an important manifestation of the *opinio juris* of the international community about the issue of State immunity. In particular, the fact that a relevant number of States have decided to sign it (although not to ratify it) means that there is a widespread convincement in the international community that the issue of State immunity should be governed according to the principles enounced in the Convention itself. Likewise, as to the issues of State immunity which are not covered by the Convention, it could be argued that this is an evidence of the fact that in relation to such aspects a common opinion has not developed yet within the international community.[6]

[4] ICJ: *Arrest Warrant (Democratic Republic of the Congo v. Belgium)*; Judgement of 11 April 2000; Separate Opinion of Judge Koroma; par. 5.; B. CONFORTI; *Diritto Internazionale*; cit.; p. 181.

[5] J. CRAWFORD; *Execution of judgments and foreign sovereign immunity*; in *American Journal of International Law*; 1981; p. 854; H. FOX; *The law of state immunity*; Oxford University Press; 2002; p. 19; R. LUZZATTO, I. QUEIROLO; *Sovranità territoriale, "jurisdiction" e regole di immunità*; S. M. CARBONE, R. LUZZATTO, A. SANTA MARIA; *Istituzioni di diritto internazionale*; 3. ed. - Torino : Giappichelli; 2006; p. 203-209.

[6] On the importance of the UN Convention in spite of the fact it has not entered into force, reference could be made *inter alia* to AIG Capital Partners Inc v Kazakhstan; Judgement of 20-10-2005 of the

Therefore, in the analysis undertaken in this chapter more attention must be paid to another source of international law mentioned, *inter alia*, at art. 38 of the ICJ Statute: it is the international custom, which rises when the members of the international community follow a consistent practice for a relevant period of time *(duiturnitas)* with the convincement this is necessary and this corresponds to a legal obligation (*opinio juris sive necessitatis)*. State practice which is particularly relevant under this point of view is constituted by the judicial decisions adopted by domestic Courts when they have to assess, on a case by case basis, whether they have jurisdiction in claims involving foreign States. They should be analysed in conjunction with the reaction of other States to such practice, with a focus on those States which are sued and on those States whose judges are required to enforce the decisions adopted by foreign courts on these issues. Finally, it is possible to derive the basic principles applicable to State immunity from a comparative survey of domestic legislation[7].

Until the beginning of the 20th century the basic principle of public international law applicable to State immunity was that of absolute immunity: States could never be sued before the courts of any other State and no enforcement measure was possible

High Court of Justice, Queen's Bench Division Commercial Court; [2005] APP.L.R. 10/20 in World Trade and Arbitration Materials; 2006; p. 283-314; par. 80 in which Judge Aikens states that he regards "the UN Convention on Jurisdictional Immunities of States and their Property, adopted by the General Assembly, as a most important guide on the state of international opinion on what is, and what is not, a legitimate restriction on the right of parties to enforce against State property generally." he added that although "the Convention has not yet been adopted by any States" however "its existence and adoption by the UN after the long and careful work of the International Law Commission and the UN Ad Hoc Committee on Jurisdictional Immunities of States and Their Property, [75] powerfully demonstrates international thinking on the point". This sentence is quoted, and its approach to the UN Convention is supported, in Jones v. Ministry of Interior Al-Mamlaka Al-Arabiya AS Saudiya (the Kingdom of Saudi Arabia) and others; opinion of 14-06-2006 of the House of Lords: [2006] UKHL 26; par. 8 and 9. Opinion available online at http://www.publications.parliament.uk/pa/ld200506/ldjudgmt/jd060614/jones-1.htm page visited on 20-01-2011.

For the doctrine, see: H. FOX; *In defence of State immunity*; cit.; p. 399-406; A. DICKINSON; *State immunity and State owned enterprises*; cit.; p. 98-99; R. LUZZATTO; *La giurisdizione sugli Stati stranieri tra Convenzione di New York, norme internazionali generali e diritto interno*; cit.; p. 3-20.

[7] This method is in particular recommended by: H. FOX; *The law of state immunity*; cit.; p. 67-130. For a comparative study of provisions applicable to State immunity from adjudication and enforcement see, for instance: H. FOX; *The law of state immunity*; cit.; and A. DICKINSON et al.; *State immunity: selected material and commentary*; Oxford; Oxford University Press; 2004. For an introduction on the issue of State immunity see also: B. CONFORTI; *Diritto Internazionale*; cit.; p. 251-252; I. BROWNLIE; cit.; p. 326-335.

against their properties. A State could waive its immunity and subject itself to the jurisdiction of other States (and to enforcement measures too, although this was even rarer), but only to the extent it manifested its explicit consent to such a limitation of its own sovereignty.

The principle of absolute immunity started to evolve during the first half of the 20th century. That age was characterised by the increase of the scope of State activities and of the sphere of intervention of States in the economy. The most impressive example of this evolving trend was clearly represented by the central planning and the State ownership of the means of production in the Soviet Union and, after the second world war in Socialist States of Eastern Europe. The fact that all entities undertaking commercial activities and originating from such countries were State entities prompted a discussion on the opportunity to regard them as States and not as commercial entities for the purposes of State immunity.[8]

However, an increased involvement of the State in the production of goods and in commercial activities occurred also in non socialist States, be they liberal democracies or right-wing authoritarian regimes. Such developments were first of all connected to the needs which emerged in occasion of the world wars: these conflicts were characterised by a special degree of intensity and required a complete mobilizations of all the available resources of the State in order to achieve the absolute victory, which was regarded as the sole kind of acceptable victory. The involvement of the State was no more limited to the conduct of war operations and of diplomatic relations, but it needed to be extended to the regulation of the production or to the direct production of any good which was used in the conflict.

[8] For a general introduction of the involvement of the State in commercial activities in socialist countries and especially in the Soviet Union see: E. S. STROEV; L. S. BLIAKHMAN; M. I. KROTOV; *Russia and Eurasia at the crossroads: experience and problems of economic reforms in the Commonwealth of Independent States*; Berlin; Springer, 1999; p. 40; L. MIGALE; *L'impresa nella transizione dall'economia pianificata all'economia di mercato*; Padova; CEDAM, 1993; p. 23-27; G. POGGI; *Lo stato: natura, sviluppo, prospettive*; Bologna: Il mulino; 1992; p. 200-201.
p. 231-241. For a detailed analysis of the implications this has on the issue of State immunity see: B. FENSTERWALD, JR.; *Sovereign Immunity and Soviet State trading*; in *Harvard Law Review*; 1949-1950; p. 614-642.

Another important cause of the increased involvement of the State in industrial and commercial activities, was the great economic crisis of the 1930s. States confronted this situation not only by adopting policies (inspired by Keynesian theories) which consisted in the growth of public investments in order to support the aggregate demand, but also by rescuing failing banks and companies, which in some countries became, and remained for a long time, State-owned.[9]

The increased involvement of many States in activities which were no more strictly related to their typical sovereign powers (which traditionally were, for instance, diplomacy, war, the maintenance of domestic order and the administration of justice) but which rather had a commercial character, involved problems in particular when such commercial activities were performed abroad or when they entailed relations with other States or with persons which were nationals of other States. For instance the national of one State who concluded a contract with a foreign State entity on commercial matters (suppose for the sale of goods) would have not been able to sue it if this State entity decided not to pay him.[10] It was in this context that it became necessary to develop a restricted theory of State immunity, which today is still prevailing in State practice, especially in western States[11]. The forerunners of such approach were Italian, Belgian and Greek Courts, which developed it since the beginning of the 20th century; however they were soon followed by French Courts and after a few decades the doctrine of restricted immunity was endorsed also in common law countries also by means of *ad hoc* legislation.

[9] G. POGGI; cit.; p. 164-178; R. LUZZATTO, I. QUEIROLO; cit.; p. 210-211.

[10] I. M. SINCLAIR; *European Convention on State Immunity*; in *International and Comparative Law Quarterly*; 1973; p. 255-260.

[11] Other States are still more cautious on this point. It is also for this reason that the UN Convention is important, because it contributes to extend the principle of relative immunity, which today is quite well established in western States but whose adoption in countries like China or those pertaining to the former Soviet Union is much more recent and uncertain. See: H. FOX; *In defence of State immunity: why the UN convention on State immunity is important*; in *International and Comparative Law Quarterly*; 2006; p. 399.

The theory of restricted immunity implies that immunity from adjudication[12] applies to *acta jure imperii* only, i. e. to public, governmental, acts that a State performs as a Sovereign, for example those related to immigration policies, the administration of justice, the conduct of war and diplomacy. *Acta jure gestionis* or *acta jure privatorum*, i. e. commercial acts a State performs as a private individual, like running a commercial enterprise or entering in business relations with individuals, are not entitled to immunity anymore. The private or public character of the act of a State determines whether the latter can claim immunity from jurisdiction to adjudicate. It might seem unclear whether the public character of a State act or of a State property depends on the status of the entity performing it or owning it (immunity *ratione personae*) or on the nature and the purpose of the act itself (immunity *ratione materiae*). Nevertheless, if it is supported the principle of restricted immunity, then the second option should be more correct. In fact, while it is necessary, in order to grant immunity, that an act and a property are respectively performed and owned by a State or by a State entity, it is also necessary that such act or property are directly related to a manifestation of the sovereign and public power of the State.[13] Some authors have finally underlined that the public character should be assessed with

[12] The theory of restricted immunity from adjudication developed before the theory of restricted immunity from measures of constraint. In any case, the content of the principle of immunity from adjudication remains quite different from the content of the principle of immunity from measures of constraint. The discussion undertaken in the present paragraph will focus on immunity from jurisdiction to adjudicate, while immunity from jurisdiction to enforce will be studied in the following paragraph.

[13] J. DONOHO; *Minimalist Interpretation of the Jurisdictional Immunities Convention*; in *Chicago Journal of International Law*; 2009; p. 663 B. CONFORTI; *Diritto Internazionale*; cit.; p. 257-258; H. FOX; *The law of state immunity*; cit.; p. 100-120; I. BROWNLIE; cit.; p. 333-336; B. DE MEESTER; *International legal aspects of Sovereign Wealth Funds: Reconciling international economic law and the law of State Immunities with a new role of the State*; in *European Business Law Review*; 2009; p. 811-812; A. BLANE; *Sovereign immunity as a bar to the execution of international arbitral awards*; in *New York University Journal of International Law and Politics*; 2009; p. 454-504; H. MAFI; *Iran's Concession Agreements and the Role of the National Iranian Oil Company: Economic Development and Sovereign Immunity*; in *Natural Resources Journal*; 2008; p. 421-428; N. PENGELLEY; *Waiver of sovereign immunity from execution: arbitration is not enough*; in *Journal of International Arbitration*; 2009; p. 59-60; J. FOAKES, E. WILMSHURST; *State Immunity: The United Nations Convention and its effect*; ILP BP 05/01; Chatham House; 2005; R. LUZZATTO, I. QUEIROLO; cit.; p. 210-214.

respect to the *nature* rather than to the *purpose* of the act or of the property of the State, but on this point there is neither broad consensus nor certainty.[14]

Some States have included these principles in their own legislation. It is the case, for instance, of the United States, where the issue is governed by the Foreign State Immunity Act (FSIA). Section 1604 provides that "subject to existing international agreements to which the United States is a party at the time of enactment of this Act a foreign state shall be immune from the jurisdiction of the courts of the United States and of the States except as provided in sections 1605 to 1607 of this chapter"[15]

Section 1605 provides a detailed list of the circumstances in which immunity from jurisdiction does not apply. For the purposes of the present analysis it is sufficient to focus on a few parts of it. According to par. 1 "a foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case [...] in which the foreign state has waived its immunity either explicitly or by implication, notwithstanding any withdrawal of the waiver which the foreign state may purport to effect except in accordance with the terms of the waiver". Par. 2 of the same section lays down the principle of restrictive immunity by emphasising the distinction between *acta jure imperii* and *acta jure gestionis* and confirming that only those belonging to the former group are entitled to immunity from jurisdiction. In fact it states that immunity from jurisdiction does not apply in case of "commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States."

Section 1607, adds that immunity is not accorded "with respect to any counterclaim (a) for which a foreign state would not be entitled to immunity under section 1605 of

[14] J. FOAKES, E. WILMSHURST; cit. p. 4; B. DE MEESTER; cit.; p. 813-814; H. FOX; *The law of state immunity*; cit.; p. 284-286; J. DONOHO; cit.; p. 668.; I. BROWNLIE; cit.; p. 336; H. MAFI; cit. p. 421-428; I. PINGEL; cit.; p. 1045-1056; R. LUZZATTO; *La giurisdizione sugli Stati stranieri tra Convenzione di New York, norme internazionali generali e diritto interno*; cit.; p. 13-17. See also, *infra*, paragraphs 4 and 5.

[15] 28 U.S.C. § 1604 : US Code Available online at: http://codes.lp.findlaw.com/uscode/28/IV/97/1604

this chapter had such claim been brought in a separate action against the foreign state; or (b) arising out of the transaction or occurrence that is the subject matter of the claim of the foreign state; or (c) to the extent that the counterclaim does not seek relief exceeding in amount or differing in kind from that sought by the
foreign state."

In the UK, the issue of State immunity is governed since 1978 by the State Immunity Act.[16] While its sec.1 provides for the general principle of immunity of foreign States from the jurisdiction of British Courts, however several exceptions apply, which are listed from section 2 to section 11. For the purposes of the present analysis special attention should be paid to sec.3, which provides that:

"A State is not immune as respects proceedings relating to

(a) a commercial transaction entered into by the State; or

(b) an obligation of the State which by virtue of a contract (whether a commercial transaction or not) falls to be performed wholly or partly in the United Kingdom.

Par. 3 of the same article defines the notion of “commercial transaction” as:

"(a)any contract for the supply of goods or services;

(b)any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation; and

(c)any other transaction or activity (whether of a commercial, industrial, financial, professional or other similar character) into which a State enters or in which it engages otherwise than in the exercise of sovereign authority".

Other States have not adopted a law which govern the issue of State immunity. It is the case of Italy, whose Courts have considered the principle of (relative) State immunity as embodied in customary international law and therefore they have deemed that it shall be directly applied by them by virtue of art. 10 of the Italian Constitution, which provides that: "L'ordinamento giuridico italiano si conforma alle

[16] It must be reminded that until the 1970s the UK was, amongst the European countries, one of the main supporter of the principle of absolute immunity. On this issue see: I. M. SINCLAIR; cit.; 254.

norme del diritto internazionale generalmente riconosciute".[17] Italian Courts, in fact, have assessed the existence of the principle of State immunity as related to the well established principles of customary international law of sovereignty and independence of States, as well as of non-interference in the domestic affairs of foreign sovereigns. In particular, the rationale underlying the approach of Italian case law is that if a State exercises its jurisdiction on another State, the result would be that the former might interfere into the domestic affairs of the latter.

As to the limitation of the immunity to *acta jure imperii*, Italian Courts have often supported the view that the criteria which must be used in order to assess which State activities have a governmental character should not be related to the analysis of the features of the organs of the State or of the State entities that undertake such activities and on their qualification as States or State organs, irrespective of the fact that such a qualification is made according to the Italian or to the law of the foreign State concerned. In fact, such an approach would have resulted into a kind of interference of the Italian Courts into the domestic affairs of other States, especially since their sovereign right to organise themselves as they prefer would be indirectly questioned. Instead, Italian case law has focused on the nature of the acts performed by a State: if they are typical of those performed by a sovereign, and in principle precluded to any other person, they deserve immunity. On the contrary, acts which are performed by a State as if it was a private individual, should not be covered by State immunity. [18] While, as it has been told above, Italian Courts have been the forerunners as regards the development of the principle of restrictive immunity of foreign States, it must be remarked that not always the Italian case law has judged consistently on this issue, even in recent cases.[19]

[17] E. SCISO; *L'immunità degli Stati esteri dalla giurisdizione dopo la conversione del decreto legge 28 aprile 2010 n. 63*; in *Rivista di Diritto Internazionale*; 2010; p. 802-809.

[18] For a detailed review of the Italian case law see: A. DE LUCA; *L'immunità degli Stati Stranieri dalla giurisdizione civile*; in N. RONZITTI, G. VENTURINI; ed. *Le immunità giurisdizionali degli Stati e degli altri enti internazionali*; CEDAM; 2008; p.15-28.

[19] See, for instance the recent case: Corte Suprema di Cassazione; *Luca Borri c. Argentina*; ordinanza N. 6532/2005 of 27 May 2005. The case concerned a dispute between an Italian national which purchased bonds issued by Argentina and who reported a loss when Argentina defaulted on its sovereign debt. The Court, in order to assess its jurisdiction, had to decide whether the acts of

The distinction between acts *jure imperii* and *jure gestionis* is recognised in international Conventions governing the issue of State immunity. As it has already been pointed out above, the limited applicability of such conventions (related to the fact that one of them has not entered into force while the other has been ratified by a very limited number of States) does not deprive them of their utility, if their texts are taken into consideration in an attempt to understand which is the *opinio* of the international community as to the content of the law of State immunity beyond the practice of individual States.[20]

The European Convention on State immunity of 1972 in its preamble recognises that "there is in international law a tendency to restrict the cases in which a State may claim immunity before foreign courts". Consistently with this concept, the Convention illustrates the cases in which international law does not impose a duty upon Courts of States (which are parties to the Convention) to refrain from exercising their jurisdiction to adjudicate towards third States. According to art. 1, immunity does not apply when a "State which institutes or intervenes in proceedings before a court of another Contracting State submits, for the purpose of those proceedings, to the jurisdiction of the courts of that State" or when it files counterclaims in proceedings before a foreign Courts, provided that other requirements, which are listed in art. 1 par. 2 and 3 are satisfied. In addition a State, or *rectius* its Courts, can lawfully

Argentina, and in particular the issuance of bonds and the subsequent default were covered by the State immunity. The Corte di Cassazione first of all, in par. 2 confirmed the distinction between acta jure imperii and acta jure gestionis, "in virtu' del quale l'esenzione degli Stati stranieri dalla giurisdizione civile e' limitata agli atti iure imperii (a quegli atti, cioe', attraverso i quali si esplica l'esercizio delle funzioni pubbliche statali) e non si estende, invece, agli atti iure gestionis o iure privatorum (ossia agli atti aventi carattere privatistico, che lo Stato straniero ponga in essere, indipendentemente dal suo potere sovrano, alla stregua di un privato cittadino (cfr., ex plurimis, Sez. un. nn. 2329/1989; 919/1999; 531/2000; 17087/2003)." However the Court stated in par. 4 that: " mentre natura innegabilmente privatistica hanno gli atti di emissione e di collocazione sul mercato internazionale delle obbligazioni di che trattasi, non analoga natura paritetica hanno i successivi provvedimenti di moratoria, adottati dal Governo argentino, ai quali, del resto, lo stesso ricorrente sostanzialmente pretende di ricollegare la perdita del beneficio del termine ex art. 1186 c.c. ed il conseguente inadempimento di quello Stato. This judgment therefore seems to be inconsistent with the practice of refusing to recognize immunity for acts whose *nature* was commercial, irrespective of the governmental nature of the objectives or consequences it might have. For a comment on this judgment see: A.VITERBO; *Sull'immunità dalla giurisdizione della Repubblica Argentina nel caso dei c.d. tangobond*; in: *Responsabilità Civile e Previdenza*; 2005; p. 1022-1033.

[20] On this point see *supra*, par. 1 of the present chapter.

exercise their adjudicative jurisdiction in case of explicit consent of a State to waive its immunity. This possibility is envisaged in art. 2, which also specifies that the ways in which a State can manifest its consent are "by international agreement; by an express term contained in a contract in writing; or by an express consent given after a dispute between the parties has arisen." Art. 3 provides that a "Contracting State cannot claim immunity from the jurisdiction of a court of another Contracting State if, before claiming immunity, it takes any step in the proceedings relating to the merits [...]" while art. 5 excludes immunity in case of proceedings related to "contract of employment between the State and an individual where the work has to be performed on the territory of the State of the forum."

However, for the purposes of the present analysis, art. 6 and 7 are much more relevant.

In particular, art. 6 par. 1 provides that a "Contracting State cannot claim immunity from the jurisdiction of a court of another Contracting State if it participates with one or more private persons in a company, association or other legal entity having its seat, registered office or principal place of business on the territory of the State of the forum, and the proceedings concern the relationship, in matters arising out of that participation, between the State on the one hand and the entity or any other participant on the other hand." From the wording of this provision it seems clear that financial transactions consisting for instance in the purchase or in the sale of financial assets directly to private business or on financial markets is an activity which is excluded from the immunity from jurisdiction, except otherwise agreed in writing by the State of the forum and the State which undertake such activity, as envisaged at par. 2 of art. 6.

Art. 7 continues by providing that immunity is also excluded for the State which "has on the territory of the State of the forum an office, agency or other establishment through which it engages, in the same manner as a private person, in an industrial, commercial or financial activity, and the proceedings relate to that activity of the office, agency or establishment." This provision applies, in particular, when a foreign States has a foreign direct investment in the territory of another State and it prevents that the former might invoke immunity before the Courts of the latter for business activities comparable to those that any other private person might undertake. Par. 2 of art. 7 provides that such restriction to the principle of absolute immunity can in turn be waived in case of agreement in writing between the two concerned States. Art 8 to art. 16 lay down further exceptions to the principle of State immunity, while the following articles deal with other matters included procedural issues; for sake of brevity and since their analysis is not strictly necessary in the present research, they will not be discussed.

They main principles concerning State immunity are substantially repeated in the UN Convention of 2004. Art. 7 provides that " A State enjoys immunity, in respect of itself and its property, from the jurisdiction of the courts of another State subject to the provisions of the present Convention." The following articles list, *inter alia*, exceptions to such principle. Immunity shall not apply in case of express consent to exercise of jurisdiction manifested by the State (art. 7), certain counterclaims presented by the State invoking immunity (art. 9), contract of employments (art. 11), personal injuries and damage to property (art. 12) participation in a proceeding before a court of another State when the State invoking immunity has "itself instituted the proceeding" or "intervened in the proceeding or taken any other step relating to the merits". (art. 8). As to the distinction between *acta jure imperii* and *acta jure gestionis*, art. 10 provides that "if a State engages in a commercial transaction with a foreign natural or juridical person and, [...] differences relating to the commercial transaction fall within the jurisdiction of a court of another State, the State cannot invoke immunity from that jurisdiction in a proceeding arising out of that commercial transaction." Par. 2 specifies when par. 1 does not apply: "in the case of a commercial transaction between States" or "if the parties to the commercial transaction have expressly agreed otherwise."[21]

Art. 15, in a way similar although not identical to art. 7 of the European Convention of 1972 excludes immunity for activities undertaken by a State in relation to its

[21] R. LUZZATTO; *La giurisdizione sugli Stati stranieri tra Convenzione di New York, norme internazionali generali e diritto interno*; cit.; p. 5-6.

"participation in a company or other collective body, whether incorporated or unincorporated [...]". This provision should be construed in a way to prevent immunity in relation to activities performed by means of branches and subsidiaries by a foreign State undertaking FDIs.

After having explained that immunity from jurisdiction does not extend to *acta jure gestionis*, it is necessary to study more in depth what such notion actually means. This will make it possible to develop an analysis, in the following paragraphs, on the issue as to whether the creation of the SWFs, as well as their operations overseas, can be regarded as governmental or commercial activities and therefore whether they should be entitled to enjoy from State immunity.

First of all, it could be argued that it seem unclear whether the public character of a State act or of a State property depends on the status of the entity performing it or owning it (immunity *ratione personae*) or on the nature and the purpose of the act or of the property themselves (immunity *ratione materiae*). Nevertheless, if it is supported the principle of restricted immunity, then it could be argued that while it is necessary, in order to grant immunity, that an act and a property are respectively performed and owned by a State or a State entity, it is also necessary that such act or property are directly related to a manifestation of the sovereign and public power of the State (immunity *ratione materiae*). Some authors have finally underlined that the public character should be assessed with respect to the *nature* rather than to the *purpose* of the act or of the property of the State, but on this point there is neither broad consensus nor certainty[22]. On this last issue, a brief overview of State and international practice could be useful to shed more light.

In US legislation, commercial activity is defined in sec. 1603 d)) as "either a regular course of commercial conduct or a particular commercial transaction or act." the same provision adds that "the commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular

[22] J. FOAKES, E. WILMSHURST; cit. p. 4; B. DE MEESTER; cit.; p. 813-814; H. FOX; *The law of state immunity*; cit.; p. 284-286; J. DONOHO; cit.; p. 668; H. MAFI; cit. p. 421-428.

transaction or act, rather than by reference to its purpose." In the UK, the State Immunity Act provides at sec. 3 subsection 3 that "“commercial transaction” means—
(a)any contract for the supply of goods or services;
(b)any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation; and
(c)any other transaction or activity (whether of a commercial, industrial, financial, professional or other similar character) into which a State enters or in which it engages otherwise than in the exercise of sovereign authority"
The UN Convention at art. 2,1 c) defines that it is regarded as involving a commercial activity
"(i) any commercial contract or transaction for the sale of goods or supply of services;
(ii) any contract for a loan or other transaction of a financial nature, including any obligation of guarantee or of indemnity in respect of any such loan or transaction;
(iii) any other contract or transaction of a commercial, industrial, trading or professional nature, but not including a contract of employment of persons."
Par. 2 of the same article further specifies that in determining whether a contract or transaction is a “commercial transaction” [...] reference should be made primarily to the *nature* of the contract or transaction" [emphasis added] However the same provision also adds that the *purpose* or the transaction "should also be taken into account if the parties to the contract or transaction have so agreed, or if, in the practice of the State of the forum, that purpose is relevant to determine the non-commercial character of the contract or transaction." The possibility to consider not only the nature but also the purposes of the activity rises relevant practical implications. In fact, if the focus is on the purpose of the activity undertaken by the State, every act performed by a State could be directly or indirectly related to a public interest or to a public interest of a State and therefore it could be regarded as pertaining to the sphere of *acta jure imperii*. Since, for instance, any commercial transaction by a State can have an impact on its incomes and on its resources; and since the availability of State resources can determine the economic feasibility of

governmental activities, virtually all commercial transaction able to affect the amount of money available to a State could be classified as non-commercial.

On the contrary, if determination of whether an act is commercial is made in relation exclusively to its nature, i. e. considering if the act exhibits certain features so that it can be legally performed exclusively by a State and not by a private individual, the scope of the notion of *acta jure gestionis* would be narrower. Within the UN Committee in charge of drafting the Convention of State Immunity, there were States like France and Japan which supported the idea that, to the extent of determining whether a State activity is a commercial or governmental one, attention should have been paid to its *purpose*, while others, like Italy and the US, stressed the importance of focusing on the *nature* of the activity. The wording of the UN Convention on State immunities on this issue should be meant as the outcome of an attempt to find a compromise between these two opposite views.[23]

2. The immunity of States from measures of constraint

As it has been seen in the previous paragraph, State immunity from adjudication has clearly developed from being absolute to being restricted to certain limited cases. As to immunity from measures of constraint, a similar development has occurred, although in more recent times and with some more resistances and delays. In the beginning States tended to follow a mixed approach, consisting in the application of the principle of restricted immunity from jurisdiction to adjudicate and of the principle of absolute immunity from jurisdiction to enforce. On one side it can be argued that such resistances were justified by clear concerns of States which arose in relation to their national sovereignty, since the possibility to be subjected to measures of constraint ordered by the Courts of other States could prove much more threatening than the possibility of being subjected to mere adjudicatory jurisdiction or foreign Courts. On the other side, it was argued that maintaining the principle of absolute

[23] For the debate within the UN committee on this issue and for a more general discussion of the solution adopted by the UN Convention see: I. PINGEL; cit.; p. 1045-1056.

immunity from measures of constraint would have finally made it useless the same development of the doctrine of relative State immunity. In fact, when a State can claim immunity from measures of constraint in any case, it can finally prevent any award or any judgment contrary to its interests from producing effects. In conclusion, there was the concrete risk to make it useless the possibility to sue a State when there was not the possibility to force it to abide by unfavourable judicial or arbitral decisions. The outcome would be the limitation of the utility of any award or judgment whose adoption has been made possible thanks to the application of the principle of restrictive immunity from jurisdiction. As a result of these recent developments, it can be argued that today most States endorse, although with some differences, the principle of restricted immunity with respect to adjudication and enforcement both. In other words, it can be traced an analogy between the provisions governing the issue of immunity from adjudication and immunity from measures of constraint, although such an analogy does not imply perfect identity between them.[24] However, some authors point out that there are still States which apply the principle of absolute immunity in relation to measures of constraint and attachment of State property and which acknowledge that consent of the State whose properties can be affected is the sole circumstance making it possible to submit foreign State properties to measures of constraint. Therefore, such authors suggest that it is better to consider the principle of the restrictive immunity, especially from measures of constraint, as a current trend in the practice of the majority of States and not as corresponding to a well-established rule of customary international law.[25]

As for the discussion on immunity from adjudication, it is not possible to identify clear and well established rules of international law governing the issue of State immunity from measures of constraint: as a result a brief and necessarily incomplete review of State practice and of international instruments must be made. A last *caveat* must be made, before starting the analysis of relevant provisions. For the purposes of the present research, the term measures of constraint refers both to those adopted

[24] R. LUZZATTO, I. QUEIROLO; cit.; p. 218-219; I. M. SINCLAIR; cit.; 254-255.
[25] N. PENGELLEY; cit.; p. 861-871; I. BROWNLIE; p. 342-343.

before or during the proceedings (in the case, for instance, of freezing orders or other conservative measures) and to those adopted after the proceedings in order to enforce the judgment or the award rendered as the outcome of such proceedings.

In the US the issue of immunity from measures of constraint is governed in the FSIA, which provides in section 1609 that [s]ubject to existing international agreements to which the United States is a party at the time of enactment of this Act the property in the United States of a foreign state shall be immune from attachment arrest and execution except as provided in sections 1610 and 1611 of this chapter."

Sec.1610 specifies, as a preliminary and necessary condition for derogating to the principle of immunity of State assets from measures of constraint, that State properties which make the object of such measures must be "used for a commercial activity in the United States". In addition, it is necessary that "the foreign state has waived its immunity from attachment in aid of execution or from execution" or, alternatively that the State property at issue "is or was used for the commercial activity upon which the claim is based." Therefore, it is not sufficient that the property attached is used for commercial purposes, but it must also be connected to the object of the claim. Sec. 1610 devises other circumstances in which measures of constraint can be adopted, however their analysis would go beyond what is strictly necessary for the present analysis.

Sec. 1611 provides further insight on which are foreign State properties which, in any case, cannot become the object of measures of constraint. They are, first of all, those "used in connection with a military activity" and which are of "a military character", or are "under the control of a military authority or defense". In addition, and this is much more interesting for the purposes of the present analysis, property which cannot be attached is "that of a foreign central bank or monetary authority held for its own account, unless such bank or authority, or its parent foreign government, has explicitly waived its immunity from attachment in aid of execution, or from execution, notwithstanding any withdrawal of the waiver which the bank, authority or government may purport to effect except in accordance with the terms of the waiver."

This provision is particularly important in the study of the case in which the foreign

SWF is not an independent entity, but it is organized as a department or a branch of the Central Bank or, even more, when it is a simple pool of assets managed by the Central Bank or by an *ad hoc* office of it. In this case the assets of the SWFs would be *de facto* and *de jure* assets of the Central Bank and any measures of constraint against them in the US would be always precluded, except in the case of explicit waiver. Therefore, in case of operations of foreign SWFs in the US, the need to undertake more in depths analysiss on the issue of whether the assets of SWFs are used for *acta jure imperii* or *acta jure gestionis* will rise only when SWFs are separate State - entities other than Central Banks or when they are pools of assets which are not separate from the State but which are not owned by the Central Bank.

As to UK law of State immunity, sec.13,2 b) provides that "the property of a State shall not be subject to any process for the enforcement of a judgment or arbitration award or, in an action in rem, for its arrest, detention or sale." However, this principle is mitigated by several exceptions listed in sec. 13. In particular, subsection 3 excludes immunity from measures of constraint in case of written consent of the State owning those assets which are subject to such measures.[26] Moreover, subsection 4 excludes from immunity "property which is for the time being in use or intended for use for commercial purposes". It must be stressed that State entities which are separate from the State (as defined in sec.14,1) in principle do not enjoy immunity from measures of constraint; nevertheless a special provision also exists, which applies to certain kinds of property of separate entities like Central Banks or other monetary authorities. In this case, sec.14,4 provides that the property of such entities "shall not be regarded for the purposes of subsection (4) of section 13 above as in use or intended for use for commercial purposes; and where any such bank or authority is a separate entity subsections (1) to (3) of that section shall apply to it as if references to a State were references to the bank or authority". The existence of a provision which allows for the application of State immunity in a way to exclude the

[26] However, it must be noted that subsection 3 adds that "a provision merely submitting to the jurisdiction of the courts is not to be regarded as a consent for" allowing measures of constraint against its property. This implies that consent of a State to subject itself to measures of constraint must be manifested separately from consent to subject itself to adjudication.

possibility to attach properties of Central Banks is extremely important for the issue of the investment activity undertaken by foreign SWFs in the UK; the reasoning developed above in relation to the analysis of a similar provision in US legislation applies and therefore there will be no need to repeat it.

In Italy, the issue of State immunity from measures of constraint is not governed by *ad hoc* legislation but Courts have attempted to address dispute concerning it in the light of the principles of international law, in the same way they have decided in cases concerning immunity from jurisdiction which have been discussed above in the previous paragraph. In Italy too, the previous application of the principle of absolute immunity from measure of constraint, which was also prescribed by law 1263/1926 has been superseded in several judgments of the Corte di Cassazione so that to exclude the immunity of property of foreign States when they are used for *acta jure gestionis*.[27]

In conclusion, it emerges that in the practice of the States which has been quoted so far immunity from measures of constraint should apply only to State properties which are used to perform *acta jure imperii*. Also the UN Convention on Jurisdictional Immunities of States and Their Property tends to follow this approach, providing for the possibility, at art. 19 to waiver "State immunity from post-judgment measures of constraint" not only when the State has previously expressed its consent to this (par. a), but also when the property which makes the object of enforcement measures "is specifically in use or intended for use by the State for other than government non-commercial purposes and is in the territory of the State of the forum, provided that post-judgment measures of constraint may only be taken against property that has a connection with the entity against which the proceeding was directed" (par. c).[28] It must be regarded that measures of attachment against the property of a State used for commercial purposes and connected with the entity against which the proceeding

[27] R. LUZZATTO, I. QUEIROLO; cit.; p. 219-221.

[28] J. DONOHO; cit.; p. 663; B. CONFORTI; *Diritto Internazionale*; cit.; p. 257-258; H. FOX; *The law of state immunity*; cit.; p. 100-120; I. BROWNLIE; p. 344-346; B. DE MEESTER; cit.; p. 811-812; A. BLANE; cit.; p. 454-504; H. MAFI; p. 421-428; N. PENGELLEY; cit.; p. 59-60; J. FOAKES, E. WILMSHURST; cit.; R. LUZZATTO, I. QUEIROLO; cit.; p. 210-214.

was direct are possible only when they are adopted at the end of the proceeding, while conservative measures or other measures of constraint which can be adopted before or during the proceedings would in principle remain excluded from the waiver of the principle of immunity, which in practise means that they still remain not allowed irrespective of the nature of the property they seek to attach. The European Convention on State Immunity, on the other side, does not provide for a possibility to waive State immunity from measures of constraint in cases when property used for commercial purposes is targeted. In fact, art. 23 provides that "no measures of execution or preventive measures against the property of a Contracting State may be taken in the territory of another Contracting State except where and to the extent that the State has expressly consented thereto in writing in any particular case." Therefore, the European Convention seems to support, as to the issue of measures of constraint against State property, an approach which is much more consistent with the principle of absolute immunity.

3. The notion of State and its applicability to SWFs for the purposes of State immunity

If the principle of absolute immunity in favour of all States and State entities still prevailed, then SWFs, should enjoy immunity in any case, since they are owned by States or since they are State agencies and instrumentalities (and ultimately since SWFs are States themselves). However, the analysis of the issue of immunity of SWFs is made much more complex because of two reasons. The first one, which will be discussed more in depth in the present paragraph, is related to the distinction which in many cases tends to be made between organs of the government of the State and other State entities, with only the formers entitled, in principle, to State immunity. The second reason, whose analyse will be completed in the next paragraphs, is related to the development of the principle of restrictive immunity, according to which it is necessary to assess whether activities performed by SWFs should be regarded as *acta jure gestionis* or jure *imperii*.

As to the issue of the distinction between organs of the government of the State (which could be entitled to sovereign immunity if they perform acts *jure imperii*) and other State entities, it must be remarked that certain States, in their domestic legislation, specifies which are the State organs to which the rules of immunity must in principle apply. For instance, in the UK, sec. 14 of the State immunity Act considers as State for the purposes of immunity only "a) the sovereign or other head of that State in his public capacity; b) the government of that State; and c) any department of that government". On the contrary, sec. 14,1 excludes from the notion of State "any entity (hereafter referred to as a separate entity) which is distinct from the executive organs of the government of the State and capable of suing or being sued". This would imply that some SWFs could be regarded as States in English Courts when they are constituted as a departments of Governments or when they are pools of assets deprived of legal personality and owned by the government. On the contrary, SWFs which are established as an independent person of public law or as State owned corporation would be excluded from this notion. However subsection 2 mitigates the effects of the previous subsections when it declares that "A separate entity is immune from the jurisdiction of the courts of the United Kingdom if, and only if (a) the proceedings relate to anything done by it in the exercise of sovereign authority; and (b) the circumstances are such that a State [...] would have been so immune." Therefore, in conclusion, also a SWF which is an independent entity could enjoy immunity under UK legislation whenever it is deemed to perform *acta jure imperii*.[29]

The US legislation governing this issue is worded in a different way, although the practical effects are quite similar. The Foreign State Immunity Act specifies that the notion of foreign State "includes a political subdivision of a foreign state or an agency or instrumentality of a foreign state". It also defines as "agency or instrumentality of a foreign state" any entity

"(1) which is a separate legal person, corporate or otherwise, and

[29] A. DICKINSON; *State immunity and State owned enterprises*; cit.; p. 109-115.

(2) which is an organ of a foreign state or political subdivision thereof, or a majority of whose shares or other ownership interest is owned by a foreign state or political subdivision thereof [...]"[30]

Therefore, the provisions on State immunity in the US apply to any SWFs, irrespective of their internal organization, i. e. irrespective of whether they are instituted as separate entities from the government or as agencies which are part of the structure of the government.

As to international instruments, reference can be made to art. 27,1 of the European Convention on State Immunity, according to which the words “Contracting State” to which provisions on immunity apply "shall not include any legal entity of a Contracting State which is distinct therefrom and is capable of suing or being sued, even if that entity has been entrusted with public functions." Therefore, as par. specifies, "[p]roceedings may be instituted against any entity referred to in paragraph 1 before the courts of another Contracting State in the same manner as against a private person". However, par. 2 continues by stating that "the courts may not entertain proceedings in respect of acts performed by the entity in the exercise of sovereign authority (acta jure imperii)." Therefore, if State entities separate from the government are entrusted with public tasks, they enjoy immunity only in relation to those *acta jure imperii* they perform. This rule, if applied to SWFs, can have a very relevant impact, since it would not be sufficient to assess whether SWFs are State entities and if they are entrusted by the State which owns them with activities like the management of the monetary policy and which can be regarded in principle as having governmental character. What needs to be assessed is whether the specific activity performed by the SWF in relation to which the SWF itself invoke the applicability of immunity is an act *jure imperii* or *jure gestionis*.

The UN Convention[31] at art. 2,1 b) provides that the notion of State for the purposes of the application of the rules on immunity includes:

"(i) the State and its various organs of government;

[30] 28 U.S.C. § 1604 : US Code Available online at: http://codes.lp.findlaw.com/uscode/28/IV/97/1604

[31] A. DICKINSON; *State immunity and State owned enterprises*; cit.; p. 115- 119.

(ii) constituent units of a federal State or political subdivisions of the State, which are entitled to perform acts in the exercise of sovereign authority, and are acting in that capacity;

(iii) agencies or instrumentalities of the State or other entities, to the extent that they are entitled to perform and are actually performing acts in the exercise of sovereign authority of the State;

(iv) representatives of the State acting in that capacity".

In principle, the rules on State immunity should therefore apply to SWFs, since they fall without doubt in one of the *species* of art. 2,1 b) provided that it is also assessed that they perform *acta jure imperii*. To better understand this issue, reference should be made to an excerpt of the official commentary prepared by the International Law Commission on its 1991 Draft Articles on Jurisdictional Immunities, on which the final version of the UN Convention was based. Although par. 120 of the commentaries refers to art. 2,1 b) of the Draft Articles, the wording of the latter is very similar to that of art. 2,1 b) of the convention; for this reason the text of the commentaries of the Draft Articles can help to understand the provisions of the Convention itself. Par. 120 preliminarily acknowledges that "the concept of 'agencies or instrumentalities of the State or other entities' could theoretically include State enterprises or other entities established by the State performing commercial transactions." However it argues that in principle "such State enterprises are presumed not to be entitled to perform governmental functions, and accordingly, as a rule, are not entitled to invoke immunity." The Commentaries do not mention SWFs; however it seems reasonable to extend to them the reasoning developed in relation to State owned enterprises and in general to State agencies and instrumentalities. If a SWF claims to be entitled to assert immunity according to the wording of the UN Convention, it will bear the burden of proving, against the above mentioned general presumption, that it is entitled to perform and it is actually performing *acta jure imperii*.[32]

[32] A. DICKINSON; *State immunity and State owned enterprises*; cit.; p. 117- 119.

Even when SWFs are regarded as States[33] or when an approach is followed according to which all State entities are regarded as in principle subject to the same rules on immunity to which States themselves are subjected, the mere fact that SWFs are States or State entities is not enough to conclude that they should be entitled to immunity. On the contrary, it is necessary to carefully study their operations and to assess whether such operations are governmental or commercial in character,[34] irrespective of the sovereign nature of the entity which performs them.

A further element which limits the utility of an approach exclusively based on the definition of SWFs as State entities and which does not consider the real nature of their activities, is related to the fact that SWFs are organised under the law of the State owning them in very different ways and therefore also the degree they are enshrined within the structure of the State-owner significantly varies. As it has been pointed out by the International Working Group on SWFs[35], many SWFs are established as separate legal entities of public law, with full capacity to act and governed by a specific constitutive law (first group). This is the case of the SWFs established by Kuwait, Korea, Qatar, and United Arab Emirates (Abu Dhabi Investment Authority -ADIA-). Other SWFs take the form of state-owned corporations (second group). They are created in accordance to the corporate law of the State owning them and their main difference from other investment vehicles, for instance

[33] The issue as to whether SWFs could be regarded as States has already been studied in chapter 4 paragraph 2 of the present work. It must be underlined that the rules applicable to the issue of State attribution or State responsibility, which allow to study whether an act of a State entity like a SWFs can be attributable to the State which owns it, are separate and to a certain extent different from those governing State immunity, according to which a SWF could claim immunity like the State which owns it.

In fact, an organ of the State like its government with its acts always engages the responsibility of the State itself irrespective of whether the acts it performs have governmental or commercial character. On the contrary, immunity from jurisdiction to adjudicate is in principle granted in relation to acts having a commercial character, irrespective of whether they are performed by organs of the government of the State or by other State entities.

[34] In this context the term "character" as been preferred to the term "nature". This choice is motivated by the fact that not all the States fully endorse the idea that State activities can be regarded as commercial or governmental depending on their intrinsic nature but they rather support the view that such assessment should be made in relation to the purpose of the activities. Also the UN Convention does not provide a definitive answer on this issue. See *supra*, par. 1 and 2 of the present chapter.

[35] For further information on the International Working Group for Sovereign Wealth Funds and the documents it has adopted see *infra*, chapter 8.

mutual funds, resides in the fact that SWFs are owned by the State. This solution has been adopted, *inter alia*, by the Singapore's Temasek Fund, by the Government of Singapore Investment Corporation (GIC) and by the China Investment Corporation (CIC). Finally, SWFs can consist in pools of assets without a separate legal identity, owned and managed directly by the central bank or the ministry of economic affairs (third group). This occurs, for instance, in Botswana, Canada (Alberta), Chile, and Norway[36].

If an approach only based on immunity *ratione personae* is followed, then there is the risk that recipient States could consider as States, and therefore recognise as entitled to sovereign immunity, only those SWFs belonging to the above mentioned third group. Likewise, recipient States might consider as corporations, and thus as not entitled to immunity, those SWFs included in the second group and, partially in the first group. In other words, some SWFs might enjoy State immunity and other might not, solely depending on the extent to which authorities of recipient States consider SWFs embedded in the organization of the State of origin and irrespective of the fact that the investment activities performed by different kind of SWFs in the host States might actually share the same features.[37]

In particular, it must be underlined that most States grant immunity in relation to the acts performed and to the properties owned by foreign central banks[38]. As in some cases SWFs manage official reserves which have been transferred to them by central banks or they are even controlled or owned by central banks, then immunity to such kind of SWFs would provide them with a special protection from the

[36] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 11; INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Sovereign Wealth Funds - current institutional and operational practices*; cit.; ; S. KERN, H. REISEN; cit.. See also *supra*, chapter 1, paragraph 1.

[37] S. KIRCHNER; *State-Owned Corporations and State Immunity in Europe*; Institute for Public Law, University of Goettingen; 2006; p. 1-4; T. J. CENTNER; *Discerning Immunity for Governmental Entities - Analyzing Legislative Choices*; in *Review of Policy Research*; 2007; p. 425-441; D. CHAMLONGRASDR; *Defining a State for the Purposes of Immunity and Liability of a State and its Entities*; in *European Business Law Review*; 2005; p. 1287-1324; H. FOX; *The law of state immunity*; cit.; p. 323-360.

[38] See; supra; par. 2 of this chapter. See also: W. BLAIR; *The legal status of central bank investment under English law*; in *Cambridge Law Journal*; 1998; p. 374-390; H. FOX; *The law of state immunity*; cit.; p. 360-367; D. CHAMLONGRASDR; cit.; p. 323-360; C. CRAWFORD LICHENSTEIN; *International Jurisdiction over international capital flows and the role of the IMF*; cit.; p. 63-64.

jurisdiction of the host State thus provoking a discrimination against those SWFs which are established as separate entities from central banks.

This supports the need to look at the nature of the operations SWFs undertake. If SWFs' activity falls within the notion of *acta jure imperii*, then the activities they perform should be granted State immunity from jurisdiction to adjudicate of foreign Courts. Likewise, assets under management of SWFs and located abroad as a result of foreign investments undertaken by SWFs should be regarded as used for non-commercial purposes and therefore protected by the immunity from measures of constraint.

To address this issue, as a first step it is necessary to distinguish between two separate categories of activities connected with SWFs. The first category includes those activities performed by the State which owns the SWFs (rather than by the SWFs themselves) and which are related to the creation of the SWFs: from their establishment and incorporation, to their organization and, in particular, to their source of financing and the (macroeconomic) role they are required to play in the State owning them. The second category includes the activities directly performed by SWFs and in detail the investments they undertake overseas.

Then, as a second step, it should be studied whether either or both of such categories of State acts fall within the notion of *acta jure imperii*. Since activity of SWFs consists in the purchase and sale of the assets they own, then the issue of the character of the activity of SWFs (relevant for the issue of immunity from jurisdiction to adjudicate) and of the use of their properties (relevant for the issue of immunity from jurisdiction to enforce) are hardly separable in practise. For this reason, in the following paragraphs, the issue of immunity of SWFs and of their property from jurisdiction to adjudicate and to enforce shall be considered jointly.

As SWFs, with respect to their source of financing, the reasons why they are established and the functions they are required to perform, are divided between commodity funds and non commodity (foreign exchange or “forex”) funds, it will be necessary to undertake such analysis for both categories of SWFs.

4. May the creation of SWFs be regarded as an act *jure imperii*?

There is a strong link between the creation of forex funds and the management of official reserves (foreign currency reserve), which in turn falls into the scope of the conduct of the monetary policy of a State. The issue has been studied more in detail *supra* in chapter 1 and 3 but some basic concepts should be repeated in the present paragraph for a better understanding of the reasoning which will be further developed. Usually official reserves are invested in short term and low return financial assets, for instance US treasury bonds, in order to ensure the maximum degree of safety and liquidity. When the amount of official reserves held by a State exceeds the level needed to effectively manage a State’s short-term monetary policy, foreign currency in excess is transferred to a Fund controlled and managed directly or indirectly by the government or by the central bank or by a special State agency and whose task is to invest such resources in a more profitable way, also purchasing riskier assets denominated in foreign currency. In this way forex SWFs are created. Differently from what occurs with other pools of official reserves, the main objectives the management of SWFs must pursue are the profitability and the safety (but with a higher level of risk tolerance) of investments, while liquidity is less important.[39] Therefore, SWFs are a tool for the management of official reserves and the creation of SWFs can be regarded as an integral part of the conduct of the monetary policy of a State. No one doubts that the exclusive management of the monetary policy by the State is a fundamental feature of its sovereignty:[40] therefore it can be concluded that the creation of forex SWFs is an act *jure imperii*.

With respect to commodity funds, it is more difficult to reach similar conclusions. Commodity funds are created in States rich in natural resources whose sale in the international markets determines to a great extent their level of wealth. It has been established, in particular by domestic Courts of European States as well as by international arbitral tribunals, that the mere exploration, exploitation and sale of

[39] See, supra, chapter 1 and 2.

[40] On the conduct of monetary policy as an essential item of State sovereignty see *supra* chapter 3

natural resources located in the territory of a State by the State itself cannot be regarded as a governmental activity. Likewise, State-owned companies established with the aim to exploiting local national resources, even though they are State entities, perform acts *jure gestionis* and are not entitled to sovereign immunity[41]. However, the issue of the immunity of commodity SWFs must be distinguished from that of State-owned companies operating in the field of natural resources, since SWFs' activity is related to the management of the *revenues* obtained from the sale of natural resources, rather than to the direct exploitation of the natural resources themselves.

Any analysis of commodity funds should start from the evidence that commodities are very volatile assets as their price can change faster and more widely than that of many other assets like bonds, real estate and even shares. Commodity price fluctuations may have disruptive effects on economies heavily relying on the proceeds from the exploitation of their natural resources. Therefore, States highly dependent on the proceeds from the sale of their natural resources and willing to reduce the problems this entails, have undertaken to create stabilization funds. States transfer to stabilization funds a quota of the proceeds from the exploitation of their natural resources when commodity prices are high and then they will be able to draw money from such funds when commodity prices are low and provoke a slump in State revenues.

A proper management of the revenues from natural resources would also require the creation of saving funds. The rationale underlying their establishment is the following one. Most natural resources (in particular mineral ones) are exhaustible. As their exploitation at present causes their depletion in the future, future generations will not be able to rely on the same proceeds current and past generations have obtained from such resources. This has severe consequences in States which are not able to develop profitable sectors other than those related to the exploitation of natural resources. Saving funds allow to exploit natural resources at present and, at the same time, to set aside a part of the proceeds in a fund. The fund shall carry out

[41] G. DELAUME; *Economic development and sovereign immunity*; in *American Journal of International Law*; 1985; p. 319-327; H. MAFI; cit.; p. 415-429.

investments in sectors others than those related to the exploitation of natural resources. The returns from such investments will ensure that future generations will enjoy the same level of wealth of current generations even when natural resources are exhausted.[42] When stabilization funds and saving funds invest abroad, then fall into the definition of SWFs.

Commodity funds undertake an activity which is indispensable to ensure the stability of State revenues related to natural resources. One could wonder whether, for this reason, the creation of commodity SWFs can be regarded as an act *jure imperii*. This view could be supported by the fact that some States which establish SWFs are highly dependent on the exploitation of their natural resources and at the same time they are low-income countries, with a relevant number of people under the threshold of poverty. In this case sharp fluctuations of revenues from the sale of commodities can have disruptive effects on the safety and the security on such States. It could be argued that preventing these dangers from occurring is therefore a fundamental task of a State and the acts it undertakes to this purpose, which can consist *inter alia* in the creation of stabilization and saving funds, could be regarded as *acta jure imperii*. However, it should be noted that not all the States with commodity SWFs are in the conditions described above. Among the owners of commodity funds there are also Norway, Alaska, Alberta, and it would be difficult to assess that fluctuations of commodity prices might threaten their national security or the survival of their populations, in a way to conclude that the management of the revenues of natural resources should be undoubtedly regarded as a governmental function. The situation is even more blurred in case of middle-income countries which are heavily although not completely dependent on their natural resources (Russia,[43] for example) or several States of the Gulf region which are even high-income countries but whose

[42] J. JOHNSON-CALARI; cit.; p. 47-70; M. BARBIERI; *Developing Countries and their Natural Resources*; cit.; p. 26-27; S. GRIFFITH-JONES, J. A. OCAMPO; cit; p. 9-12; S. KERN, H. REISEN; cit.; p. 1-10.

[43] Russia is regarded as an upper-middle income country by the World Bank. See: World Bank, Country Profile: Russia. Available online at http://data.worldbank.org/country/russian-federation . Page visited on 23-03-2010.

degree of dependency on oil revenues is extreme (Saudi Arabia or some of the United Arab Emirates).

It is hardly conceivable that Courts of the States where commodity SWFs invest might undertake, on a case by case basis, an effective and correct analysis of the level of wealth and of dependency on natural resources of the State owner of the SWFs and it is even less likely that, building upon these conclusions, the same Courts might decide whether the creation of SWFs is an act *jure imperii* giving rise to the obligation to accord immunity to the SWFs at issue. It could be argued that such an approach would imply that Courts undertake an assessment of the domestic situation of foreign States and this would be inconsistent with the general principles of sovereignty and non interference which are enshrined in international law.

In addition, it can be argued that for some respects the acts of a State establishing a commodity SWF are not so different from those acts any private individual may undertake when she decides to set aside some money during a period in which she earns more in order to preserve a certain level of wealth also in periods when she earns less. As repeatedly argued so far, when an act of a State is similar to those activities private individuals perform, this constitutes a strong evidence that it falls within the category of *acta jure gestionis*. If such a reasoning is followed, commodity SWFs should not be entitled to sovereign immunity.

In summary, it seems that while the creation of forex SWFs can be regarded as an act *jure imperii*, it can be difficult to assess that the same occurs in case of commodity SWFs. With respect to the consequence this may entail in relation to the issue of State immunity, it can be questioned whether it could be conceivable to ensure immunity from jurisdiction and from enforcement not to commodity funds but exclusively to forex funds. The answer to this question should be negative for at least three reasons.

Firstly, there are not relevant differences between the investment activity undertaken overseas by commodity SWFs and by forex SWFs which might justify a differential treatment in relation to the issue of State immunity.

Secondly, it could be argued that, after all, since the activity of commodity SWFs is in any case the preservation of public wealth, this should be regarded as a sovereign activity and, ultimately, an act *jure imperii*, irrespective of the [44]

Thirdly, it is not always easy to distinguish between these two categories of SWFs in practice. For instance, the sale of oil by a State-owned enterprise in the international market entails an increase of the governmental revenues and at the same time an increase of the reserves of foreign currency (mainly dollars) which are received as a result of such sale and which are owned by the government itself or by the central bank.[45] In this case, if such revenues are transferred to a SWF it is questionable to assess that it is a commodity and not a forex fund. While, in relation to the source of financing, a forex fund can be considered as conceptually distinct from a commodity fund since the former can be financed by the surplus of foreign exchange obtained from the sale of goods other than natural resources; on the contrary a commodity fund always is, for certain aspects, also a forex fund, since the proceeds from the sale of natural resources in international markets are most often denominated in foreign currency. Therefore, as a commodity SWF is created to manage revenues from the exploitation of natural resources and as such revenues are denominated in foreign currency, the commodity fund has to manage reserves of foreign currency and, as a result, it will also play a function of forex fund.[46]

From the discussion carried out in this paragraph, it emerges quite clearly that the approach consisting in focusing on the reasons why SWFs are created does not allow to answer to the question whether SWFs should be entitled to State immunity. It is thus necessary to analyse SWFs' investment activity undertaken overseas and to assess if it can be regarded as a sovereign or commercial act.

[44] L. C. BACKER; *Sovereign Wealth Funds as regulatory chameleons: the Norwegian Sovereign wealth Funds and public global governance through private global investments*; in *Georgetown Journal of International Law*; 2010; p. 442.

[45] There is a correlation between the increase of the reserves of foreign currency and the exportation of natural resources when commodities are invoiced in foreign currency. In practice this occurs very often, since most contracts for the international sale of commodities, and especially of oil, provide for payments in USD.

[46] M. BARBIERI; *Sovereign Wealth Funds and the Principle of State Immunity from Taxation. Which Implications for Economic Development?* UNCTAD- Virtual Institute Digital Library; 2010; p. 13-16.

5. May the investments of SWFs be regarded as acts *jure imperii*?

A popular idea is that the investments of SWFs are driven by political and not by commercial reasons. In other words, SWFs investment strategies would not aim at maximizing returns (as any other investment fund, like a private equity or a hedge fund might do), but at unduly pursuing political and strategic purposes in the territory of the host State and at the expenses of the national interests of the latter. In these cases qualification of the investments of SWFs as *acta jure gestionis* would be doubtful. Although the operations of SWFs would be formally commercial in character, actually their purpose and nature would be clearly governmental and political. However, if the host State fears that SWFs, through their investments, are exercising in its own territory their sovereign powers while pursuing political interests, then it can decide simply not to admit their investments. Therefore, the issue as to whether SWFs should be entitled to State immunity from the jurisdiction of the host State simply would not arise.

However, in recent years most of the fears about the politicization of the investments of SWFs have been dismissed and it has been argued that in many cases SWFs have pursued investment strategies similar to those of other long-term non-State investors.[47] On one side this means that SWFs in principle do not represent a threat and therefore that their operations should not be prevented as a rule, but only monitored, controlled and restricted in limited circumstances. On the other hand this implies that SWFs undertake a commercial activity which clearly falls within the scope of *acta jure gestionis*.

An objection can be made. In the case of forex funds, the performance and the return of the investments of SWFs have direct consequences on the amount of the official reserves of a State (at least on those transferred to the SWF itself) and, as a result, on the monetary policy of the State. In case of commodity funds, the outcome of the investments affects the size of saving and stabilization funds ad as a result the

[47] These arguments have been discussed in particular *supra* chapter 1 paragraph 4 and the literature quoted thereby.

possibility to achieve the aim that their creation pursues. As the conduct of the monetary policy and, for certain aspects, the management of revenues from the sale of natural resources, fall within the scope of the sovereign activities of a State, it could be argued that the investment activity of SWFs is only apparently commercial, but actually it has a governmental character, to the extent to which its outcome affects sovereign functions of a State. This argument should be rejected for three reasons.

First of all this approach would end up to focus again on the creation of SWFs rather than on their investment activity: in the previous paragraph it has already been explained why this method is unworkable.

Secondly, it can be argued that almost any act *jure gestionis* performed by a State can have an impact on the wealth and on the finances of such State and in this sense it might affect the availability of State's resources to finance other State activities falling within the category of *acta jure imperii*. If we adopt such approach the category of *acta jure gestionis* shall result dramatically restricted or it would even cease to exist. This would be inconsistent with the development of the law of State immunity which has been described above at paragraphs 1 and 2 of the present chapter.

Thirdly, SWFs should not enjoy State immunity to the extent they are the first ones to claim that they act as any other (non sovereign) investor, which is clearly not entitled to immunity. They declare they just seek to maximize the return on their investments and they don't pursue any political aim. Clearly such a pledge is explained by the fact that SWFs don't want to be perceived as pursuing political objectives and therefore as constituting a threat to the national security of the host State. In this way they try to convince recipient States not to hinder or restrict their investments. Therefore, on these bases an acceptable compromise can be found. As SWFs demand to be treated like any other commercial investor in the sense that they require not to be subject to restrictions and controls other than those applicable to any other foreign investor in the recipient State, they should also accept to be treated as any other private investor also with respect to the issue of State immunities.[48]

6. The issue of the immunity of the assets of SWFs from measures of constraint adopted to enforce an award issued against the State owner of the SWFs.

As it has been stressed several times in this research, one of the typical features of SWFs is that they invest at least a part of the wealth under their management in foreign assets. This means that the development of SWFs in recent times has increased the amount of wealth owned by States which is held in the jurisdiction of other States and which is therefore potentially subject to measures of constraints adopted by the Courts of such other States.

Measures of constraint could include those measures which are adopted in order to enforce awards issued as an outcome of an arbitration between a foreign investor and the host State, as described in chapter 4. It must be stressed that the awards at issue may concern disputes which by themselves are unrelated to SWFs.

A hypothetical example can clarify this issue. Suppose that an Italian company invests in China and that, as a result of a dispute with the authorities of the host State, it starts proceedings before an ICSID Tribunal. Suppose also that the Tribunal endorses the claims of the Italian investor and that it requires the Chinese Government to pay compensation. It is important to know whether, in the case China does not comply with the award, it is possible for the Courts in which assets owned by the Chinese SWFs are located to seize such assets in order to enforce the award, even if the SWFs were not directly implicated in the dispute.

The analysis of the possibility to attach properties of SWFs in order to enforce awards issued against the State owning the SWFs themselves is therefore extremely

[48] M. BARBIERI; *Sovereign Wealth Funds and the Principle of State Immunity from Taxation*; cit.; p. 16-19.
B. DE MEESTER; cit.; p. 814-815.

important from a practical point of view. Such an analysis cannot be carried out without discussing the issue of the enforceability of arbitral awards which are rendered in investor-State disputes.

Limiting the present discussion to ICSID arbitration[49], it must be remarked that the Washington Convention of 1965 provides at art. 53 that "The award shall be binding on the parties and shall not be subject to any appeal or to any other remedy except those provided for in this Convention. Each party shall abide by and comply with the terms of the award except to the extent that enforcement shall have been stayed pursuant to the relevant provisions of this Convention."[50] This implies that, differently from awards issued as a result of arbitral proceedings other than those administered by ICSID, State Courts are prevented from reviewing or annulling ICSID awards.[51] The only way to challenge an ICSID award in a way consistent with the Washington Convention, is described at art. 51 and 52 of the same Convention, where it is provided for the possibility to require to the Secretary General of ICSID to establish an ad hoc committee (also called annulment committee) to annul the award, exclusively on one or more of the grounds listed in art. 52,1.[52] Art. 54 continues by

[49] It is also possible that disputes between a foreign investor and the host State and which arise in relation to an investment might be settled by means of non ICSID arbitration, e. g. by means of commercial arbitration. This eventuality will be considered only marginally in the discussion carried out in the present paragraph and only a few references to it will be made in footnotes. For a discussion on the differences of the recognition and enforcement of ICSID and non-ICSID awards see: A. K BJORKLUND; *State immunity and the enforcement of investor-State arbitral award*; in VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford : Oxford university press, 2009; p. 305- 309.

[50] See also, on this issue: S. A. ALEXANDROV; *Enforcement of ICSID awards: articles 53 and 54 of the ICSID Convention*; in VVAA*; International investment law for the 21st century: essays in honour of Christoph Schreuer*; Oxford; Oxford university press, 2009; p. 322-337.

[51] If, on the contrary the investor-State dispute is settled through other kinds of arbitration, domestic Courts, and precisely the courts of the State of the seat of the arbitral tribunal, are in principle competent to review and annul the award. On this point see, for instance: A. REDFERN, M. HUNTER, N. BLACKABY, C. PARTASIDES; *Law and practice of international commercial arbitration,* 4. ed. - London; Sweet & Maxwell, 2004; p. 404-430; R. LUZZATTO, *L'impugnazione del lodo arbitrale internazionale;* in *Rivista dell'Arbitrato*, 1997, pagg. 19-37.

[52] Under art. 52,1 of the ICSID Convention, an ICSID award can be annulled by the ad hoc committee, and exclusively by it, if one of more of the following circumstances are met:
"a) that the Tribunal was not properly constituted;
(b) that the Tribunal has manifestly exceeded its powers;
(c) that there was corruption on the part of a member of
the Tribunal;

providing that "Each Contracting State shall recognize an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State [...]". This means that a foreign investor which has prevailed in an ICSID arbitration, can virtually require the seizure of all the assets of the losing State in all the countries which are parties to the Washington Convention. Such States are mandated to enforce the award and they are prevented from reviewing it. Those reasons which can be lawfully invoked by Courts to refuse enforcement of foreign non-ICSID awards (for instance those concerning public policy or non arbitrability according to the law of the State of enforcement) are not relevant in case of request for recognition and enforcement of ICSID awards.[53]

However, despite the existence of a clear obligation upon States to abide by ICSID awards, it can occur that some State do not do so. Reasons can be manifold: there can be a clear will of a State not to abide by the award or to subject it to review of its own Courts, although, on this last point, it seems that the wording of the Washington Convention leaves little room for manoeuvre. Moreover, failure to comply with the

(d) that there has been a serious departure from a fundamental
rule of procedure; or
(e) that the award has failed to state the reasons on which it
is based."

[53] The grounds for refusal to recognize and enforce foreign non-ICSID awards are provided for in domestic legislation of each State. However, a large number of States, including the main recipients of the investments of SWFs, are contracting parties of the New York Convention of 1958 on the recognition and enforcement of foreign arbitral awards. Art. V of such convention provides an exhaustive list of the circumstances under which contracting parties can lawfully refuse recognition and enforcement of foreign awards and therefore it limits the discretion of States on this point. Nevertheless, the New York Convention does not entirely prevent domestic Courts from refusing the enforcement of foreign awards. For this reason it can be argued that ICSID awards have much more possibilities to be enforced by the Courts of the contracting parties of the Washington Convention than non ICSID awards in the contracting parties of the New York Convention. For more information on recognition and enforcement of non-ICSID awards see: T.L. HARRIS; *The "Public Policy" exception to enforcement of international arbitration awards under the New York Convention*; in *Journal of International Arbitration*; 2007 p. 10-24; L. LAUDISA; *Arbitrato internazionale e ordine pubblico*; in *Rivista dell'arbitrato*; 2004; p. 857-872; P. MAYER, *Recommandations de l'association de droit international sur le recours a l'ordre public en tant que motif de refus de reconnaissance ou d'éxecution des sentences arbitrales internationales*; in *Revue de l'arbitrage;* 2002; p. 1061-1068; Q. TANNOCK*, Judging the effectiveness of arbitration through the assessment of compliance with and enforcement of international arbitration awards*; in *Arbitration International*; 2005; p. 71-89; T. TAMPIERI; *Poteri del giudice nazionale, compatibilità con l'ordine pubblico e divieto di riesame del merito nel riconoscimento di lodi arbitrali stranieri*; in *Rivista dell'arbitrato*; 2005; p. 637-656.

award can also be the consequence of the lack of a workable mechanism in the State which is due to pay compensation to the affected investor to ensure that such payment might actually be made without delays. Since refusal to abide by an ICSID award implies a violation of the Washington Convention, this could give rise to inter-State disputes between the State which is blamed for failing to comply with the award and other ICSID members, especially those of which the affected investors are national. To this extent, art. 27 provides that "No Contracting State shall give diplomatic protection, or bring an international claim, in respect of a dispute which one of its nationals and another Contracting State shall have consented to submit or shall have submitted to arbitration under this Convention"; however it also specifies that intervention of the home State is allowed when the host State has "failed to abide by and comply with the award rendered in such dispute." Inter-State disputes mentioned above, according to art. 64 shall be "settled by negotiation" or, when this is not possible, they "shall be referred to the International Court of Justice". However, also in case of a condemnation by the International Court of Justice of a State which has already been condemned by an ICSID tribunal, further and more effective international means to force it to comply with the award can lack.

For these reasons, the need to ensure the possibility to attach the assets of the States located abroad, in order to ensure that the affected investor might receive compensation in spite of refusal of that State to abide by the ICSID award, is particularly important.

However, despite art. 54 of the Washington Convention, attachment of assets owned by the losing State could encounter several difficulties in many jurisdictions where enforcement of the award is sought. Art. 55 of the ICSID Convention could leave them a certain margin of manoeuvre to do so. In fact, it provides that "[n]othing in Article 54 shall be construed as derogating from the law in force in any Contracting State relating to immunity of that State or of any foreign State from execution". Therefore, the actual enforceability of ICSID awards largely relies on domestic legislation governing State immunity from execution as well as on the practise of domestic Courts interpreting such laws or international law (in case of States, like

Italy, where State immunity is not governed by a domestic provisions but through reference to customary international law).[54]

The assets under the management of SWFs and owned by Central Banks or by local or central Governments through their SWFs, probably represent the greatest pools of State assets located abroad. Their increase in the last years implies an increase of State properties which could be subjected to measures of enforcement, especially in case of failure to comply on behalf of States owning SWFs with investor-State awards. This development is even more important since in the last decade the number of investor-State disputes (ICSID and non ICSID both) has increased fast, together with the amount of money awarded as compensation to investor.

The increase of cases in which States are required to pay compensation to investors and the increase of assets owned by States abroad through their SWFs are unrelated trends; however it could be argued that the increase of State properties located abroad as investments of SWFs may favourably affect the possibility to ensure the enforcement of awards issues as an outcome of investor-State dispute, when the State is the losing party. Everything depends, ultimately, on whether the assets under management of the SWFs could be subjected to measures of enforcement. If, consistently with the analysis undertaken in this chapter, Courts before which enforcement of awards is sought deem that assets under the management of SWFs are used for commercial purposes, then the growth of the size of SWFs as well as of their operations overseas could indirectly lead to an increased possibility to ensure the enforcement of investor-State awards. On the contrary, if

[54] G. K. FOSTER; *Collecting from Sovereigns: the current legal framework for enforcing arbitral awards and court judgments against States and their instrumentalities, and some proposals for its reform*; in *Arizona Journal of International and Comparative Law*; 2008; p. 666-731; E. BALDWIN, M. KANTOR, M. NOLAN; *Limits to Enforcement of ICSID Awards*; in *Journal of International Arbitration*; 2006; p. 1-24; N. B. TURCK; *French and US Courts define Limits of Sovereign Immunity in Execution and Enforcement of Arbitral Awards*; in *Arbitration International*; 2001; p. 327-342; A. S. ALEXANDROSS, I. A LAIRD; *Compliance and Enforcement*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press; 2008; p. 1171-1187; V. BALAS; *Review of Awards*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press; 2008; p 1125- 1153; A. K BJORKLUND; *State immunity and the enforcement of investor-State arbitral award*; cit.; p. 305-321; See also, on this issue: S. A. ALEXANDROV; cit.; p. 322-337.

Courts believe that the assets under the management of SWFs are used for *acta jure imperii*, then there will be no possibility to seize them in order to ensure the enforcement of the awards rendered against the State owning the SWFs at issue.

Finally, it should be argued that even in the case Courts consider that assets owned by SWFs are used or intended to be used for commercial purposes, this could be not sufficient to attach them in order to ensure the enforcement of an award against the State which own them. In fact, some domestic legislations provide that there should be a link between the assets subject to measures of constraint and the claim in which the State is involved.[55] If this reasoning is endorsed, assets of a SWFs, when they are regarded as used for commercial purposes, could be attached only in order to enforce an award (but probably, not an ICSID award[56]) or another judicial decision in which a foreign SWF is the losing party.

It could even be discussed that if a SWF is constituted as a separate entity from the Government, then its assets would not be attachable for the purposes to enforcing an award against that government. In this case, in fact, they would not be regarded as State assets *strictu sensu*.[57]

So far case law concerning the immunity of SWFs from jurisdiction to adjudicate and in particular to enforce of foreign Courts is scarce. A recent judgement of English Court dealing with these problems could be quoted, which however rises some perplexities since the reasoning it develops is, according to some respect, inconsistent with the concepts developed so far in the present chapter. This

[55] See, *supra*, par. 3 of the present chapter.

[56] The difficulties which rise when an attempt is made to assess whether SWFs should be regarded predominantly as investors or as States for the purposes of the ICSID Convention have already made the object of discussion in the present work. See *supra*, chapter 4 par 2.

[57] To support this view it may be considered that, in a symmetrical way, arbitral tribunals have deemed that if a State entity is separate from the State owning it, it is not possible to attach the properties of that State when the State entity fails to comply with an award and there is no practical possibility to attach its own assets in order to ensure the enforcement of the award at issue. On this point, and for a review of arbitral decisions dealing with this issue see: M. SAUNDERS, C. SALOMON; *Enforcement of Arbitral Awards against States and State entities*; in *Arbitration international*; 2007; p. 467-477.

judgement, to which we refer to as the AIG case[58], deals with the possibility to attach the assets of a SWF for the purposes of the enforcement of an award issued against the State which owns the SWF itself.

AIG, a company incorporated in the US, claimed that the investment it undertook in the Republic of Kazakhstan (RoK) was expropriated as a result of the conduct of the host State. The dispute was brought before an ICSID tribunal, which had jurisdiction under art. VI,4 of the BIT concluded in 1992 between the US and Kazakhstan. The tribunal in the award it rendered on 7 October 2003 found that Kazakhstan had unlawfully expropriated the investment of AIG and required it to pay compensation. Since Kazakhstan did not spontaneously comply with the award, AIG initiated proceedings in order to obtain its enforcement and the seizure of Kazakhs assets in States which were the signatories of the ICSID Convention.[59] In particular, AIG started proceedings before an English Court in order to attach the assets which formed part of the SWF of Kazakhstan (whose name was the National Fund of Kazakhstan, hereinafter referred to as NFK) and which were owned by the National bank of Kazakhstan (NBK). Such assets were deposited into separate accounts at the London branch of ABN AMRO Mellon Global Security Services BV (hereinafter AAMGS) and they consisted in £3.1 million in cash and in securities whose valued was estimated £91 million. The terms and conditions governing this deposits were provided for in a kind of contract called "Global Custody Agreement" concluded between the above mentioned bank and the National Bank of Kazakhstan, which is the Central Bank of the Republic of Kazakhstan.[60] The issue of immunity of the assets of the NFK was risen during the proceedings. The claimant put forward several arguments to suggest that such assets were not covered by State immunity.

AIG argued that the assets of the NFK "are held ultimately for the beneficial ownership of the RoK"; therefore, although the GCA was concluded by the NBK, the

[58] High Court of Justice; Queen's bench division; Commercial Court; London; *AIG Capital Partners Inc v Kazakhstan*; Judgement of 20 October 2005; [2005] APP.L.R. 10/20 .(Comm) in *World Trade and Arbitration Materials*; 2006; p. 283-314.

[59] *AIG Capital Partners Inc v Kazakhstan*; cit.; par. 3-8.

[60] *AIG Capital Partners Inc v Kazakhstan*; cit.; par. 9-19.

assets at issue were not property of the NBK but the RoK. Since they were used to be "invested in securities that are actively traded so as to produce a high level of investment income, as it is required by paragraph 24 of the Budget Code of the RoK" they constituted property of the State used for commercial purposes and therefore they were not entitled to State immunity from measures of constraint.

In addition, even if it had been admitted that such assets belonged to the NBK, it would have had to be pointed out that, since they were used for commercial purposes, the principle of immunity from measures of constraint enjoyed by the properties of Central Banks as laid down at art. 14,4 should have not applied. In fact, even if the assets forming part of the NFK were deemed to belong to the Central Bank, they were not used for the performance of the typical function of Central Banks, i. e. the conduct of monetary policy; therefore they should have not been treated as property of the central Bank for the purposes of the applicability of the provisions governing State immunity. For these reasons, the claimant supported the view that sec. 14,4 of the State Immunity Act could not apply to the assets at issue.[61]

The respondent argued that the cash and the securities at issue were immune because of two reasons. First, since the assets of the NFK were owned by the NBK, which in turn was a separate entity performing the task of Central Bank of Kazakhstan, art. 14,4 of the State Immunity Act ensured that they shall be immune from measures of constraint. The respondent then added that even if the assets at issue "are not property of a State's central bank or other monetary authority within the meaning of section 14(4), nonetheless" they "are the property of the RoK" and they "are not and never have been used or intended for use for commercial purposes." but, "on the contrary, it is clear [...] that those assets, being part of the National Fund, are being used and always have been used in the exercise of sovereign authority." The respondent then concluded that for this reason these assets "are immune from being

[61] *AIG Capital Partners Inc v Kazakhstan*; cit.; par. 27.

subject to any process for the enforcement of the judgment obtained by the Claimants, pursuant to section 13(2) of the SIA" [62]

According to the Court, "the words 'Property of a State's central bank or other monetary authority' in section 14(4), when construed using common law principles of construction, mean any asset in which the central bank has some kind of "property" interest" In other words, attention must be paid on whether property at issue "is allocated to or held in the name of a central bank, irrespective of the capacity in which the central bank holds it, or the purpose for which the property is held"[63]

The Court argued that the assets of the NFK, which were deposited at the London branch of AAMGS on behalf of the NBK, were property of the NBK, i. e. property of a Central Bank which is a separate entity. Therefore their immunity from measures of constraint was ensured under sec. 14,4 of the State Immunities Act. In other words, the fact that property was owned by a Central Bank separate from the government made it useless to assess whether it was used for governmental or commercial purposes, since the Court held that the State Immunities Act cannot be construed in a manner to require that property of a Central Bank be used exclusively for non commercial purposes in order to enjoy immunity.[64]

Although this finding would have been sufficient to settle the dispute in a way unfavourable to AIG, the Court, in order to provide a more exhaustive answer to the issues arisen by the parties, added that, even if it had been concluded that the assets at issue were not property of the NBK but of the RoK, they would have enjoyed immunity. In fact, in this case it would have been necessary to study whether such assets were used for *acta jure imperii* or *acta jure gestionis* and the Court argued that such assets "were not at any time either in use or intended for use for 'commercial purposes' within the meaning of section 13(4) of the SIA."[65] To reach this conclusion, the Court undertook an interesting analysis of the use of the properties which were

[62] *AIG Capital Partners Inc v Kazakhstan*; cit.; par. 28.

[63] *AIG Capital Partners Inc v Kazakhstan*; cit.; par 61. For a broader discussion on the ownership of the assets of the NFK to the NBK see: par. 33-60

[64] *AIG Capital Partners Inc v Kazakhstan*; cit.; par 95,7.

[65] *AIG Capital Partners Inc v Kazakhstan*; cit.; par 89-93 and par. 95,8.

owned by the NBK and which formed part of the NFK. In particular, the Court stressed that the assets at issue formed part of the NFK, which, according to the Court was "created to assist in the management of the economy and government revenues of the RoK, both in the short and long term." Then, the Court added that "management of a State's economy and revenue must constitute a sovereign activity." The fact that the NFK undertook investments in a way which was similar to a commercial activity should not be relevant, since, it was argued, "the National Fund had to be managed by the NBK in accordance with the law set out in the Budget Code, in particular Article 24" which required "that the National Fund be invested". According to the Court, the fact that the NFK was required by law to invest "in authorised financial assets in order to secure, amongst other things, 'high profitability levels of the [National Fund] in the long term outlook at reasonable risk levels'" as well as the fact that assets of the NFK "were actively traded at all times and that the NBK obtained from the RoK a commission on good results and paid a penalty for poor ones" did not imply that the activity of the NFK "is inconsistent with the Stability and Savings Funds of the National Fund being used or intended for use for sovereign purposes." According to the Court, "the aim of the exercise, at all times, [of the NFK] was and is to enhance the National Fund. To do that the assets have to be put to use to obtain returns which are reinvested in the National Fund, i. e. to assist the sovereign actions." The Court disagreed with the view that "the trading activities of the Securities Accounts by AAMGS are clearly financial transactions and their aim is to make profits." Likewise, it disagreed with the conclusions that they "could not be transactions 'in the exercise of sovereign authority' within section 3(3)" and that "for the purposes of 13(4), at least the Securities Accounts of the London Assets constitute 'property in use or intended for use for commercial purposes'".

To reach these conclusions the Court did not look at the intrinsic nature of the acts performed by the NBK when using the resources forming part of the NFK but it stressed that "the dealings of the Securities Accounts must [...] be set against the background of the purpose of the GCA." According to the Court, the "GCA was established to assist in running the National Fund." and "the Securities Accounts contain assets which are part of the National Fund." Therefore, it held that "the dealings are all part of the overall exercise of sovereign authority by the Republic of Kazakhstan."[66]

The reasoning developed by the English Court, in the light of the discussion developed in the previous paragraphs of the present chapter, could rise some criticism. As to the issue that assets owned by the Central Bank, when such institution is an independent entity, should be immune from jurisdiction to enforce, it could be remarked that such approach, although consistent with sec. 14,4 of the UK State Immunity Act, rise however some problems.

First of all, in the judgement of the Court, immunity is not granted by taking in consideration the actual use of the property, i. e. whether they are used for commercial or governmental purposes, but the focus is exclusively on the owner of the property. Such an approach could determine relevant discrimination in the treatment of different SWFs. While the Kazakhstan fund, as it is owned and managed by the Central Bank, would enjoy immunity, on the contrary other SWFs like the Chinese ones, since they are separate from the Central Bank, should be treated differently for the purposes of the applicability of the law of State immunity. Such discrimination could be eventually lamented by the foreign SWFs which are not entitled to State immunity. For instance, they could initiate proceedings against the UK before ICSID tribunals for the violation of the MFN clause, provided that such clause is included in an International Investment agreement concluded between the UK and the home State of the SWF.

However, the part of the judgement in the AIG case which rises more perplexities is the one in which it is stated (*inter alia, ad abundantiam*) that the property of the NBK transferred to the Kazakhstan SWF was used for non commercial purposes and that for this reason it would have enjoyed immunity in any case. By doing so, the Court did not focus on the nature, but on the purpose of the activity for which the assets forming part of the NFK were used. The inadequacy of this approach, as well as all

[66] *AIG Capital Partners Inc v Kazakhstan*; cit.; par. 92.

the practical problems it might determine, has been discussed in depth in the previous paragraphs of the present chapter and in particular in paragraph 4. The Court should have paid more attention to the arguments of the claimant, which stressed that the element to consider was the fact that property at issue was used and was intended to be used, as it was clear to everyone, to make purchases and sales of financial securities in order to maximise returns, like any investor may do. Moreover, the Court should have not focused on the (supposed) ultimate purpose for which the property was used. The difficulty and the inappropriateness of this approach is further proved by the inability of the Court to develop a convincing explanation on the reason why the NFK played a governmental function; in fact it seems that the Court rather limited itself to assume that the management of State revenues was an act *jure imperii*, instead of motivating this finding in a more detailed way, taking into account all the peculiarities of the case at issue in a more in depth analysis.

7. The principle of immunity from taxation and its applicability to SWFs

After having explained the applicability to SWFs of the principles of immunity from jurisdiction to adjudicate and to enforce, as well as the practical implications this may have on their operations overseas, it is necessary to quickly discuss the principle of immunity from taxation and the effects it might have on the operations of SWFs. Given the peculiarities of tax law and the difficulties to apply to tax issues most principles and approaches developed in other fields of law and in particular of international law, the discussion will be limited to a review of a few aspects of particular interest.

When in paragraph 1 of the present chapter it was provided an introductory systematization of the issue of State jurisdiction and State immunity, the issue of taxation was not addressed. However, in the light of the findings of that paragraph, it can be argued that immunity from taxation could fall within the notion of immunity from jurisdiction to prescribe, as taxing properties or income of a State located in the territory of another State depends on the existence of a law of the latter providing for such a possibility. Nevertheless, the power of the territorial State to levy taxes would rather relate to the notion of enforcement measures or *rectius*, to the sphere of the measures undertaken to ensure the application of the rules prescribed. Without getting into this complex, doctrinal question, it is probably sufficient to stress that the principle according to which foreign States and their properties should not be subject to taxation in other States, lies on the same theoretical and functional basis as the principles of immunity from adjudication and enforcement. They all draw from the principles of sovereignty and equality between States and non-interference in the affairs of other Sovereigns, as well as from the functional need to leave foreign States unencumbered in the pursuit of their mission.[67] Once State A taxes the properties of State B located in its territory, it behaves as if B was subject to it instead of being its peer; in addition, this might affect the sovereignty of B and finally this might cause an undue interference in the ability of B to manage its sovereign affairs, by reducing its ability to freely dispose of its properties to this purpose.[68] The principles of restricted immunity from adjudication and enforcement should apply to immunity from taxation as well, because they all lie on the same theoretical and functional basis. For these reasons States, and State entities like SWFs, should be taxed on income or on properties which are related to their commercial or business activities and they should be entitled to immunity from taxation only with respect to assets and incomes closely related to governmental activities.[69]

The issue of State immunity from taxation is scarcely addressed in international treaty law. The European Convention on State Immunity of 1972 and the United

[67] On the argument that principle of State immunity relies on the principle of equal sovereignty of States and of non-interference into the internal affairs of other sovereigns see, for instance: R. LUZZATTO; *La giurisdizione sugli Stati stranieri tra Convenzione di New York, norme internazionali generali e diritto interno*; cit.; p. 16.

[68] V. FLEISCHER; cit.; p.456-460; I. BROWNLIE; cit.; p. 326-327; H. FOX; *The law of state immunity*; cit.; p. 30 and p. 170.; M. DESAI, D. DHARMAPALA; p. 98-100; J. CRAWFORD; *Execution of judgments and foreign sovereign immunity*; cit.; p. 856; R. LUZZATTO, I. QUEIROLO; cit.; p. 203-210; M. BARBIERI; *Sovereign Wealth Funds and the Principle of State Immunity from Taxation*; cit. p 4-8.

[69] M. BARBIERI; *Sovereign Wealth Funds and the Principle of State Immunity from Taxation*; cit.; p. 1-10.

Nations Convention on Jurisdictional Immunities of States and Their Property of 2004 do not provide insight, since they declare that they do not deal with immunity from taxation. More in detail, the UN Convention never mentions taxation and at art. 1 it specifies that it only applies to the "immunity of a State and its property from the jurisdiction of the courts of another State." The European Convention, at art. 29 explicitly excludes tax issues from its scope, even when taxation is the object of a judicial proceeding.

For the purposes of the present analysis, it seems more useful to refer to a short OECD document which deals with the issue of the immunity of SWFs from taxation, although without providing definitive answers. It is titled "discussion draft on the application of tax treaties to State-owned entities, including Sovereign Wealth Funds"[70] (hereinafter referred to as the "discussion draft") and it has been published on November 25th 2009. Its aim is to start a debate on the taxation of the cross-border investments undertaken by State-owned entities, also in relation to the need to update the OECD model tax convention of 2008 and the related commentaries.[71] In the next pages it will be studied which are the changes to the 2008 model tax convention the discussion draft proposes and then which of them have been adopted in the updated version of 2010.

The first issue analysed in the discussion draft is whether tax treaties concluded by States on the basis of the OECD model convention should apply to SWFs too and, as a result, whether SWFs should be entitled to the same benefits accorded to other persons covered by the tax treaties.[72] According to art. 1 of the version of the OECD

[70] OECD; *Discussion draft on the application of tax treaties to State-owned entities, including Sovereign Wealth Funds*; OECD; 2009, available online at: http://www.oecd.org/dataoecd/59/63/44080490.pdf page visited on 12-09-2011.

[71] For an introduction to international tax treaties and in particular to the OECD model treaty see: V. UCKMAR, G. CORASANITI, P. DE' CAPITANI DI VIMERCATE; *Diritto tributario internazionale : manuale* - Padova; Cedam, 2009; p. 46-114; A. J. BRIAN, M. J. MCINTYRE; *International tax primer*; 2nd ed.;The Hague; New York; Kluwer Law International; 2002; p. 103-134.

[72] On these issues see: M. BARBIERI; *Sovereign Wealth Funds and the Principle of State Immunity from Taxation*; cit.; p 23-26.

model tax Convention of 2008,[73] tax treaties which are adopted pursuant to this model "shall apply to persons who are residents of one or both of the Contracting States". Art 4 of the same convention then specifies which persons shall be regarded as residents and, *inter alia*, it includes in this notion contracting States themselves and all their political subdivisions or local authorities. SWFs are not explicitly mentioned, but they should be included into such a broad notion of residents, be they regarded as States or as (State owned) corporations (provided that they are resident in the State which own them). Some uncertainties could rise only if SWFs are regarded as State entities different from corporations and distinct from the States or from the regional and political subdivisions of the States themselves. On this topic, the discussion draft points out that "issues may arise, however, in the case of *entities set up and wholly-owned* [emphasis added] by a State or one of its political subdivisions or local authorities." To address this problem is relevant also from a practical point of view because, as correctly stressed in the discussion draft, "[s]ome of these entities may derive substantial income from other countries and it may therefore be important to determine whether tax treaties apply to them (this would be the case, for instance, of sovereign wealth funds [...])."

The discussion draft seems therefore to distinguish between SWFs on one side and on the other side the State or the State political and local subdivisions which may establish SWFs. It also takes into consideration that in some cases States, when concluding tax treaties based on the OECD model convention, "modify the definition of 'resident of a Contracting State' in paragraph 1 of Article 4 and include in that definition a 'statutory body' or an 'agency or instrumentality' of a State, a political subdivision or local authority, which would therefore cover wholly-owned entities that are not considered to be a part of the State or its political subdivisions or local authorities" as it can be the case of some SWFs. In fact, as it was explained above in paragraph 3 of the present chapter, SWFs are organised under the law of the State

[73] OECD; *Articles of the model convention with respect to taxes on income and on capital* [as they read on 17 July 2008]; OECD; available online at http://www.oecd.org/dataoecd/43/57/42219418.pdf page visited on 12-09-2011.

owning them in very different ways: some of them can be regarded as political/administrative subdivisions of the State, while others are constituted as separate legal entities of public law or corporate law. Therefore, if a modification of the definition provided for at art. 4 of the OECD model convention is made as suggested above, this should provide a higher degree of legal certainty as to the inclusion of SWFs in the notion of residents for the purposes of the applicability of the provisions contained in the tax conventions.

In conclusion, if States desire to ensure the application of tax treaties to SWFs too, when they conclude a tax treaty they should specify, in the articles providing for the scope *ratione personae* of the treaty itself, that it shall also apply to statutory bodies or agencies or instrumentalities of a contracting State or of its political subdivisions and local authorities as well as to other entities owned by a contracting State or by its political subdivisions and local authorities. This is especially important to the extent States, as it has been recommended in the present chapter, regard the assets under the management of SWFs as intended to be used for commercial purposes and therefore to be treated like the transactions undertaken by any other investor also with respect to the applicability of the provisions of tax treaties.

On the contrary if, inconsistently with the arguments developed in the present chapters, States decide to grant immunity from taxation to SWFs, the importance of ensuring them some of the benefits provided for by the articles of tax treaties is significantly reduced. In fact, if an entity simply is not subject to taxation, it has no interest in benefiting, for instance, of the provisions against double taxation contained in applicable tax treaties.

The discussion draft recognises that several States grant immunity from taxation to other States, to their local and political subdivisions as well as to their agencies and their instrumentalities. It declares that the tax treaties adopted on the basis of the model convention shall not "be interpreted [...] as affecting in any way the possible application by each State of the customary international law principle of sovereign immunity." The discussion draft reminds that "there is no international consensus, [...] on the precise limits of the sovereign immunity principle. Most States, for example, would not recognise that the principle applies to business activities and many States do not recognise any application of this principle in tax matters. There are therefore considerable differences between States as regards the extent, if any, to which that principle applies to taxation" In fact, as it was underlined in the previous paragraphs of the present chapter, the principle of State immunity has been developed in relation to the issue of immunity from jurisdiction to adjudicate and to enforcement and its extension to taxation, although it seems recommendable and correct in the light of the reasoning developed in the present analysis, rises nonetheless some theoretical and practical difficulties. In addition, it must not be forgotten that the distinction between *acta jure imperii* and *acta jure gestionis*, whose utility and validity has been supported in the present chapter, could be described more as a prevalent trend in the practice of the international community rather than as a well established rule of customary international law whose content is clear and well defined.

The discussion draft underlines that "States often take account of various factors when considering whether and to what extent tax exemptions should be granted, through specific treaty or domestic law provisions or through the application of the sovereign immunity doctrine, with respect to the income derived by other States, their political subdivisions, local authorities, or their statutory bodies, agencies or instrumentalities." Then it provides a non-exhaustive list of such relevant factors, which includes the issue of reciprocity, the distinction between *acta jure imperii* and *acta jure gestionis,* the distinction between income derived from a portfolio or a direct investment and whether the assets and income of State-owned entity, like the SWFs, which are carrying out investments overseas, are used for "public purposes". The discussion draft does not specify neither the scope of the notion of "public purposes", nor its relation with the notion of act *jure imperii*.[74] However, it has been explained

[74] In other words, it remains unclear whether, according to the discussion draft, an act performed by a State for public purposes is for this same reason an act *jure imperii* or if the notion of act *jure imperii* and act performed for public purposes should remain separate. In the last hypothesis also an act which is commercial in nature could be undertaken with the aim to pursuing public purposes. In the present chapter the latter approach will be endorsed and therefore it will be reasonable to consider that the operations of SWFs, although they are not *acta jure imperii*, in any case pursue public purposes too.

above that both commodity and forex SWFs play an important role in the promotion of sustainable economic development in the States owning them (especially when such States are developing countries and economies in transition) since they contribute to the improvement, respectively, of the management of the revenues from the exploitation of natural resources and of the conduct of monetary policy and the use of foreign exchange reserves. The host State could regard the pursuit of such aims as pertaining to the notion of "public purposes" mentioned in the discussion draft and it can grant certain exemptions to SWFs consistently with this rationale. This argument will be better developed in the following paragraph of the present chapter.

On July 22nd 2010 a new Model Tax Convention on income and capital has been adopted by the OECD, updating the previous model of 2008. Art. 1 and art. 4 are not modified consistently with the discussion draft and they still do not include any explicit reference to 'statutory body' or to 'agency or instrumentality' of a State. Such a change, at least from the point of view of the discussion draft, would have allowed to cover with a higher degree of legal certainty also wholly-owned entities that are not considered to be a part of the State or its political subdivisions or local authorities, as it can be the case of some SWFs. However, the commentaries of the Convention, with a wording which is practically identical to the one of the discussion draft, keep on considering as a solution to this possible shortcoming the widespread practise of States to include, in the tax treaties they sign using the OECD convention as model, an additional reference to 'statutory body' or 'agency or instrumentality' of States in order to ensure that also all kind of SWFs might be covered by the tax treaties at issue.[75]

The commentaries to the Model Convention of 2010 contain for the first time some direct reference to the issue of SWFs. After having provided a brief definition and restriction of these State-owned investment vehicles, they discuss whether, beyond

[75] OECD; *Commentaries of the OECD Model Tax Convention on income and capital*; 2010; par 6.35-6.37; available online at: http://browse.oecdbookshop.org/oecd/pdfs/browseit/2310081E.PDF page visited on 12-09-2011.

the general discussion on art. 1 and 4, the provisions of the Model Convention itself can apply to them. The commentaries argue that: "[w]hether a sovereign wealth fund qualifies as 'a resident of a contracting State' depends on the fact and circumstances of each case. For example, when a sovereign wealth fund is an integral part of the State, it will likely fall within the scope of the expression '[the] State and any political subdivision or local authority thereof' in Article 4." Given the impossibility to reach a one-size fits all solution the commentaries suggest that: "States may want to address the issue in the course of bilateral negotiations, particularly in relation to whether a sovereign wealth fund qualifies as 'a person' and is 'liable to tax' for purposes of the relevant tax treaty" [76]

As to the issue of immunity to taxation, the commentaries, consistently with the discussion draft, provide that "[t]he application of the Convention [...] should not be interpreted [...] as affecting in any way the possible application by each State of the customary international law principle of sovereign immunity".[77]

After a review of international documents, it is possible to focus on domestic legislations and tax practices of States, which, however, is unable to shed much more light and, even more, to find out a clear and consistent trend on the issue of the immunity of SWFs from taxation. For the purposes of the present research, it is clearly impossible to review all the laws and the administrative practises of the tax authorities of all the States, therefore the present analysis will be limited to a short review of those of a few developed countries which so far have been among the main recipients of the investments of SWFs.

In the USA, SWFs’ immunity from taxation is provided for in section 892 of the Internal Revenue Code.[78] Sub section a) 1 provides that:

[76] OECD; *Commentaries of the OECD Model Tax Convention on income and capital*; 2010; cit.; par 8.5.

[77] OECD; *Commentaries of the OECD Model Tax Convention on income and capital*; 2010; cit.; par. 6.38.

[78] The text of the provisions can be consulted online at: http://www.fourmilab.ch/uscode/26usc/. For a detailed explanation of the issue see: US HOUSE OF REPRESENTATIVES; JOINT COMMITTEE ON TAXATION; cit.; p. 56; V. FLEISCHER; cit.; p. 465-467. For further comments see also: F. BASSAN; *The law of Sovereign Wealth Funds*; cit.; p. 107-108

"The income of foreign governments received from -

(A) investments in the United States in -

(i) stocks, bonds, or other domestic securities owned by such foreign governments, or

(ii) financial instruments held in the execution of governmental financial or monetary policy, or

(B) interest on deposits in banks in the United States of moneys belonging to such foreign governments,

shall not be included in gross income and shall be exempt from taxation under this subtitle."

Although subsection a) 2 seems to exclude commercial activities from the scope of State immunity from taxation; the US tax practise so far has applied subsection a) 1 to SWFs, thus ensuring them immunity from taxation.

This situation rises acute criticism and several authors argue that in such a way State-owned investors are given undue advantages relative to private-sector investors, thus causing distortion to free competition[79]. In any case it cannot be concealed the paradox that, while many policymakers and commentators emphasise the threats SWFs can pose to national security and while they ask for tougher regulation of their operation (or even a prohibition *tout court* of many investments of theirs) the actual legal framework governing SWFs' investments, at least with respect to tax issues, is even more favourable than the one applicable to non sovereign investors.

Also in the United Kingdom SWFs are exempted from taxation on passive investment income, but only when they can be regarded as an integral part of the government of

[79] V. FLEISCHER; cit. p. 468-472; M. S. KNOLL; *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?;* in *Southern California Law Review*; 2009; p. 718-730; M. A. MELONE; *Should the United States tax Sovereign Wealth Funds?;* in *Boston University International Law Journal*; 2008; p. 143-225; M. DESAI, D. DHARMAPALA; cit.; p. 98-103. However, other authors who do not share such a concern: W. CUI; *Is Section 892 the Right Place to Look for a Response to Sovereign Wealth Funds*; in *Tax Notes*, Vol. 123, 2009; available online at http://chapters.ssrn.com/sol3/chapters.cfm?abstract_id=1413137## page visited on 12-09-2011.

a foreign State, while the exemption is denied if they are organised as entities separate from the Government although owned by the latter.[80] This may cause an unjustified discrimination between SWFs on the ground of the legal status they have in the country which owns them and irrespective of the nature of the activities they actually perform. In fact, if a State creates a SWF which is organised as a branch of the ministry of economy or of the central bank, its investments in the UK shall be tax exempt; nevertheless the same economic operations shall be taxed in the UK whenever they are undertaken by a SWF which is organised as a State-owned corporation.

Many other important recipients of SWFs' investments do not follow the approach of the US and the UK. Australia and Canada, for instance, permit commercial investments of foreign sovereigns to be taxed[81]: therefore SWFs should pay taxes, except when a tax treaty grants immunity from taxation to the SWFs of the other contracting party.[82] Japanese legislation provides that foreign government shall pay taxes on incomes earned in Japan; nevertheless a custom has developed according to which foreign States enjoy immunity *de facto*. There is not a specific provision related to SWFs in Japanese law: however SWFs are treated as any other investment fund and therefore they are liable to pay taxes[83].

Germany and Switzerland tax foreign governments on their passive investments in the same manner as any other foreign corporate entity. Therefore SWFs do not enjoy immunity from taxation in these States except otherwise provided in bilateral treaty: for instance the tax treaty between Switzerland and Norway specifically exempts

[80] DIRECTORATE OF LEGAL RESEARCH FOR INTERNATIONAL, COMPARATIVE, AND FOREIGN LAW OF THE US CONGRESS; *Report for the Congress - Taxation of the Passive Income of foreign Governments and Sovereign Wealth Funds in selected foreign countries*; LL File No. 2008-00763; 2008; p. 49.

[81] Nevertheless, it could be argued that if (contrary to the reasoning developed in the present chapter) investments of SWFs are not considered commercial acts, then immunity from taxation would apply as well.

[82] DIRECTORATE OF LEGAL RESEARCH FOR INTERNATIONAL, COMPARATIVE, AND FOREIGN LAW OF THE US CONGRESS; cit.; p. 7 and p. 26.

[83] DIRECTORATE OF LEGAL RESEARCH FOR INTERNATIONAL, COMPARATIVE, AND FOREIGN LAW OF THE US CONGRESS; cit.; p. 34.

Norway's government, central bank, and oil fund from taxation on dividends earned from investments in Swiss companies.[84]

As it may appear from this quick review of State practice, SWFs are entitled to very different tax treatments in different countries. In the States where they enjoy immunity from taxation, it results that foreign investments are subject to different tax treatments depending on the sovereign or non sovereign character of the investor. Under the point of view of international law and in particular of international investment law, this should not have severe legal consequences. In fact, it would be difficult to prove that this might entail a violation of the provisions contained in most BITs dealing with the issue of non discrimination, since most IIAs tend to exclude tax issues from their scope *ratione materiae,* except when taxation is used in order to carry out in a disguised way violations of other provisions of IIAs.[85]

On the contrary, economic and policy implications would be much more relevant. Although taxation (or, *rectius*, the lack of taxation, in the present case) is not the main element that brings a foreign investor to chose a certain country as a recipient of its operations, it is undeniable that radical differences in taxation among countries, which result from the eligibility or non-eligibility to immunity from taxation, have a potential to distort the allocation of investment flows of SWFs worldwide. It is difficult not to believe that *ceteris paribus*, SWFs will not direct their investments towards countries which ensure immunity from taxation to States and State entities in any case or, more often, which grant immunity only in relation to governmental activities but also consider the operations of SWFs as falling within this category. This could indirectly affect investments undertaken by non sovereign investors. In fact, in countries where SWFs are granted immunity from taxation, other investors which can

[84] DIRECTORATE OF LEGAL RESEARCH FOR INTERNATIONAL, COMPARATIVE, AND FOREIGN LAW OF THE US CONGRESS; cit.; p. 29 and p. 45.

[85] On the issue of the (non) coverage of tax issues in IIAs see: of T.WÄLDE, A. KOLO; *Investor-State disputes: the interface between Treaty based international investment protection and fiscal sovereignty*; in *Intertax*; 2007; p. 424-449.; T.WÄLDE, A. KOLO; *Coverage of taxation under modern investment treaties*; in P. MUCHLINSKI, F. ORTINO AND C. SCHREUER; ed.; *The Oxford handbook of international investment law*; Oxford: Oxford University Press; 2008 p. 319; UNCTAD; *International Investment Agreements: Key issues*; cit.; p. 70.

be the competitors of SWFs may find themselves in a disadvantaged situation. Therefore, the particularly favourable treatment granted to SWFs might end up to squeeze out non sovereign investors. The outcome could be a re-distribution of investment flows in the sense that there might be an increase of investments of SWFs in countries which accord them immunity from taxation, while non-SWFs investments would flow to countries which do not accord SWFs such immunity.

These observations support the view that the development of a shared approach to the taxation of SWFs as suggested in the present chapter, i. e. based on the denial of immunity to SWFs and to their investments, would bring beneficial economic effects.

8. The idea of considering immunity from taxation granted to SWFs owned by developing countries as a form of aid to development.[86]

In the previous paragraphs all relevant arguments on whether SWFs perform *acta jure imperii* or *acta jure gestionis*, have been discussed. Although it has been concluded that, since the focus should be on the nature of the operations (i. e. the investments) they carry out overseas, then SWFs should not be entitled to immunity from taxation, this nonetheless does not mean that a tax exemption granted by the host States to SWFs would be irrelevant for the possibility of SWFs to better achieve their macroeconomic functions in the States which own them.

The proper performance of these macroeconomic functions, i. e. of the conduct of monetary policy and of the management of revenues of natural resources, is instrumental to the promotion of the economic and social development of the States which own SWFs. Therefore, a link exists between the issue of granting tax exemptions to SWFs and the improvement of the ability of the SWFs to enhance economic development in the States which own them. Such link is even clearer in developing countries, on which the analysis developed in this paragraph will mainly focus.

[86] The finding of this paragraphs largely rely on the following paper: M. BARBIERI; *Sovereign Wealth Funds and the Principle of State Immunity from Taxation*; cit.; p 19-23.

Therefore, it could be discussed whether exemption from taxation to the investments of SWFs owned by developing countries or by certain States with economies in transition could be justified not on the ground of the principle of State immunity, but to the extent it might constitute a form of aid to development. In other words, the host States, when refraining from taxing the returns obtained in their territories by a SWF owned by a developing country would act as if they were facilitating the achievement of the developmental goals pursued by the State owner of the SWF through the operations of the SWF itself. In other words, exemption to taxation in favour of these SWFs would be tantamount to transferring to the owner of SWFs a relevant quota of wealth or *rectius* to preventing a transfer of wealth, which would be otherwise due, from the owner of SWFs to the recipient of the investment. This theory can also be supported by the evidence that many States owning a SWF and using it to invest overseas are also recipients of official aid to development: this occurs for instance in the case of Algeria, Azerbaijan, Botswana, Chile China, Kazakhstan, Libya, Nigeria, Oman, Trinidad and Tobago, Venezuela.[87]

The idea of exempting SWFs from taxation as a form of aid to development should nonetheless be refined and detailed, in order to prove useful in practice. Following the rationale underlined above, only SWFs owned by developing countries and economies in transition should be considered for exemption from taxation. But then several doubts emerge. First: should all the SWFs established by States belonging to such categories be exempted? Or should exemption be limited to SWFs owned by LDCs only, or by countries particularly dependent on the exploitation of their natural resources or by those especially vulnerable to capital outflows and where the need to keep large foreign exchange reserves to prevent currency crisis is extremely acute? Another issue which should not be neglected is that SWFs *could be* and *should be* a tool for the promotion of sustainable development, but this does not mean that they always and necessarily act like this. In case of SWFs which are opaque instruments in the hands of corrupt and unaccountable elites using the enormous wealth under

[87] P. J. KEENAN; *Sovereign Wealth Funds and Social Arrears*; cit.; p. 440-442.

their management in order to pursue their personal interests or other objectives inconsistent with the promotion of the wellbeing of the People of the State which has established the SWF (the same People which should always be regarded as the ultimate owner and beneficiary of the SWF), then granting a more favourable tax treatment to such SWFs would not result into an effective form of aid to development. According to these concerns, further requirements should thus be attached to SWFs owned by developing countries and economies in transition in order to make them eligible to tax exemptions. For instance, they should be required to meet certain standards of transparency: in this way recipient States will be able to verify whether tax exemptions in favour of SWFs really result in a valuable aid to development.[88]

However, it cannot be neglected that this approach could be excessively intrusive and that it can result into an undue interference into the domestic affairs of States owners of SWFs, since the organization, management and activities of entities owned and controlled by them would constantly be under the scrutiny of the authorities of recipient States. This would hardly be consistent with international law and especially with the principle of non interference with the domestic affairs of foreign States.

On the other side it could be argued that such form of scrutiny occurs only when a SWF decides to invest in a foreign country; in this case that country has the right to subject the investments undertaken in its territory to particular controls and it also preserves the right to require the respect of certain standards. If the foreign SWFs and the States which own them do not mean to subject themselves to these controls, they are free not to invest in the recipient States and, likewise, the recipient States are allowed to refuse admission of the investments at issue.

The above mentioned standards in principle could require a higher level of transparency on behalf of SWFs and they could even contemplate the demand to conform to certain management and investment practises. In other words international law does not prevent a host State from subjecting foreign investors to

[88] P. J. KEENAN; *Sovereign Wealth Funds and Social Arrears*; cit.; p. 439-471; M. BARBIERI; *Developing Countries and their Natural Resources*; cit.; p. 26-31

disclosure requirements and even to make admission of foreign investments subject to such requirements.[89] The fact that SWFs are not only investors but also State entities should not invalidate these findings, especially since SWFs, as it has been previously demonstrated, should be regarded as performing non-governmental acts when they invest overseas and therefore they should not be entitled to standards of treatment different from those applied to other investors. Also for these reasons, they should not be exempted from controls and disclosure duties as provided for in the domestic legislation of the host country.

Finally it could be questioned whether only developed countries which are the recipients of the investments of SWFs should exempt such State-owned investors, or whether emerging countries too should be encouraged to do so. For instance the tax exemption accorded to the China Investment Corporation by a recipient State which belongs to the category of LDCs, would result into an aid to development granted by the latter to China and its opportunity and fairness could clearly rise several doubts. This last issue is getting more important as the number of investments by SWFs owned by emerging economies undertaken in developing countries has been increasing in 2009[90].

It is difficult to provide a satisfactory answer to all these questions and to decide in practice the criteria according to which certain SWFs should be exempt from taxes to the extent they can be regarded as tools for development. The ambition of the present paragraph has not been to solve all these issues, but only to stress that any attempt to consider whether SWFs could be exempt from taxes not because they shall benefit from the principle of State immunity from taxation but because of their developmental function cannot escape an in depth discussion of all such problems. Finding a practical solution to them all can be extremely difficult. Each State can adopt a different approach, given the great number of elements to be taken into consideration and the different importance which can be attributed to them.

[89] see, *supra*, chapter 4, especially par. 4 to 6.

[90] W. MIRACKY, V. BARBARY, V. FOTAK, B. BORTOLOTTI; *Sovereign Wealth Fund Investment Behavior: Analysis of Sovereign Wealth Funds Transactions during Q2 2009*; Monitor Group and FEEM; 2009; p. 14-15.

In addition, it is possible for a developed country recipient of SWFs investments to agree on a bilateral basis with a low-income country owner of SWFs exemptions from taxation of the funds of the latter as a form of aid to development. This could occur by means of an *ad hoc agreement* or it could take place within the framework of a broader agreement concerning investments (for instance a BIT) or concerning other kinds of aid to developments. To our knowledge, so far no agreement of this kind have been concluded.

It can be argued that both in the case of tax exceptions granted unilaterally and by means of bilateral agreement, the outcome could be a further increase of differences in tax treatments applicable to SWFs across States, with the same distortive effects on world capital flows which have been analysed above when it was discussed that some States apply the principle of State immunity from taxation to the investments of SWFs. As a result, it could be argued that the criteria to assess which SWFs should be entitled to tax exemptions because of their developmental functions should not be autonomously decided by host States acting individually, also because this would further jeopardise the tax treatment of the transnational operations of SWFs and it would offer a pretext for disputes concerning alleged unreasonable discriminations between SWFs owned by different States. It would be better to establish at the international level some standards providing for a guidance to States which desire to differentiate the tax treatment they mean to apply to SWFs. This would entail that the International Community, also through the adoption of an instrument of soft law, might first of all enhance the principle that the income earned by some SWFs from their investment overseas should be tax exempt, to the extent such a more favourable tax treatment constitutes a form of aid to development. Basic criteria according to which recipient States shall decide which SWFs are eligible to tax exemptions could also be provided for in soft law instruments. The elements that could be taken into consideration might be: the level of income of the States owning the SWFs, their degree of dependency on a few natural resources, further particular elements of vulnerability of its economy. In addition, also the level of transparency of the SWFs at issue, together with the soundness and effectiveness of their legal framework and of their operational strategies, should be considered. Chapter 8 of the present research will provide a short overview of the international instruments adopted in relation to SWFs and of the ongoing works of the main international organisations on this subject[91]. It will study the extent to which they might have a relevance in relation to tax issues too and if they could be used as a preliminary step towards the establishment of a legal framework governing the taxation of SWFs at the international level. However it is possible to anticipate that such instruments do not address neither tax issues nor aspects concerning State immunity.

[91] For a more detailed review of such works, see: M. AUDIT; cit.; p. 3-5; M. BARBIERI; *The International Regulation of Sovereign Wealth Funds. Which Role for the European Union?*; cit.; p. 9-10; P. GUGLER, J. CHAISSE; *Sovereign Wealth Funds in the European Union: General trust despite concerns*; NCCR TRADE Working Chapter No 2009/4; 2009; R. A. EPSTEIN, A. M. ROSE; cit.; p. 111-141; B. DE MEESTER; cit.; p. 797-800.

CHAPTER 6.

THE INVESTMENTS OF SWFS IN THE COMMON MARKET AND THE APPLICABILITY OF EU LAW

Introduction.

The present chapter and the following one will study the investments of SWFs in the European Union (EU) as well as the EU law and policies which may affect the operations of these State-owned investment vehicles. The decision to analyse these issues not in chapter IV but in separate chapters can be understood taking into consideration the following elements.

First of all, the EU is one of the main recipients of the investments of SWFs. This reason is sufficient to understand why it is important, both from the point of view of the recipient countries and of the SWFs themselves, to know more in detail the way EU law may affect the operations of SWFs.

Secondly, the EU has developed a set of norms applicable to investments, included those undertaken by SWFs, which present unique features as to the their content, their overarching character and their incidence in the domestic legal systems of member States[1].

For these reasons, EU provisions are substantially different from those contained in IIAs or in the law of other international organizations and therefore they need to be dealt with separately.

Thirdly, since the EU is a subject actively engaged in international relations, it is important to assess the contribution it has given and it still might give to the development of an international legal framework governing international investments,

[1] In particular, some EU law provisions are provided with direct effect. This means that they are able to directly create duties and rights upon individuals.

the operations of SWFs and the policies of the recipient countries which can be adopted in relation to these issues.

Consistently with these findings, the present chapter shall be organised as follows.

Paragraph 1 will provide a brief overview of the operations of SWFs in the EU. It will explain which are the countries and the industries in the EU where SWFs tend to invest more. It will try to explain why the banking and the financial sectors have been able to attract so far a particularly large share of the investments of SWFs and it will discuss the relation of the attractiveness of these sectors with the European integration and with the creation of the EU Common market. In addition, paragraph 1 will analyse the relation between the competitiveness of the EU economy and the investments of SWFs. After providing an overview of the notion of competitiveness, it will be studied whether and how the increasing competitiveness of the EU economy might increase its ability to attract the investments of SWFs and then whether and how the investments of SWFs might in turn contribute to the enhancement of the competitiveness of the EU economy.

Given the complex challenges and opportunities related to the investments of SWFs in the EU, in paragraph 2 it will be studied whether the European Institutions have found it necessary to act in order to address these issues. It will be studied whether the EU has adopted legally binding instruments explicitly addressing SWFs or whether it has preferred for the time being to adopt other kinds of approaches and therefore, of instruments. It will be studied that the most important document so far adopted by the EU in this field is a Communication of the Commission providing for an EU approach to SWFs. Paragraph 2 will be devoted to the analysis of this instrument of soft law.

In paragraph 3 an analysis will be developed on the content of EU provisions which are applicable to the investments in the EU and, then, to the investments undertaken in the EU by SWFs in particular. It will be stressed that, in principle, two sets of provisions are applicable. They are the provisions on freedom of establishment and on free movement of capitals.

In the remainder of paragraph 3 it will be studied, also considering EU secondary law, other official documents of the Commission and the abundant case law of the European Court of Justice, whether both sets of provisions may be equally important in addressing the issue of the investments of SWFs in the EU or whether one of them must prevail.

In paragraph 4 it will be studied more in depth whether EU provisions on the right to establishment may apply to the investments of SWFs, taking into consideration the main features that this kind of investments has so far presented. It will be pointed out that provisions on freedom of establishment could properly govern only FDIs which entail the acquisition of complete control over the invested company and which are undertaken by SWFs owned by EU members. Therefore, in the remainder of paragraph 4 it will be studied whether there are SWFs owned by EU members and whether they undertake investments in other EU members which can consist in setting up or purchasing branches and subsidiaries.

In paragraph 5 an analysis will be made of the articles of the TFEU concerning movements of capitals, as well as of the derogations to this principle which are admitted in EU law. This analysis shall be carried out taking into consideration the abundant case law of the ECJ. As a second step, it will be discussed whether EU law on movement of capitals, as it has been interpreted by the ECJ, may apply *mutatis mutandis*, to the investments of SWFs too. This will also imply a discussion on the limits that EU law may pose to member States when they try to regulate, control and eventually restrict the investments undertaken by SWFs in their territory. In other words, it will be assessed whether EU law may restrict the ability of member States to protect their essential interests when they may be threatened by the operations of SWFs.

Finally, in paragraph 6 it will be studied whether the ability of EU members to decide which domestic assets cannot be owned by foreign SWFs, may be preserved by art. 345 TFEU, which provides that EU law does not prejudice "the rules in Member States governing the system of property ownership." To this purpose, it will be reviewed the interpretation made by the ECJ of art. 345 in different cases, especially those concerning so-called golden shares legislation.

The last part of the paragraph will study more in depth the issue of golden shares. It will be investigated whether they can prove useful to EU members in order to minimise the threats to national security that certain investments of SWFs may pose. Finally, it will be discussed the extent to which EU law restrict the ability of member States to make recourse to golden shares and the consequences this may have on the investments of SWFs in the EU.

Other aspects concerning the investments of SWFs in the EU, and especially the relation between EU law and other international instruments which can be used to govern also or exclusively the operations of SWFs in the EU, will be analysed in chapter 7.

A final remark must be made, in order to ensure the full intelligibility of the research which is to be developed in the present and in the following chapter. Several official documents and legal acts which will be discussed have been adopted by EU institutions before December 1st 2009, i. e. before the entry into force of the Lisbon Treaty, which has replaced the "old" Treaty on European Union (hereinafter referred to as TEU "pre-Lisbon") and the Treaty on European Community (TE) with the "new" Treaty on European Union (TEU) and the Treaty on the functioning of the European Union, (TFEU). Therefore, they refer to articles contained in treaties which are no more in force. Likewise, several judgements of the European Court of Justice (ECJ) which will be analysed refer to cases initiated (and often concluded) before the entry into force of the Lisbon treaty and which concern the interpretation of articles of the TEU "pre-Lisbon" and of the TEC.

However, in most cases, the wording of the articles of the repealed TEU pre Lisbon and of the TEC which are relevant for the purposes of the present analysis are identical to the wording of provisions of the TEU and of the TFEU. For this reason, in this chapter reference to relevant treaty articles will be made taking into consideration the current numeration and when necessary it will be also indicated the number of the similar provision contained in the treaties before the entry into force of the Lisbon treaty. When judgments, legal acts or other official documents referring to the articles of the Treaties before the entry into force of the Lisbon treaty are directly quoted, then the old numeration will be used, but the new numeration will also be added in parenthesis.

1. Overview of the investments of the SWFs in the EU and their relation with the competitiveness of the European economy.

As it was explained in chapter 1, EU countries, together with the US, so far have been the main recipients of SWFs' capitals. In fact, if we consider SWFs foreign investments which have taken place since 1995 until the end of 2008, it emerges that 32% of the total transaction volume is related to EU based[2] firms, while 37% is related to US firms.

[2] The economic data provided does not clarify how the term "based" must be meant. In any case, in the present research it will not be investigated whether, according to EU law, a company is deemed to be based in one EU country because it has been registered or incorporated under the law of that country (theory of incorporation) or because it has established its centre of administration and undertakes its main economic activity in that country (theory of the legal seat). The ECJ has been asked to adjudicate upon this issue in several judgments, among which many were related to the issue of the transfer of the seat of EU companies. Nevertheless, the conclusions which can be drawn from an analysis of the case law of the ECJ are not completely clear. See: Judgment of the Court of 27 September 1988; *The Queen v H. M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc*.; Case 81/87.; European Court reports 1988 Page 05483; Judgment of the Court of 9 March 1999; *Centros Ltd v Erhvervs- og Selskabsstyrelsen*; Case C-212/97; European Court reports 1999 Page I-01459; Judgment of the Court of 5 November 2002; *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)*; Case C-208/00; European Court reports 2002 Page I-09919; Judgment of the Court of 30 September 2003; *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd; Case C-167/01*; European Court reports 2003 Page I-10155; Judgment of the Court (Grand Chamber) of 16 December 2008; *CARTESIO Oktató és Szolgáltató bt*.; Case C-210/06; European Court reports 2008 Page I-09641. The literature on this issue is very rich. See, for instance: T. BACHNER; *Freedom of establishment for companies: a great leap forward*; in *The Cambridge law Journal*; 2003; p. 47-50; W. F. EBKE; *The European conflict-of-corporate-law revolution: Uberseering, Inspire Art and beyond*; in *European Business Law Review*; 2005; p. 9-55; J. BORG-BARTHET; *European private international law of companies after Cartesio*; in *International and Comparative Law Quarterly*; 2009; p. 1020-1028; H. C. HIRT; *Freedom of establishment*, *international company law and the comparison of European company law systems after the ECJ's decision in Inspire Art Ltd*; in *European Business Law Review*; 2004; p. 1189-1222; M. MENJUCQ; *L'Europe et le droit de l'entreprise*; in *La Semaine Juridique Edition Générale* n° 12; 2007; I 130; C. GERNER-BEUERLE, M. SCHILLIG; *The mysteries of freedom of establishment after Cartesio*; in *International and Comparative Law Quarterly*; 2010; p. 303-323; E. VACCARO; *Transfer of Seat and freedom of establishment in European company law*; in *European Business Law Review*; 2005; p.

The main recipient of SWFs investments in the EU is by far the UK, which has received 26 billion USD between 1995 and mid 2008, probably because of its special economic openness and its efficient and dynamic financial markets. UK companies whose equity has been purchased by SWFs are big multinationals, also operating in sectors other than banking and finance. In the same period Germany and France too have received huge amounts of capitals: 5.1 and 3.8 billion USD respectively. Italy, maybe because of the predominance in its economy of small and unlisted firms, in the beginning has been less attractive, but the recent acquisition of stakes in big, and according to some respects, strategic Italian companies like Unicredit, Eni and Finmeccanica, by Libyan SWFs might suggest an increased interest in Italian companies too.

With respect to the sectors which are the main recipients of SWFs' investments in the EU, the financial industry has proved to be the most attractive one, since it has made the object of investments amounting to 26.9 billion USD. However, while in the US other sectors have been practically neglected, in European countries investments have been more diversified, involving services (6.3 billions), industry (5.9 billions), real estate (4.6 billions), energy, commodities and retail as well.[3]

The high level of attractiveness of the EU financial and banking sector is undeniably related to the good level of integration the latter has achieved also as a result of actions undertaken by the European Union itself. In this work it is not possible to provide an exhaustive analysis of all the measures adopted by the EU in this field and therefore only very few references will be made. For instance, the adoption of a large number of secondary law according to the procedures suggested by the Lamfalussy Committee and within the framework of the Financial Services Action plan (FSAP) has contributed to harmonise to a large extent domestic legislation governing the banking and financial industry. This has allowed an increasing number

1348-1365; F. WOOLDRIDGE; *Uberseering: freedom of establishment of companies affirmed*; in *European Business law Review*; 2003; p. 227-235; S. BERNASCONI; *Il caso Cartesio e la libertà di stabilimento delle società nell'Unione Europea*; Liuc Papers n. 236, Serie Impresa e Istituzioni 28, ottobre 2010; available online at: http://www.biblio.liuc.it/liucpap/pdf/236.pdf

[3] S. KERN; *SWF's and foreign investment policies - an update*; cit.; p. 8 ; J. SEGRELLES; cit..

of EU-based banks and financial firms to supply services or to open branches and subsidiaries in other EU members, thus increasing competition, reducing costs and promoting efficiency. In addition, harmonisation in applicable laws across EU members has favoured intra-EU mergers and acquisitions which has contributed to create greater pan-European institutions which in turn are supposed to be able to achieve economies of scale and scope and therefore to prove more efficient, profitable and ultimately, more capable of attracting foreign investments.[4]

It should be stressed that not all subsectors of the EU banking and financial industry have equally benefited from European integration. In fact in some of them integration has been less successful, depending either on the persistence of resistances of member States (which in turn may be explained by the sensitiveness of interests at stake) or on the intrinsic features of the subsectors at issue. For instance, while in wholesale capital markets from an economical standpoint an almost full integration has been achieved, on the contrary other sub-sectors like retail banking still remain more domestically focused and this has determined a lower degree of integration.[5]

However, it cannot be denied that the overall good level of integration of EU banking and financial sector is a relevant achievement of the EU and one of the reason of the

[4] For a more in depth discussion of the integration of the banking and financial sector in the EU, as well as on the impact this may have on the competitiveness of EU economics see: J. DE HAAN, S. OOSTERLOO, D. SCHOENMAKER; *European financial markets and institutions*; Cambridge; Cambridge U.P.; 2009; p. 33-55 and p. 107-131; R. TILLY, P. WELFENS, M. HEISE; ed.; *50 years of EU economic dynamics: integration, financial markets and innovations*; Springer; 2007; p. 129-131; R. BALDWIN, C. WYPLOSZ; *The economics of European integration*; 2nd ed.; London; McGraw-Hill; 2006; p. 435-440. For a better understanding of the efforts undertaken by EU institutions in developing a sound legal framework governing the financial and banking system in the EU see: M. VAN EMPEL; *Financial services in the EU: harmonization and liberalization*; in M. VAN EMPEL; ed; *Financial services in Europe: an introductory overview*; Alphen aan den Rijn; Kluwer Law International, 2008; p. 25-62; Y. V. AVGERINOS; *Essential and non-essential measures: delegation of powers in EU securities regulation*; in *European Law Journal*; 2002; p. 269-289; N. MOLONEY; *New frontiers in EC capital market law: from market construction to market regulation*; in *Common Market Law Review*; 2003; p. 809-843; N. MOLONEY; *EU financial market regulation after the global financial crisis: "more Europe" or more risk?*; in *Common market Law review*; 2010; p. 1317-1383; S. PUEL, E. ROGEY; *Une réglementation rénovée: les directives UCITS*; in *Revue de Droit bancaire et financier* n° 1, Janvier 2011, étude 7; A. MULLER; *La réforme du système européen de surveillance financière: organisation et fonctionnement des autorités européennes de surveillance*; in *Revue de Droit bancaire et financier* n° 2, Mars 2011, étude 11; R. VABRES; *La réforme du système européen de surveillance financière: les pouvoirs des autorités européennes de surveillance*; in *Revue de Droit bancaire et financier* n° 2, Mars 2011, étude 12.

[5] R. TILLY, P. WELFENS, M. HEISE; ed.; cit.; p. 123-126.

development of the sector at issue as well as of its ability to attract foreign investments, included those of SWFs.

If we now turn our attention from the attractiveness of the EU financial and banking sector to the attractiveness of the EU economy as a whole, it must be noted that it is determined by several concurring elements: the high level of development of financial markets, the existence of a strong and convertible currency (at least for those EU members which have joined the Euro area), a relative openness to capital inflows. In addition to these arguments, in the present paragraph it can be useful to analyse from an economic perspective the issue of the competitiveness of the EU economy. In detail, it is necessary to study the meaning of the notion of competitiveness of the EU economy and its relation with the investments of SWFs.[6]

Competitiveness can be defined as the ability to foster strong and sustainable growth in an increasingly competitive environment.[7] The degree of competitiveness of the economy of a State, or of the EU as a whole, can be measured in several ways. For instance, it is possible to use, as a proxy, the share of its output or of its export or of its foreign direct investments (FDIs) relative to world total output, exports, FDIs.[8] According to the European Competitiveness Report of 2009[9] prepared by the European Commission, productivity growth is the key driver of competitiveness in the

[6] For a discussion of the relation between competitiveness of the EU economy and investments of SWFs see: M. BARBIERI*; A new challenge for the European Union*; cit.; p. 271-275.

[7] R. TILLY, P. WELFENS, M. HEISE; ed.; cit.; p. 48.

[8] L. NACHUM, G. JONES, J. H. DUNNING; *The international competitiveness of the UK and its multinational enterprises;* in *Structural Change and Economic Dynamics*; 2001; p. 277-294.

[9] EUROPEAN COMMISSION; *European Competitiveness Report; 2009; Commission staff working document SEC(2009)1657 final*. Available online at http://bookshop.europa.eu/en/european-competitiveness-report-2009-pbNBAK09001/;pgid=y8dIS7GUWMdSR0EAlMEUUsWb0000sqZ9JGoh;sid=ANtTtR9yUsVTs1HyMr7NEn1Xohgv5RihBgg= page visited on 26-09-2011. Other official documents which have been adopted by EU Institutions and which deals with the issue of the enhancement of EU competitiveness especially taking into consideration the role played by transnational trade and investment are the following ones. EUROPEAN COMMISSION: *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions - Global Europe - Competing in the world - A contribution to the EU's Growth and Jobs Strategy* {SEC(2006) 1228} {SEC(2006) 1229} {SEC(2006) 1230} COM/2006/0567; 4/10/2006. EUROPEAN COMMISSION: *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - The European Interest: Succeeding in the age of globalisation - Contribution of the Commission to the October Meeting of Heads of State and Government*; COM/2007/0581; 03/10/2007.

long run. Nevertheless, other factors can have an impact on competitiveness, such as the openness in trade and FDIs, the enhancement of corporate social responsibility (CSR), the development of a sustainable industrial policy as well as the support of small and medium-sized enterprises (SMEs).

The role of the nominal exchange rate of the European currency and of the level of prices, which together determine the real exchange rate, is a very important element too. It should be noted that these drivers are strictly correlated and in the European case they depend to a great extent on the establishment and development of a single market. In particular, an increased productivity is the consequence not only of improvements of the utilization, education and skills of the workforce and of technology used in the production processes, but it is also the result of a more efficient allocation of factors of production. The creation of an internal market, which has been one of the chief aims of the European Economic Community and today of the European Union, implies the free movement of goods, services, workers and capitals, as well as the freedom of establishment. The free movement of factors of production in the internal market undeniably favours their efficient allocation and therefore it helps to maximize their remuneration. This increases the overall efficiency and productivity, and finally the competitiveness of the EU economy.[10]

The open character of the EU market relative to investments and trade with third countries, favours the efficient allocation of factors of production not only at the European level but even on a worldwide scale. For this reason the openness of the EU market should be maintained and enhanced to promote even further the competitiveness of the EU. According to the report on competitiveness, “there is massive empirical evidence that open economies are richer and more productive than closed ones: macroeconomic studies indicate that a 1 percentage point increase in the share of trade in GDP raises the level of income in the range of 0.9 to 3

[10] EUROPEAN COMMISSION; *European Competitiveness Report; 2009; Commission staff working document SEC(2009)1657 final*; cit.; p. 1-12. See also: R. BALDWIN, C. WYPLOSZ; p. 163-171; W. MOLLE; *The economics of European integration: theory, practice, policy*; 5th ed.; Aldershot; Ashgate; 2006; p. 235.

percent."[11] From a sectoral perspective, a positive and significant relation is found between trade openness levels (both export openness and import penetration) and labour productivity growth.[12] In particular the report of the Commission upholds the idea that exporters tend to be more productive than non-exporters. Two complementary theories can help explain this correlation. On one side, only firms which are able to produce goods or to provide services which are competitive in the international markets are able to export. On the other side, the export activities undertaken by a firm would boost its competitiveness. Therefore, not only it could be stated that a firm exports because it is competitive, but also that a firm increases its competitiveness because it exports. According to the report, similar results can be found for importers and for firms engaged in foreign direct investment (FDIs). In particular, if firms are able to undertake FDIs abroad and to attract foreign investments, this means that they are more competitive; likewise, their investments overseas and the foreign investments they receive can enhance their competitiveness to a greater extent.

The report mainly deals with FDIs; it is therefore necessary to study whether the same concepts it develops could apply to portfolio investments too. This issue is especially relevant because, as it has been explained above, so far in the EU, as well as in most other recipient States, SWFs have mostly undertaken portfolio investments, which merely entail a transfer of SWFs' capital in EU companies without the acquisition of stakes sufficiently large to allow SWFs to exercise substantial control over the invested firms. It could be noted that portfolio investments generally do not imply transfer of technology and know-how and they do not favour other beneficial spill-over, as much as FDIs do. Therefore, it can be argued that their positive impact on the productivity and on the competitiveness of the companies and of the economic systems in which they invest is smaller than the impact of FDIs. Nevertheless portfolio investments, as they provide capitals to firms which, in the

[11] European Competitiveness Report 2009; cit.; p. 9-10

[12] Ibid; p. 33-48; On these aspects see also: M. PENEDER; *Sectoral Growth Drivers and Competitiveness in the European Union*; Brussels; European Communities; 2009; p. 161-230.

investors' expectations, shall ensure higher returns, imply an efficient allocation of one key factor of production (i. e.: capital) and as a result they concur to the improvement of competitiveness of the firms, of the sectors and of the economic systems as a whole which they target.[13] In conclusion, although the report of the Commission has focused on the link between competitiveness and FDIs, it is undeniable that there is also an important relation between competitiveness and portfolio investments.

A last remark should be made. Some authors have suggested that, in particular as a result of globalization and of the development of multinational companies, the competitiveness of the firms of a State does not correspond to the competitiveness of the economy of that State. In fact, "when firms produce outside the boundaries of their home countries, the competitiveness of a country, as measured by its export performance, is the aggregate of the exports of all the firms producing within its boundaries, but this is no longer equivalent to all firms owned by its citizens".[14] Despite this observations is correct, in the present chapter the difference between the competitiveness of the firms and the economy of the States in whose jurisdictions firms at issue are based will not be emphasised. Actually the approach followed will consider that the competitiveness of firms based and operating in a State, or in a group of States like those forming the EU, shall be linked to competitiveness of that State or of that group of States.

A very important aspect which must be stressed is that the relation between the competitiveness of the EU market and the investments of SWFs is a biunique one,[15]

This means that while on one side competitiveness of the EU economy determines its ability to attract investments of SWFs, likewise, on the other side, the investments of SWFs can have a positive impact in increasing the competitiveness of the recipient countries. This is not due to the fact that firms in which SWFs acquire stakes tend to

[13] R. BALDWIN, C. WYPLOSZ; cit.; p. 432.

[14] L. NACHUM, G. JONES, J. H. DUNNING; cit.; p. 279.

[15] It is biunique in the sense that the large extent of the investments of SWFs in the EU is not only the consequence, but can also become one of the determinants of the competitiveness of the EU economy, as it will be explained in this paragraph.

report better financial performances (actually there is not agreement among economists on this point).[16] The main reason is that SWFs inject relevant capitals in financial systems which are affected by scarcity of liquidity as a result of the economic crisis which since its inception in mid- 2007 was characterized by a credit crunch. As the availability of capitals, and its allocation in firms which ensure the highest remuneration, is an element influencing the competitiveness of any economy, when SWFs increase the level of liquidity of the system through their investments, they contribute to enhance the competitiveness of the economy in which they invest. As far as SWFs tend to invest in the sectors which, in the investors' expectations, should ensure higher returns, they would contribute to an efficient allocation of one key factor of production (i. e.: capital) and as a result, they would concur to the improvement of competitiveness of the economies in which they invest[17]. In addition, as SWFs tend to be long-term and countercyclical investors, their contribution of capitals is regarded as more stable and long-lasting than, for instance, the liquidity which can be provided for by other investors like hedge funds.[18]

All the above mentioned reasons confirm the correctness of the view, which has been upheld in previous chapters, according to which SWFs can also have beneficial effects on the economy of the recipient States and therefore that also the EU should avoid excessively protectionist attitudes vis-à -vis SWFs transactions.[19] In fact, preventing the investments of SWFs would mean to renounce not simply to the

[16] On this issue see, for instance: J. KOTTER, U. LEL; *Friends or Foes? The Stock Price Impact of Sovereign Wealth Fund Investments and the Price of Keeping Secrets*; FRB International Finance Discussion Paper No. 940; 2008.

[17] This idea is based on the assumption that SWFs, as well as any other investor, pursue strategies whose sole aim is to maximize return. Therefore they would invest in those assets which, in their expectations, would ensure the highest profitability given a certain level of risk. If SWFs pursue other objectives, this analysis does not hold anymore. A discussion about the objectives of SWFs is provided for in the second part of this paragraph.

[18] T. GOMES; cit.; p. 2-20; J. KOTTER, U. LEL; cit.; p. 22-31; S. BUTT, A. SHIVDASANI, C. STENDEVAD, A. WYMAN; cit.; p. 85.

[19] For an introductory study of the issue of protectionism from an European perspective see: C. WAYMOUTH; *Is 'protectionism' a useful concept for company law and foreign investment policy? An EU perspective*; in U. BERNITZ, W. RINGE; ed.; *Company law and economic protectionism: new challenges to European integration*; Oxford; New York; Oxford University Press, 2010; p. 32-52. See also, in the same volume: K. J. HOPT; *European company and financial law: observations on European Politics Protectionism, and the financial crisis*; p. 13-30.

capitals they may supply, but also to the positive spin-offs on competitiveness they can ensure and which have been explained above.

Another aspect of the relation between the investments of SWFs and the competitiveness of the EU economy is related to the impact of the investments of SWFs on the EU single currency and the impact that this has in turn on the competitiveness of the EU economy.

When SWFs invest in assets denominated in foreign currencies, actually they contribute to rise the demand for such currencies, and finally, they cause their appreciation (which simply means the rise of the price of these currencies expressed in term of other currencies). Therefore, if SWFs massively invest in euro-denominated assets, they cause an appreciation of the EU and this would affect the competitiveness of EU goods and of EU firms whose earnings largely depends on exports to third countries. In the last years, the quota of euro-denominated assets owned by foreign States or State-entities has grown and among the causes of such a development there is an increased trust in the European currency, which is seen as a safe store of value and a broadly accepted mean of payment.[20] In addition, it must be stressed that the same reasons underlying the creation of SWFs are consistent with international macroeconomic trends bringing to an increase of investments in euro-denominated assets relative to USD denominated assets. In fact, SWFs are created also with a view to introduce a higher degree of diversification when they invest the wealth owned by a State and especially its foreign exchange reserves. Such diversification also implies that SWFs are required to invest not exclusively or not preponderantly in USD denominated assets (as it most often occurs in the course of the "traditional" management of foreign exchange reserves) but also in assets denominated in other currencies like, for instance, the euro. As the European Commission itself has highlighted in a Communication on SWFs[21] which will make the object of more detailed analysis in the following paragraph, “for foreign exchange

[20] R. BALDWIN, C. WYPLOSZ; cit.; p. 444-449.

[21] EUROPEAN COMMISSION; *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions -A common European approach to Sovereign Wealth Funds*; COM(2008) 115 final; 2008.

reserves, the goal is liquid and safe assets denominated in a currency with low foreign exchange conversion costs – which tends to favour the US dollar."[22] On the contrary, "SWFs have more freedom [than central banks or other monetary institutions] to choose their investments. This is likely to mean a higher share of the euro assets than now is the case for reserves".[23]

It can be concluded that on one side SWFs invest a growing quota of their resources in European assets because they think they can ensure better performance also because of the high level of competitiveness of the European economy as a whole. On the other side such investment choices cause an appreciation of the euro *vis a vis* other currencies thus affecting the competitiveness of European exporters and, as a result, the competitiveness of the EU. It must be argued that the communication of the Commission has only hinted at the risks related to a sudden appreciation of the European currency, but it has preferred to focus to a greater extent on the positive effects the increased demand for euro might have on the stability and strength of the single currency. In summary, under this point of view, the Commission has not paid due attention to the consequence that a further increase of the demand for euro, related to the operations of SWFs in the EU, might have on the competitiveness of goods and services sold abroad by European firms. However, it can be argued that, as explained above, the main recipient, among EU countries, of the investments of SWFs is the UK, whose currency is not the euro. This should help to reduce the impact of the investments of SWFs in Europe on the exchange rate of the single currency. In addition, it must be underlined that the consequences on the exchange rate of the Euro (and on the competitiveness of the EU economy) of the investments of SWFs in euro-denominated financial assets could turn from threatening into desirable anytime it is deemed that the greatest concern is not the appreciation but the depreciation of the common currency. For instance, when in 2010 and in 2011 the sovereign debt crisis in some countries of the Euro Area rose fears about the same survival of the European common currency, massive purchases of euro

[22] ibid.; p 3.
[23] ibid.; p 4.

denominated assets (included of sovereign bonds of nearly-insolvent countries like Greece) undertaken by some SWFs helped to support the Euro and to enhance its stability.

Given these problems, a common European approach to the regulation of the operations of SWFs in EU Member States appears to be useful. This does not mean that the sole provisions applicable to SWFs investing in the EU should be adopted by the European Institutions, but only that there is the need for some basic principles, agreed at the European level, inspiring the adoption of domestic regulation on SWFs. In addition, in order to avoid that the decision to monitor and regulate SWFs in Europe might push SWFs to divert their investments towards countries where they are likely to be less regulated, the EU should commit at the international level in order to achieve a minimum of harmonization in standards and rules applicable to SWFs in all the States whose firms might be the target of SWFs' investments.

It seems that the basic ideas presented above underlie the communication of the European Commission of 2008, titled "a common European approach to Sovereign Wealth Funds",[24] whose content will be analysed in the following paragraph.[25]

[24] EUROPEAN COMMISSION; *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions -A common European approach to Sovereign Wealth Funds*; COM(2008) 115 final; 2008.

[25] For a preliminary comment of this document see, for instance: J. BERRIGAN, M. BERTOLDI, C. BOSMA; *A common European Union approach to sovereign wealth funds*; in M. RIETVELD; ed.; *New perspectives in sovereign asset management*; Central Banking Publication; 2008; p. 49-58; H. SCHWEITZER; *Sovereign wealth Funds - Market investors or 'Imperialist capitalists*'; in U. BERNITZ, W. RINGE; ed.; *Company law and economic protectionism: new challenges to European integration*; Oxford; New York; Oxford University Press, 2010; p. 264-266; J .Ø MØLLER; *Nationalism or Capitalism? Sovereign Wealth Funds of Non-OECD Countries*; in X. YI-CHONG, G. BAHGAT; ed.; *The political economy of Sovereign Wealth Funds*; Basingstoke; Palgrave Macmillian; 2010; p. 206-212; S. R. LINDBERG; *Sovereign Wealth Fund regulation in the E.U. and U.S.: a call for workable and uniform sovereign wealth fund review within the E.U*; in *Syracuse Journal of International Law and Commerce*; 2009; p. 106; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 176 and p. 181-182.

2. The Communication of the Commission. "A common European approach to Sovereign Wealth Funds"

The EU has traditionally pledged itself to be open to foreign investments and favourable to the liberalization of transnational movement of capital. To this extent, the TFEU prohibits, at art. 63, not only restrictions to free movement of capital and payments between Member States, but also between member States and third countries. Although art 64-66 TFEU provide some limitations to the principle laid down in art. 63, especially with respect to capitals from third countries, the EU is, and means to remain, a favourable environment for investments irrespective of the home State of the investor.[26] The Communication of the Commission titled "a common European approach to Sovereign Wealth Funds" repeats these concepts, when it declares that "the commitment to openness to investments and free movement of capital has been a long standing principle of the EU and is key to success in an increasingly globalised international system." Furthermore, it adds that "as the world's leading trader and the largest source as well as the largest destination of foreign direct investments, the EU is a major beneficiary of an open world economic system. It is committed to ensuring that its markets remain open for investment."[27]

Then, the communication points out the reasons why SWFs' investments should be welcomed.[28] They are in general long-term and counter cyclical investors and hence they can "contribute to stability in the international financial system". Moreover they help to provide liquidity in a period in which liquidity is scarce and the balance sheets of many firms (in particular financial ones) are under stress. This should contribute to

[26] A. RADU; *Foreign Investors in the EU—Which 'Best Treatment'? Interactions Between Bilateral Investment Treaties and EU Law*; in *European Law Journal*; 2008; p. 253; J. BIARD; cit.; Malan Rieltveld; ed; cit.; p. 49; P. GUGLER, J. CHAISSE; cit.; p. 21; K. J. M. MORTELMANS; *The functioning of the internal market: the freedoms*; in P. J. G. KAPTEYN, A. M. MCDONNEL, K. J. M. MORTELMANS, C. W. A TIMMERMANS, L. A. GEELHOED; ed.; *The law of the European union and the European Communities*; Kluwer Law International; 2008; p. 766-784. For more details on the EU provisions on free movement of capitals see, infra, paragraphs 3 and 5 of this chapter.

[27] EUROPEAN COMMISSION; *A common European approach to Sovereign Wealth Funds*; cit.; p. 2.

[28] For a comment of this aspect see: S. M. CARBONE; *Investimenti pubblici esteri e libera circolazione dei capitali*; in A. LIGUSTRO AND G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 641-644.

"help to strengthen the global banking system and to underpin confidence in the international financial system as a whole." Finally, as many SWFs chose to invest in the Euro Area, they increase the demand for the European currency, supporting "the international role of the Euro over the medium term". [29]

Then, the communication turns to analyse the problems that might be related to the investments of SWFs in the EU.

First of all the communication stresses the lack of transparency of some SWFs in particular as regards their organization, management and strategies. Then, it highlights that SWFs might use their investments "for ends other than for maximising return", in particular to unduly pursue political advantages. Moreover, the Commission notes that although, for the time beings in most cases SWFs have acted as portfolio investors, they might change their strategies and seek to acquire controlling stakes in European companies in the future and this could rise additional worries. For all these reasons in certain circumstances they might threaten the national security of recipient countries.[30] It is important to note that these ideas about the opportunities and the threats posed by SWFs are similar to those expressed by the majority of the economists, lawyers and by the governments of many recipient States.[31] The existence of a shared attitude in the world with respect to SWFs is a further element which encourages the EU to seek a multilateral approach to the attempt to govern and monitor the operations of SWFs, as it will be analysed below in paragraph 7 of the present chapter.

The communication of the Commission, also provides a brief review of the studies and the works related to a possible regulation of SWFs which have already been undertaken by international organizations[32] and it adds that SWFs currently do not operate in a legal vacuum, as provisions applicable to foreign investments in general may apply to investments of SWFs as well. To this purpose the communication quotes the WTO provisions applicable to investments, implicitly referring to the Trade

[29] EUROPEAN COMMISSION; *A common European approach to Sovereign Wealth Funds*; cit.; p. 3.

[30] EUROPEAN COMMISSION; *A common European approach to Sovereign Wealth Funds*; cit.; p.4.

[31] See *supra*, chapter 1 paragraph 4. See also chapter 4 paragraphs 8 to 10

[32] EUROPEAN COMMISSION; *A common European approach to Sovereign Wealth Funds*; cit.; p.5 .

related Investment measures (TRIMs) and to the provisions of the General agreement on tariffs in services (GATS) about the access and establishment of service providers.[33] It also mentions the bilateral investment treaties (BITs) in force between EU member States and third countries owning SWFs.[34] As regards the European Community law, it refers to the provisions of the EC Treaty which apply to the free movement of capital (art. 63 seq. TFEU, at the time of the adoption of the communication art. 56 seq. TEC) and to mergers and acquisitions (currently art. 101 seq. TFEU then art. 81. seq. TEC, as well as secondary legislation like regulation 139/2004).[35] Moreover it takes into account that member States are already studying changes in their national legislations to cope with the challenges posed by SWFs. Although the European Commission and the European Court of Justice can monitor that measures unilaterally adopted by member States do not jeopardise the common market, nonetheless it is necessary to promote a common European approach to SWFs in order to ensure their consistency and effectiveness. In fact, according to the communication, "an uncoordinated series of responses [on behalf of each member State] would fragment the internal market and damage the European economy as a whole." It adds that "in an integrated single market, the advantages of individual measures can be illusory" and can turn into damages for all member States (and even for those enacting them) in the long run. Moreover, as "one of the main goals of EU trade policy is to open third country markets to EU investors, […] these efforts would be more difficult if the EU was seen as imposing barriers *within* the EU". What is even more important is that, as "SWFs are a global issue" and as they require a multilateral approach, if Europe speaks with one voice in international meetings, it would be more effective and powerful than single member States acting disparately.

[33] An assessment of the utility of WTO law in governing the investments of SWFs has been made *supra*, chapter 3 paragraph 10 .

[34] On the applicability of BITs to SWFs see *supra* chapter 4. The complex issue of the relation between BITs and EU law, with the implications this might have for the regulation of SWFs investments in the EU will be developed *infra* in chapter 7.

[35] A. RADU; cit.; p. 237. See also: F. S. BENYON; *Direct investment, national champions and EU treaty freedoms: from Maastricht to Lisbon*; Oxford ; Portland: Hart Publishing, 2010; p. 41-71.

Nevertheless, without previously establishing a common European approach, this would be impossible.[36]

Finally, the communication provides the following five principles which shall underlie the European approach to SWFs.

1. Commitment to maintain an open investment environment, refraining from adopting unreasonable protectionist attitudes.
2. Support to international organisations in their efforts to enhance an open dialogue with SWFs owners and to create a multilateral legal framework for the investments of SWFs.
3. Use of legal instruments already in force at the level of the EU and of the Member States to monitor and regulate the operations of SWFs.
4. Commitment to avoid that measures taken to monitor and regulate SWFs might result in a breach of the obligations deriving from the EU and the EC Treaty and from international law.
5. Proportionality and transparency of measures taken by EU States and applicable to SWFs, whose investments should be limited only for public interest reasons (which should be meant in a restricted way).[37]

The communication of the Commission was endorsed by the Council [38] and by the European Council[39] which stressed the need to co-operate in particular with the IMF and the OECD and finally a resolution adopted by the Parliament has welcomed it. [40]

[36] EUROPEAN COMMISSION; *A common European approach to Sovereign Wealth Funds*; cit.; p.6.

[37] EUROPEAN COMMISSION; *A common European approach to Sovereign Wealth Funds*; cit.; p.8; Rieltveld, Malan; ed.; cit.; p. 52

[38] COUNCIL OF THE EUROPEAN UNION, ECONOMIC AND FINANCIAL AFFAIRS, 2857th Council meeting, 7192/08, 4 March 2008.

[39] COUNCIL OF THE EUROPEAN UNION, revised version of the Presidency Conclusions of the Brussels European Council (13/14 March 2008), 7652/1/08 REV 1, Brussels, 20 May 2008.

[40] EUROPEAN PARLIAMENT; *Resolution of the European Parliament on sovereign wealth funds*, P6_TAPROV(2008)0355, Strasbourg, 9 July 2008, point 2.

3. The content of EU investment law and the relation between provisions on freedom of establishment and on free movement of capitals.

The approach endorsed by the Communication of the Commission does not consist in promoting the adoption of *ad hoc* rules which explicitly apply to SWFs; on the contrary the Commission suggests, for the time being, to apply to investments undertaken by SWFs too those EU law provisions which are already in force and applicable to the generality of investments carried out in the EU.

Therefore it is necessary, first of all, to study in general the content of what will be referred to as EU investment law, i. e. the provisions of the TEU, the TFEU and of secondary law which govern transnational investments in the EU. In this discussion the notion of transnational investments is meant so as to consider both investment flows between two member States and between one member State and a third country, although, as it will be clarified, the EU law governing these two categories of investments displays important differences. In fact, while for some kinds of investments, EU law apply both to intra-EU investments and to investments with third country entities in an identical or at least in a very similar way, in many other cases EU law exclusively applies to intra-EU operations and creates duties and rights upon members States and individuals only in relation to investments undertaken from a member country into another member country.

As a second step, it is necessary to develop a few considerations concerning essentially two issues. Firstly, it is necessary to study whether SWFs' investments in the EU mainly are portfolio investments or FDIs. An answer to this question has already been given in paragraph 1 of the present chapter and in paragraph 1 of chapter 1 and therefore this issue will not be explored further. Since also in the EU SWFs mainly undertake portfolio investments, it is useful to assess which are the EU provisions which more properly govern portfolio investments rather than FDIs. Secondly, it is necessary to understand whether EU member States are not only the recipients but also the owners of SWFs which, in turn, invest in other EU members. As it will be explained that EU countries practically do not own SWFs and therefore that so far almost all investments of SWFs in the EU have been made by third countries SWFs, then the provisions of EU law on which the analysis undertaken in the present research will focus shall be those governing investment flows with third countries.

In conclusion, it emerges that EU investment law provisions relevant for the purposes of governing the investments of SWFs in the EU, and which therefore need to be studied in depth, are essentially EU law provisions on portfolio investments from third countries.

As a third step, it must be studied whether and how such provisions apply when investments at issue are undertaken by a particular entity like a SWFs.

The first of these steps will be analysed in the present paragraph, while the other two steps will make the object of the two following paragraphs.

When attempting to define the content of EU investment law, the first remark which needs to be made is that neither the TEU nor the TFEU contain provisions explicitly addressing the issue of foreign investments, meant as investments undertaken in the territory of an EU member by an investor from another State, be it an EU country or a third State. However, two groups of provisions of the TFEU seem to be able to apply to them. The first group comprises art. 63 to 66 TFEU and governs the free movement of capitals. The second group includes art. 49 to 55 TFEU which concern freedom of establishment. On the contrary, art. 56 to 62 TFEU, on the free movement of services do not seem to be particularly relevant, since the notion of supply of services adopted in EU law is quite different from the one adopted, for instance, in WTO law: while in the latter service supply by means of commercial presence is explicitly envisaged, in the former it is excluded, since supply of services through commercial presence falls within the empire of the notion of establishment. Other provisions of the TFEU could nonetheless have a relevant impact on investment activities. For instance, art. 45 to 48 provide for free movement of workers[41] in the EU

[41] According to well-settled ECJ case law, the notion of workers for the purposes of the application of art. 45 TFEU includes only dependent workers, while it excludes self-employed persons, whose free movement in the EU fall within the scope of the provisions on freedom of establishment.

subject to certain requirements and conditions as laid down in the TFEU itself and in secondary legislation, like Regulation 1612/68.[42] The possibility that workers might freely circulate is extremely important in case of FDIs, since this increases the ability of companies to employ workforce which might best suits their needs with less restrictions. However, since the large majority of the investments of SWFs in the EU are portfolio investments, the provisions on free movement of workers have a very marginal importance and therefore they will not be discussed further.

After having stressed that provisions on freedom of establishment and on free movement of capitals are in principle the most suitable ones for the purposes of regulating the investments in the EU and, even more, to govern the State measures which can be adopted by member States with a view to regulating such investments, it is now necessary to study the relation between such provisions. This should allow to better understand which of them must more appropriately apply in case of portfolio investments undertaken by SWFs owned by third countries.[43]

The first provisions which need to be considered for the purposes of the present analysis are those contained in directive 88/361 and, precisely, at art. 1, which for the first time liberalised capital movements. This act today is no more in force, since the liberalization of capital movements it provided has later been ensured by the same TEC after the entry into force of the Treaty of Maastricht and now, after the entry into force of the Treaty of Lisbon it is guaranteed by the TFEU.[44] However, what is relevant for the present analysis is annex one of the directive which contained the nomenclature of the capital movements referred to in article 1 of the directive. As recognised by the ECJ, such nomenclature maintains its illustrative value after the repeal of the directive to which it was annexed and it can be used to define the notion of free movement of capitals also today.[45]

[42] Council Regulation (EEC) No 1612/68 of 15 October 1968 on the free movement of workers within the Community; OJ L 257, 19.10.1968, p. 2–12. On the issue of investments in the EU and free movement of workers see: F. S. BENYON; cit.; p. 58-59.

[43] For a discussion on this issue see also: F. S. BENYON; cit.; p. 72-78.

[44] F. S. BENYON; cit.; p. 7-10.

[45] In the Judgment of the Court of 16 March 1999; *Manfred Trummer and Peter Mayer*; Case C-222/97; European Court reports 1999 Page I-01661; par. 20-21, the ECJ noted "that the EC Treaty

The nomenclature is very detailed and it explicitly refers to different typologies of investments. First of all it mentions direct investments, which include "1. Establishment and extension of branches or new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings. 2. Participation in new or existing undertaking with a view to establishing or maintaining lasting economic links. 3. Long-term loans with a view to establishing or maintaining lasting economic links. 4. Reinvestment of profits with a view to maintaining lasting economic links." Also investments in the real estate are included. Then, the nomenclature mentions portfolio investments and in detail: operations in securities and other instruments normally dealt in on the capital markets (included shares, bonds and other securities of a participating nature) and on the money market, purchase of units of undertakings for collective investment in securities (UCITS) normally dealt in on the capital market or on the money market. It is clear that such nomenclature covers all the possible investments that SWFs may undertake in the EU. Particular attention should be made on the inclusion of operations in units of undertaking for collective investment in transferable securities. It implies that it falls within the notion of capital movements for the purposes of the application of the relevant provisions of EU law any operation of SWFs which, instead of directly purchasing financial assets, invest in a mutual fund which in turn will invest in financial securities. It could be wondered why SWFs should be attracted by this kind of indirect investment, which is often used by smaller investor which do not possess sufficient resources to properly diversify their portfolio and therefore invest in mutual

does not define the terms `movements of capital' and `payments'. However, inasmuch as Article 73b of the EC Treaty substantially reproduces the contents of Article 1 of Directive 88/361, and even though that directive was adopted on the basis of Articles 69 and 70(1) of the EEC Treaty, which have since been replaced by Article 73b et seq. of the EC Treaty, the nomenclature in respect of movements of capital annexed to Directive 88/361 still has the same indicative value, for the purposes of defining the notion of capital movements, as it did before the entry into force of Article 73b et seq., subject to the qualification, contained in the introduction to the nomenclature, that the list set out therein is not exhaustive." For a comment of the judgement and of the applicability of the nomenclature in the case at issue see: A. LANDSMEER; *Capital Movements: On the Interpretation of Article 73b of the EC Treaty*; in *Legal Issues of Economic Integration*; 2000 p.195-200. On the nomenclature, on its importance in addressing the issue of the relation between EU law and international investment law and its applicability nowadays see, for instance: H. SCHWEITZER; cit.; p. 271-274.

funds which are able to gather wealth from different investors and to invest it collectively, thus ensuring a higher level of diversification and as a result of risk spreading and risk mitigation.[46] In practise SWFs quite often invest in UCITS: this could be explained by the fact that the asset managers of the SWF of a non EU country could have a relatively limited expertise and knowledge of EU financial markets and companies and therefore would prefer to delegate the asset allocation and in particular the asset picking activity to specialised managers of UCITS who should be more able to chose the best EU financial assets to invest in.

The analysis of the nomenclature contained in the annex of directive 88/361 suggests that investments in the EU, included those of SWFs, could be governed by EU provisions on free movement of capitals. However it is not clear whether provisions on freedom of establishment too might apply and under which circumstances. In an attempt to shed more light, the Commission in 1997 adopted a communication.[47] It must be pointed out that this document only deals with intra-EU investments although some of the principles underlying it should apply as well to investment flows with third countries, as it will be explained in the next pages of the present research. In addition, the Communication of the Commission underlines that it is without prejudice of other acts of the EU and of future judgements of the ECJ. Therefore, the principles it contains could evolve or they can be significantly modified. The communication, after having recalled the nomenclature of annex 1 of directive 88/361 and its validity in spite of the repeal of the directive itself, considers as falling within the notion of movement of capitals the "acquisition of domestic securities"

[46] More information on UCITS, on their legal characteristics in the EU legal order and on the role the investment strategies they help to pursue can be found in: I. RIASSETTO; *Directive OPCVM IV*; in *Revue de Droit bancaire et financier* n° 2, Mars 2010, comm. 76; P. YEOH; *UCITS from EU to Global*; in *Business Law Review*; 2009; p. 187-190; M. P. GENTILI, O. NAVA; *I gestori del risparmio: Sgr, Sim, Sicav, fiduciarie, banche specialistiche e reti di vendita*; Roma; Edibank, 2006; M. P. GENTILI, S. JANNONI, M. MASTRANGELO; *Le Sicav: strumenti flessibili per la gestione del risparmio*; Roma; Edibank; 2010; R. COSTI; *Il mercato mobiliare*; 6 ed.; Torino; Giappichelli; 2010; p.185-220; F. ANNUNZIATA; *La disciplina del mercato mobiliare*; 5. ed. Torino; Giappichelli; 2010; 189-225; N. MOLONEY; *EU financial market regulation after the global financial crisis: "more Europe" or more risk?*; cit.; p. 131; S. PUEL, E. ROGEY; cit..

[47] EUROPEAN COMMISSION; *Communication of the Commission on certain legal aspects concerning intra-EU investments*; OJ C 220; 19 July 1997; p. 15–18.

which "includes, among others, the transaction 'acquisition by non-residents` of shares and bonds in domestic companies on pure financial investment grounds, that is, without the aim of exerting any influence in the management of the company." The communication adds that "this transaction is considered as a form of capital movement" and that it is "usually known in the financial literature as 'portfolio investment.`" As to the issue of direct investments "defined as 'investments of all kinds which serve to establish or to maintain lasting and direct links between the person providing the capital and the undertaking to which the capital is made available in order to carry on an economic activity" this too must be "considered to be a form of capital movement".[48] However, the communication adds that "[a]t the same time, the acquisition of controlling stakes in a domestic company by an EU investor, in addition to being a form of capital movement, is also covered under the scope of the right of establishment."[49]

In conclusion, according to the wording of the communication, intra-EU portfolio investments are exclusively covered by provisions on free movement of capital, while intra-EU direct investments are covered by provisions on free movement of capitals and on freedom of establishment both.

However, it must be recalled that case law of the ECJ has sometimes moved away from the clear and convincing criteria set out in the above mentioned directive. To justify this choice, it can be argued that the distinction between portfolio and direct investment in practice can be more difficult, especially in border line situations. If, for instance, a 100% participation in a company is without doubt a direct investments and a stake accounting for 0,1% of the capital and owned for a short time, for instance with a view of profiting from the positive difference between the price of sale and purchase, can be easily defined as a portfolio investment, the distinction between the two categories can be more blurred in case of a participation of relative

[48] EUROPEAN COMMISSION; *Communication of the Commission on certain legal aspects concerning intra-EU investments*; cit.; par. 3.

[49] EUROPEAN COMMISSION; *Communication of the Commission on certain legal aspects concerning intra-EU investments*; cit.; par 4.

minority which nonetheless empowers the owner to exercise a certain kind of influence on the conduct of the company itself.

The first judgment of the ECJ which must be quoted for the purposes of the present analysis is the Baars case.[50] At the time of the dispute, Mr Baars is a Dutch national resident in the Netherlands. He owns all the shares in Ballyard Foods Limited (hereinafter Ballyard), a limited company incorporated under Irish law established in Dublin, Ireland. The Netherlands law exempts Dutch taxpayers from wealth tax on substantial holdings in Dutch companies but not in foreign ones. The notion of "substantial holding", as defined in Dutch law, covers the participation owned by Mr Baars. However, he is excluded from the tax exception since he owns shares in the company based in an EU State other than Ireland.[51] Baars applies to the competent domestic Court, the Gerechtshof te 's-Gravenhage, submitting that municipal law provisions which limit the undertaking exemption to holdings in companies established in the Netherlands and excluding him from such tax exceptions are contrary both to art. 52 TEC (today art. 49 TFEU) which provides for freedom of establishment, and to art. 73b TEC (currently art. 63 TFEU), which prohibits restrictions on movements of capital between the Member States.[52] The Gerechtshof te 's-Gravenhage refers the issue to the ECJ, which therefore has to state, *inter alia*, whether either provisions on freedom of establishment or free movement of capital, or both of them, are applicable. According to the Government of the Netherlands, "the provisions of the Treaty relating to freedom of establishment are not applicable to a situation such as that of the applicant in the main proceedings, which [...] is

[50]Judgment of the Court (Fifth Chamber) of 13 April 2000; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*. Case C-251/98; European Court reports 2000 Page I-02787.

[51] Judgment of the Court (Fifth Chamber) of 13 April 2000; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*; cit.; par. 1-14. See also: J. RICKFORD; *Protectionism, capital freedom and internal market*; in U. BERNITZ, W. RINGE; ed.; *Company law and economic protectionism: new challenges to European integration*; Oxford; New York; Oxford University Press, 2010; p. 82-83.

[52] Judgment of the Court (Fifth Chamber) of 13 April 2000; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, cit.; par 15-16.

covered solely by the provisions of the Treaty on the free movement of capital."[53] The Court recognises that "under Netherlands laws, a substantial holding, which is essentially a holding for the last five years of at least one third of the shares in a company and more than seven percent of paid-up nominal capital, does not necessarily imply control or management of the company, which are factors connected with the exercise of the right of establishment. Consequently, the fact that a Member State does not allow its taxpayers the undertaking exemption for a substantial holding, within the meaning of its domestic legislation, in companies established in other Member States does not necessarily affect freedom of establishment." However, the Court notes that the Baars case involves a "100% holding in the capital of a company having its seat in another Member State". According to the Court, this undoubtedly brought the case at issue "within the scope of application of the Treaty provisions on the right of establishment."

In fact, the Court concludes that "a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities *is exercising his right of establishment*."[emphasis added] [54] While the ownership of a stake in a company is not enough to assess that the owner may exercise control over such company, nevertheless control is implied in case of a 100% participation.[55]

This findings seem to be consistent with the opinion of the Advocate General Alber, who argued that: "the border between the simple investment of capital in shares in an undertaking established in another Member State, and actual establishment in that Member State, should probably be set at the point where a shareholder ceases to confine himself to the mere provision of capital in support of a particular business

[53] Judgment of the Court (Fifth Chamber) of 13 April 2000; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, cit.; par. 18.

[54] Judgment of the Court (Fifth Chamber) of 13 April 2000; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, cit.; par. 19-22.

[55] D.F.: *Une exonération d'impôt sur la fortune prévue par un Etat membre au titre du patrimoine investi en actions ne peut être réservée aux seules participations détenues dans des sociétés ayant leur siège dans cet Etat*; in *La Semaine juridique - entreprise et affaires*; 2000 p.1964.

activity carried on by another person, and begins to become involved himself in conducting the business. Such involvement requires the shareholder to go beyond simply exercising his voting rights, and to participate in a way which will enable him to exercise real influence over the company's business decisions[...]"[56] The Advocate general also added that in the case at issue it was "clear that the situation is one of establishment, since all the shares are owned by one person. The sole owner of all a company's shares can make decisions about that company's activities on his own: there is no-one else entitled to a say whose views he must heed. Only the legal form of the undertaking distinguishes him from a sole trader; like the latter, he is in a position to direct the activities of the business in question."[57]

The Court then analyses the consistency of the Dutch tax provisions at issue and concludes that they are inconsistent with EU law.[58] Given this finding, the ECJ finds that it is unnecessary to assess the consistency of those provisions with EU law on free movement of capitals.[59] It does not clarify, however, whether this decision means that in the specific case at issue freedom of establishment supplants the free movement of capitals, the latter assuming an ancillary character to establishment, or whether this is the outcome of the decision of the Court simply to start its analysis with the study of the compatibility of the provisions on freedom of establishment. The first of these two options seems to be less convincing, also in the light of the Opinion of the Advocate General, who, after having undertaken a careful analysis of previous case law rejected the argument, supported by the Government of the Netherlands,

[56] Opinion of Mr Advocate General Alber delivered on 14 October 1999; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem.* Case *C-251/98*. European Court reports 2000 Page I-02787; par. 33

[57] Opinion of Mr Advocate General Alber delivered on 14 October 1999; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, cit.; par 34.

[58] Judgment of the Court (Fifth Chamber) of 13 April 2000; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, cit.; par. 23-41.

[59] Judgment of the Court (Fifth Chamber) of 13 April 2000; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, cit.; par 42.

"that capital-movement rules and other fundamental freedoms are generally mutually exclusive"; on the contrary he stressed that they "could indeed apply in parallel."[60]

However, a later judgment, in the A and B case,[61] seems inconsistent with these findings. The case concerns a dispute between Swedish tax authorities on one side and on the other side shareholders and employers (which are referred to as A and B) of a Swedish company which owns a branch in Russia. They claim the inconsistency with EU law of certain provisions of Swedish tax law which adversely affect some of the operations of the company of A and B in Russia. Since a direct investment is at issue, in principle, and according to the approach adopted in the communication of the Commission mentioned above, both provisions concerning freedom to establishment and free movement of capitals should apply. Nevertheless, the ECJ supports the view that national provisions at issue can "only be examined from the angle of freedom of establishment and not the free movement of capital." [62] According to the Court, if the national measure at issue also "has restrictive effects on the free movement of capital, such effects must be seen as an unavoidable consequence of any restriction on freedom of establishment and do not justify an examination of that measure in the light of Articles 56 EC and 58 EC" (today art. 63 and 65 TFEU).[63]

The Court seems therefore to considers that, in case of establishment, free movement of capitals has a mere ancillary function and therefore that provisions on free movement of capitals should not apply on an autonomous ground. It follows that, in case of a direct investment which implies establishment in a third country[64], since

[60] Opinion of Mr Advocate General Alber delivered on 14 October 1999; *C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, cit.; par. 22. See also: J. RICKFORD; cit.; p. 83-86.

[61] Order of the Court (Fourth Chamber) of 10 May 2007; *Skatteverket v. A and B*.; Case C-102/05; European Court reports 2007 Page I-03871. For a comment, see: J. RICKFORD; cit.; p. 87-88.

[62] Order of the Court (Fourth Chamber) of 10 May 2007; *Skatteverket v. A and B*.; cit.; par 21-22.

[63] Order of the Court (Fourth Chamber) of 10 May 2007; *Skatteverket v. A and B*.; cit.; par. 27.

[64] It should be stressed that establishment and making of a FDI sometimes could refer to two slightly different concepts. For instance it is not so clear in the Baars as well as in the A and B case whether a minority stake which nonetheless allows to exercise a certain degree of control over the business activity of a firm could be regarded not only as a FDI, but also as a form of establishment. The next ECJ judgment which will be studied in the present analysis seems to shed more light on this point.

EU provisions on freedom of establishment could not apply[65], provisions on free movement of capitals, which in principle could have been applied to govern also extra-EU investments, cannot be taken into consideration. The result of such a judgement brings to unconvincing conclusions. It would result that in case of FDIs with third countries implying establishment, neither current art. 49 nor art 63 TFEU could apply, while art. 63 could be applicable only in case of portfolio investments from and to third countries. As a result, only portfolio investments with third countries could be covered by EU freedom, while direct investments from or to third States could not be covered neither by EU rules on freedom of establishment nor by EU rules on free movement of capitals. This discrimination seems to be deprived of theoretical and practical justification.

It must be underlined that the approach followed by the ECJ in the A and B case when assessing the applicability of provisions on freedom of establishment and free movement of capitals in situations involving operations with third country nationals, is similar to the one adopted in the Fidium Finanz case. [66] Although it concerns the distinction between free movement of capitals and services, and not between free movement of capital and freedom of establishment, it deserves to be quickly discussed.

In the Fidium Finanz case the Court has to assess whether the activity of a Swiss company, the Fidium Finanz, which at the time of the dispute consists in granting credit on a commercial basis in Germany, should be regarded as supply of services or as movement of capitals. The distinction is of the outmost importance: in fact since EU provisions only prevent restrictions to movements of capitals and not of services

[65] As it will be studied in the following paragraph of the present chapter, while current art. 63 TFEU applies both to intra-EU investments and to investments between EU and non EU States, on the contrary current art. 49 TFEU applies only in case of intra-EU operations.

[66] Judgment of the Court (Grand Chamber) of 3 October 2006; *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*; Case C-452/04; European Court reports 2006 Page I-09521. For a comment on the issue of the interaction between different treaty freedoms and the ECJ "centre of gravity approach", see: H. SCHWEITZER; cit.; p. 273- 275; F. KAUFF-GAZIN; *Distinction services/capitaux*; in *Europe* 2006; Décembre Comm. nº 369 p.22-23; M. O'BRIEN; *Case C-452/04, Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht, judgment of the Court of Justice (Grand Chamber) of 3 October 2006, [2006] ECR I-9521*; in *Common Market Law Review* 2007 p.1483-1499.

in case of economic relations concerning third countries, then the qualification of the activity carried out by Fidium Finanz exclusively as supply of service would result into the impossibility for the Swiss company to invoke the applicability of EU law against German measures. In fact, as the Court itself notes, "at the time of the facts in the main proceedings, the Agreement between the European Community and its Member States, of the one part, and the Swiss Confederation, of the other, [...] to facilitate the provision of services in the territory of the Contracting Parties, had not yet entered into force"[67]

On one side, the Court acknowledges that granting of loans on a commercial basis could be regarded both as a business services, as it is apparent in well established case law, and as movement of capital, in accordance, inter alia, with the nomenclature contained in annex 1 of directive 88/361.[68]

Instead of deciding that both EU provisions on free movement of services and on free movement of capitals should apply, being them equally relevant, the Court argues that "[w]here a national measure relates to the freedom to provide services and the free movement of capital at the same time, it is necessary to consider to what extent the exercise of those fundamental liberties is affected and whether, in the circumstances of the main proceedings, one of those prevails over the other." For these reasons the Court finds it more appropriate to "examine the measure in dispute in relation to only one of those two freedoms if it appears, in the circumstances of the case, that one of them is entirely secondary in relation to the other and may be considered together with it".[69] The key issue is to decide whether the dispute submitted to the Court mainly concerns the movement of services or of capitals.

The Court recognises that, although it may occur that German legislation at issue causes a restriction of the free movement of capitals, however "that is merely an

[67] Judgment of the Court (Grand Chamber) of 3 October 2006; *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*; cit.; par. 26.

[68] Judgment of the Court (Grand Chamber) of 3 October 2006; *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*; cit.; par. 40-43.

[69] Judgment of the Court (Grand Chamber) of 3 October 2006; *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*; cit.; par. 34.

unavoidable consequence of the restriction on the freedom to provide services".[70] In fact, the Court adds, in the Fidium Finanz case "the predominant consideration is freedom to provide services rather than the free movement of capital. Since the rules in dispute impede access to the German financial market for companies established in non-member countries, they affect primarily the freedom to provide services. Given that the restrictive effects of those rules on the free movement of capital are merely an inevitable consequence of the restriction imposed on the provision of services, it is not necessary to consider whether the rules are compatible with Article 56 EC et seq." [current art. 63 et seq.][71]

In the later judgement Commission v. Italy[72], the ECJ, while preserving some arguments of the A and B case, nonetheless seems to develop a more articulated and convincing analysis.

The Court states that "[p]rovisions of national law which apply to the possession by nationals of one Member State of holdings in the capital of a company established in another Member State allowing them to exert a definite influence on the company's decisions and to determine its activities fall within the ambit ratione materiae of the provisions of the EC Treaty on freedom of establishment".[73]

Then the Court turns to direct investments, which it defines as "investments of any kind made by natural or legal persons which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available in order to carry out an economic activity ." FDI, in other words, occur when "the shares held by the shareholder enable him to participate effectively in the management of that company or in its control". Such

[70] Judgment of the Court (Grand Chamber) of 3 October 2006; *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*; cit.; par. 48.

[71] Judgment of the Court (Grand Chamber) of 3 October 2006; *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*; cit.; par. 49-50.

[72] Judgment of the Court (Third Chamber) of 26 March 2009; *Commission of the European Communities v Italian Republic*; Case C-326/07. European Court reports 2009 Page I-02291. For a comment on this judgment and its relation with previously discussed Baars and A and B cases see: J. RICKFORD; cit.; p. 88-93.

[73] Judgment of the Court (Third Chamber) of 26 March 2009; *Commission of the European Communities v Italian Republic*; cit.; par. 34.

operations, in the view of the ECJ, must "fall within the ambit of Article 56 EC [current art. 63 TFEU] on the free movement of capital". [74]

It must be underlined that the ECJ adopts a different approach from the (more convincing, in our view) approach of the Commission in the communication of 1997. In fact, while in the communication distinction was made between FDIs and portfolio investments, in the present judgment the distinction is between establishment and FDIs. However, such distinction, especially according to the terms in which it is made, is far from being clear. In fact, both in case of establishment and of FDIs, two elements are present: the ownership of a significant amount of shares and the possibility to use them to exert a certain degree of control over the management of the company. It could be argued that in case of establishment the degree of influence on the management must be "defined". The authentic language of the Judgment is Italian, and the word used to translate the term "defined" is "sicuro". This means that if the shareholding is such as to allow the shareholder to exert *without doubt* a substantial influence over the management of the company, then, and only in this specific case, EU provisions on freedom of establishment apply. However, the Court is finally not able to provide a clearer test which allow to distinguish between the notion of FDI and of establishment.

In any case, the ECJ concludes that when national legislation could have restricted effects both on establishment and on FDIs, then both provisions on freedom of establishment and on free movement of capitals are applicable. In fact, in the words of the Court: "[n]ational legislation not intended to apply only to those shareholdings which enable the holder to have a definite influence on a company's decisions and to determine its activities but which applies irrespective of the size of the holding which the shareholder has in a company may fall within the ambit of both Article 43 EC and Article 56 EC"[75]

[74] Judgment of the Court (Third Chamber) of 26 March 2009; *Commission of the European Communities v Italian Republic*; cit.; par. 35.

[75] Judgment of the Court (Third Chamber) of 26 March 2009; *Commission of the European Communities v Italian Republic*; cit.; par 36.

Consistently with these findings, the ECJ concludes that some of the provisions of Italian law challenged by the Commission are contrary to current art. 49 TFEU, while others are contrary to art. 63, depending on the level of restriction to the possibility to exert control and influence by the shareholders on the management of the company.

However, the Court does not find that measures inconsistent with art. 49 TFEU could also be inconsistent with art. 63. In fact, the Court argues that if measures which restrict free movement of capitals also entail effects which are "restrictive of the free movement of capital, those effects would be the unavoidable consequence of any restriction on freedom of establishment and would not warrant independent examination in the light of Article 56 EC" [current art. 63 TFEU]. Consequently, the criteria applying to the exercise of the power of veto must be examined solely from the point of view of Article 43 EC [art 49 TFEU].[76]

Several other judgements of the ECJ have nonetheless considered State measures which impair or make it less attractive transnational investments, be they portfolio investments, FDIs, or even investments entailing establishment, as inconsistent with current art. 63 only.

For instance in Commission v. France[77] the ECJ assesses the consistency of French law concerning golden shares with EU law.[78] The Commission argues that French measures at issues are inconsistent both with art. 73b TCE (today art. 63 TFEU) and art 52 TCE (today art. 49 TFEU).[79] The Court refers to nomenclature of dir 88/361

[76] Judgment of the Court (Third Chamber) of 26 March 2009; *Commission of the European Communities v Italian Republic*; cit.; par 39.

[77] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; Case C-483/99; European Court reports 2002 Page I-04781.

[78] The term golden shares (or "actions spécifiques" in French) refers to those shares owned by the Government or by local subdivision of a State in certain companies, in most case newly privatised firms in sensitive sectors. The owners of golden shares are entitled to more rights than those they would be entitled by their stake under company law. There are different kinds of golden shares, according to the different special rights they confer to their owner. A more detailed analysis of the issue of golden shares will be made *infra* in paragraph 6 of the present chapter, when it will be also studied whether they could be used, consistently with EU law, in order to protect overriding interests of the State possibly threatened by the investments of SWFs.

[79] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 19.

and to the communication of 1997[80] and firstly analyses the issue of the compatibility of French provisions on golden shares with EU provisions concerning free movement of capitals. After finding the inconsistency with such provisions, it finds it superfluous to address also the issue of the alleged breach of provisions on freedom of establishment. The rationale underlying this choice is also consistent with the idea that freedom of establishment is a consequence of the principle of free movement of capitals. This concept is well expressed in the judgement, where the Court states: "[t]o the extent that the legislation in issue involves restrictions on freedom of establishment, such restrictions are a direct consequence of the obstacles to the free movement of capital considered above, to which they are inextricably linked. Consequently, since an infringement of Article 73b of the Treaty has been established, there is no need for a separate examination of the measures at issue in the light of the Treaty rules concerning freedom of establishment".[81]

In another judgement concerning Golden Shares, which was issued the same day of the above mentioned Commission v. France judgement, the Court reached the same conclusions by adopting identical words.[82] Also in Commission v. Belgium the approach adopted by the Court was that of considering restrictions to freedom of establishment as a consequence of restrictions of free movement of capitals. The main difference between this case and the two above mentioned Commission v. France and Commission v Portugal cases resides in the fact that in Commission v. Belgium the ECJ concluded that Belgian legislation concerning golden shares was framed in a way so as to be consistent with EU provisions. In particular, in the Court's view, the derogations provided for in art. 73,d (current art. 65,1,b TFEU) could apply,

[80] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 5-18

[81] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 56

[82] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; Case C-367/98; European Court reports 2002 Page I-04731; par. 56.

differently from what occurred in the other two cases concerning golden shares which have been mentioned above.[83]

The Court argued that since the derogations provided for in EU law concerning free movement of capitals applied, then the same derogations concerning public policy and public security apply in case of alleged restrictions of freedom of establishment. For these reasons it found it superfluous to analyse the issue of the consistency of Belgian legislation concerning golden shares also in relation to EU provisions concerning freedom of establishment. In fact, the Court argued that "even if it were assumed that the power of a Member State to oppose any transfer, use as security or change in the intended use of certain assets of an existing undertaking, or certain management decisions taken by that undertaking, may constitute a restriction on freedom of establishment, such a restriction would be justified" for the same reasons according to which restrictions to free movements of capitals have been justified.[84]

Another judgement which needs to be discussed in order to shed more light on the relation between freedom of establishment and free movement of capitals has been issued in the Commission v. Germany case.[85] At the time of the dispute, the Commission claims that the German legislation at issue is inconsistent both with EU provisions concerning freedom of establishment and free movement of capitals. The ECJ only considers the possible breach of the latter, however it motivates this choice in quite a different way than in the other cases on golden shares mentioned above. In fact the Court, in the beginning concedes that, also "according to settled case-law, national provisions which apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company’s decisions and allowing them to determine its activities, come within the substantive scope of the provisions of the EC Treaty on

[83] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; cit.; par. 45-57

[84] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; cit.; par. 59.

[85] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*. Case C-112/05. European Court reports 2007 Page I-08995.

freedom of establishment".[86] However, the Court also adds that "the Commission did not advance any specific line of argument in support of any restriction on the freedom of establishment, either in its application or in its reply, or even at the hearing" and therefore the "Court must dismiss the action in so far as it is based on a breach of Article 43 EC." [current art. 49 TFEU].[87] The Court then turns to the issue of the consistency of German legislation on golden shares exclusively in relation to art. 56 TCE (today art. 63 TFEU) and concludes that the respondent has actually failed to comply with this provision. It must be remarked that in this case the Court does not exclude the analysis of alleged restrictions to freedom of establishment because of the fact that they are a mere consequence of restrictions to movements of capitals. This is further proved by the fact that in the Commission v. Germany case the study of the applicability of provisions on freedom of establishment precedes the investigation of the breach of the provisions on the free movement of capitals. Simply, the Court states that the Commission has failed to prove that a restriction to freedom of establishment was at stake. In any case, another aspect of the Judgement which deserves to be underlined is that the Court confirms the principle that provisions on free movement of capitals could apply not only in case of portfolio investments but also in case of FDIs. The Court, in the case at issue, recognises that German legislation on golden shares is unlikely to adversely affect portfolio investments, while it is liable to deter mainly FDIs, i. e. investments aiming at "establishing or maintaining lasting and direct economic links with [the invested company] which would make possible effective participation in the management of that company or in its control".[88]

[86] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 13.

[87] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v. Federal Republic of Germany*; cit.; par 15-16.

[88] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 52.

The more recent Federconsumatori[89] case differs from the above mentioned cases concerning golden shares in that it originated not from an infringement procedure initiated by the Commission under current art. 258 TFEU, but from a request for a preliminary ruling filed by an Italian tribunal under current 294 TFEU. What is to be underlined is that in this case the issue of the compatibility of Italian legislation with EU provisions on freedom of establishment simply was not risen, while the only EU provisions whose breach was invoked by the parties, and finally ascertained by the Court, was current art. 63 TFEU.[90]

It is difficult to draw clear conclusions from the case law of the ECJ which has been analysed in this paragraph in order to ascertain which provisions of EU law can more appropriately apply to transnational investments. Two diverging approaches have emerged. According to the first one, portfolio investments are governed by art. 63 TFEU only, while FDIs which imply a degree of control such as to make the FDI at issue tantamount to establishment would fall under the empire of art. 49 TFEU. This means that in case of FDIs from or to third countries, since art. 49 cannot apply, also art. 63 cannot be taken into consideration. As a result, FDIs from or to third countries cannot benefit from the fundamental economic freedoms provided for in EU law. On the contrary, such provisions would exclusively benefit portfolio investments.

Another approach, which seems to be more convincing and which seems to be more often endorsed in recent EU case law and in particular in the judgements concerning golden shares, consists in considering that investments are covered first of all by provisions on free movement of capitals. In this case intra-EU investments and investments from or to third countries are equally covered irrespective of whether they are direct or portfolio investments.

[89] Judgment of the Court (First Chamber) of 6 December 2007; *Federconsumatori and Others (C-463/04) and Associazione Azionariato Diffuso dell'AEM SpA and Others (C-464/04) v Comune di Milano*; Joined cases C-463/04 and C-464/04. European Court reports 2007 Page I-10419.

[90] For more comments on the Federconsumatori case see, for instance: L. IDOT; *Nouvelle prise de position sur les droits spécifiques*; in *Europe*; 2008; Février Comm. nº 42; p.20-21; F. GHEZZI, M. VENTORUZZO; *Golden share e diritto comunitario: la Corte di Giustizia delle Comunità Europee afferma l'incompatibilità dell'art. 2449 c.c. con il principio di libera circolazione dei capitali nel caso AEM*; in *Rivista delle società* 2008 p.252-254; A. TRICOLI; *Diritto speciale di nomina degli amministratori di s.p.a. privatizzata e diritto comunitario. Il caso AEM*; in *Rivista di diritto societario* 2009; p.275-287.

4. The very limited relevance of the provisions on the freedom of establishment in the case of the investments of SWFs in the EU

The discussion undertaken in the previous paragraphs brings to the conclusion that, since most investments undertaken by SWFs in the EU are portfolio investments originating from a third country, EU provisions which are more likely to apply are only those concerning free movement of capitals. Provisions on freedom of establishment would be applicable in the case of SWFs based in an EU country which undertake direct investments ensuring a complete control over the invested company. Therefore, it must be studied whether this case has occurred or whether, given the current situation, it is likely to occur in practise in a near future.

According to the SWF Institute, there are two SWFs owned by EU members. The first one which is mentioned is owned by France and it is the Strategic Investment Fund (SIF), managed by the Caisse des Dépôts et de Consignation (which in turn is a French State entity).[91] The SIF has been constituted in 2008 as a French public limited company (société anonyme), a subsidiary of Caisse des Dépôts, which owns 51% of its capital, while the remaining 49% is directly owned by the Government of France. It's task is to invest in French companies. In particular, it supports by means of provision of capital financing the development of French enterprises and especially of those whose activities may provide important spill over for the domestic economy as a whole. In addition, the SIF acquires stakes in firms which are regarded as strategic also with a view to maintaining a State presence in them.[92] Therefore, the SIF plays a protectionist role and it is a tool for the implementation of a domestic industrial policy. However, the French SIF should not be correctly regarded as a SWF, if the criteria for defining a SWF which have been explained in the first paragraph of the first chapter of the present work are applied. In fact, while it is

[91] See: http://www.swfinstitute.org/swfs/strategic-investment-fund/

[92] Most information hereby reported are drawn from the website of the Caisse des Dépôts et de Consignation at the page: http://www.caissedesdepots.fr/en/the-group/organisation/subsidiary-companies/fsi.html and from the website of the SIF at the page http://www.fonds-fsi.fr/ Both websites have been visited on 15/04/2011

owned by the State and it performs also macroeconomic functions when supporting the implementation of domestic industrial policy,[93] the fact that a substantial part of its investments is not carried out overseas prevents it from falling within the notion of SWFs.

Under this point of view, it must be remarked that other State-owned or State-controlled entities exist in the EU, which are similar to the French Caisse des Dépôts et de Consignation, which nonetheless are not explicitly mentioned by the SWF institute. It is for instance the case of the Italian Cassa Depositi e Prestiti. However, it must be stressed that until they continue to exclusively or almost exclusively invest in domestic companies and infrastructures in order to promote domestic economic growth, they cannot be qualified as SWFs. In the future, their mission is hardly expected to turn into that of portfolio investors whose task is to manage wealth in excess; therefore it is not expected that they may turn into SWFs.

Another SWF owned by an EU member according to the SWF Institute is the National Pensions Reserve Fund, (NPRF)[94] established in Ireland in 2001 to meet "the costs of Ireland's social welfare and public service pensions from 2025 onwards, when these costs are projected to increase dramatically due to the ageing of the population".[95] The difficulties to qualify a State owned pension fund as a SWF, especially if it is not funded by the proceeds from the sale of natural resources, or when it is not also a tool for the management of foreign exchange reserves deemed to be in excess, have already been investigated in chapter 1 paragraph 1 and they shall not be repeated. In addition, it must be remarked that the amount of investments undertaken overseas by the NPRF, in recent times has dramatically decreased. As a result, also the requirement to invest a substantial part of the wealth under management in foreign assets, which must be fulfilled by a State entity in order to be regarded as a SWF, is hardly met by the NPRF. This change in investment

[93] On the role of domestic investments of SWFs in the implementation of the industrial policy of the State owner of the SWFs themselves see *supra* chapter 3 par. 9.

[94] See: http://www.swfinstitute.org/swfs/national-pensions-reserve-fund/ visited on 15/04/2011

[95] Homepage of the website of the National Pensions Reserve Fund: http://www.nprf.ie/home.html visited on 15/04/2011

strategy of the NPRF is related to the worsening of Irish economy and especially to the very difficult situations of Irish banks. In fact in 2009 the Irish Government needed to intervene to rescue Irish banks, but the costs of bailouts (which nevertheless did not prove sufficient) were so high that they destabilised the same State budget, forcing the Irish Government itself to apply to the EU, the IMF and to individual EU members and ask for financial assistance. These developments has clearly affected the strategy and the function of the NPRF, since it made no sense to keep on investing State wealth abroad while the risk of bankruptcy of domestic banks and later of the State itself was forcing Ireland to demand for foreign financial assistance. Therefore, since 2009, the National Pensions Reserve Fund and Miscellaneous Provisions Act allowed the NPRF to undertake investments in domestic credit institutions, as directed by the Minister for Finance where, having consulted the Governor of the Central Bank and the Financial Regulator, it was deemed it necessary to do so, in the public interest, "to remedy a serious disturbance in the economy of the State" or "to prevent potential serious damage to the financial system in the State and ensure the continued stability of the system." These developments were therefore related to the first part of the Irish crisis, when it seemed that the priority was the rescue of domestic banks and when it was not expected yet that need to rescue the State itself would have in turn emerged. The existence of this threat became clearer in 2010, when, with the adoption of the Credit Institutions (Stabilisation) Act it was provided that the NPRF could have been required by the Minister for Finance "to invest in Irish Government securities or for payments to the Exchequer to fund capital expenditure in the financial years 2011, 2012 and 2013. Later, in relation to the joint IMF/EU rescue plan, it was provided that NPRF would have provided up to €10 billion of the State’s €17.5 billion contribution to the €85bn rescue Programme. After an NPRF contribution of €10 billion, the value of the assets remaining in the Discretionary Portfolio (which was, together with the direct investment portfolio, one of the two portfolio in which the NRPF was split in the meanwhile) was limited to about €4.9 billion, which would have been used to invest in certain Irish infrastructure as set out in The National Recovery Plan 2011-2014. [96]

Therefore, the dramatic developments that the Irish economy underwent forced the NPRF to focus on domestic investments. The relevant reduction of foreign investments has made it lose one of the main feature a State entity should have in order to be regarded as a SWF.

It is quite difficult that other EU member States in the future might be able to hoard large wealth which can be used to invest overseas through SWFs. In fact most EU member States do not have budget surpluses or surpluses of the balance of payments which may make the creation of SWFs a viable or desirable option.[97] From the analysis developed so far it can therefore be concluded that no operation undertaken by State entities owned by an EU member State can qualify as an investment undertaken by a SWF owned by an EU member State into the territory of another EU member. This entails that EU provisions on freedom on establishment cannot apply.

It can be discussed whether the European Financial Stability Facility (EFSF) could be regarded as a SWF. The EFSF is a company, incorporated under Luxemburgish law as a societé anonyme and whose shareholder are the euro area member States. It has been created in 2010 in order to provide financial assistance to EU members whose budgets is under stress. It is expected to be replaced in 2013 by another EU instrument which will be permanent and which will be created as an international organisation.[98] Several arguments stand against the qualification of the EFSF as a

[96] Homepage of the website of the National Pensions Reserve Fund: http://www.nprf.ie/home.html visited on 15/04/2011. See also: Investment Strategy of the National Pensions Reserve Fund: http://www.nprf.ie/InvestmentStrategy/investmentStrategy.htm page visited on 15/04/2011

[97] The only EU country which, given the surplus of its current account balance, (5,6% of the GDP expected in 2011) and its modest deficit of the budget balance (2,6% of its GDP expected in 2011) could be in the condition to create a SWF is Germany. However, it does not seem that Germany is currently interested in such an option. The source of the data quoted in this note is The Economist; July 16th- 22nd 2011; p. 90

[98] More information on the EFSF can be found on its website: http://www.efsf.europa.eu/about/index.htm visited on 21/08/2011 For a broader discussion on the instruments put in place by the EU to cope with the crisis of the sovereign debt in the EU see: J. LOUIS; *Guest editorial; the no-bailout clause and rescue packages*; in *Common Market Law Review*; 2010; p.

SWF. Some of them, for instance the fact that it is not owned by one State but by a plurality of EU States, or the fact that it does not aim at investing abroad if the term "abroad" means outside the euro area, do not seem to be so decisive. Other arguments are on the contrary more relevant. In particular, it must be remarked that, even if the EFSF is used in order to purchase a relevant part of the distressed debt of countries, as it has been agreed by the members of the Euro Area on July 21st 2001,[99] nevertheless also this activity should qualify as financial assistance, rather than as an investment. If the notion of investment activity is meant in such a broad way so as to include the supply of financial facilities and loans, then also the IMF operations would qualify as investments: this seems to be a very unconvincing approach. Moreover, SWFs are created in order to manage wealth in excess owned by a State, while the task of the EFSF is to provide assistance to certain EU members: therefore the resources under its management are not surpluses of the budget or of the balance of payment which need to be invested, but resources which have been risen (and not without political and economic difficulties) by issuing bonds guaranteed by the members of the Euro Area and with the explicit purpose to provide EU members facing a concrete risk of bankruptcy with the financing they need. It can be concluded that the purchase of debt instruments of EU members by the EFSF cannot be regarded as an investment undertaken by an EU SWF. Moreover, even if such operation is regarded as an investment, it would fall within the notion of portfolio

971-986; M. LAMANDINI; *Orderly sovereign default in the EU: a strong case for European regulation;* in *European Company Law*; 2010; p. 233-237; C. TOMUSCHAT; *The Euro – A Fortress Threatened from Within*; in A. LIGUSTRO AND G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 275- 300. The EFSF could therefore be regarded not as an investor but as an instrument whose objective is to prevent State bankruptcy. For an overview of the issue of sovereign debt crisis see: M. MEGLIANI; *Debitori sovrani e obbligazionisti esteri*; Milano; Giuffrè; 2009; M. C. MALAGUTI; *Se a fallire sono gli Stati*; in A. LIGUSTRO AND G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 213-230; C. G. PAULUS; *What Constitutes a Debt in the Sovereign Debt Restructuring Context?*; in A. LIGUSTRO AND G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 231-248; M. MEGLIANI; D*ebitori sovrani e obbligazionisti sovrani*; in *Diritto del Commercio internazionale*; 2010; p. 265-270.

[99] See Il Sole 24 Ore; July 22nd, 2011.

investment: this means that in any case the provisions on freedom of establishment cannot apply.

Another case in which it should be discussed whether provisions on freedom of establishment can apply to investments of SWFs in the EU, can occur if all the following three circumstances are verified. First of all, an EU member admits the investment of a third country SWF. Secondly, the investment consists in the creation of a subsidiary of that SWFs in the EU member State at issue. Such subsidiary must be regarded as an EU company although owned by a foreign SWF.[100] As such, this company benefits of the EU provisions concerning the freedom of establishment. Thirdly, the subsidiary based in an EU member State and owned by a third country SWF set up or purchases branches and subsidiaries in other EU countries.

It must be remarked that in this case it is not the foreign SWF, but the European company owned by it, which is directly benefiting of the EU provisions on freedom of establishment. However, as the ultimate owner is a third country SWF, the potential threats to the host State such subsidiary may pose in the course of its investment activity are the same as those which can be posed by a third country SWF directly investing.[101]

The third country SWF may have a right to establish in the EU the subsidiary at issue exclusively under art. 63 TFEU and not under art. 49, which does not apply to third country companies. Alternatively, if the focus is put on a legal order different from the one of the EU, it could be argued that the possibility for the SWFs to create or purchase such company in the EU would derive from IIAs concluded between the EU host State and the home State (and owner) of the SWF. However, this last option seems to be less feasible, because the model BITs adopted by EU States most often

[100] In fact, according to art. 54 TFEU: "Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States".

[101] On the feasibility of this approach, and on the limits it might encounter, see, for instance: UNCTAD; *The REIO exception in MFN Treatment Clauses*; UNCTAD 2004; p. 7. For the limitation that such a device would entail to the ability of EU host States to decide whether or not to ensure freedom of establishment to third country investors see: H. SCHWEITZER; cit.; p. 275.

do not lay down obligations concerning the pre admission phase, but only the treatment of the investment after it has been admitted. Finally, in case of establishment of a subsidiary by a third country SWF in the territory of a member State, the domestic legislation of the host country plays a very important role in determining the actual possibility for the SWF to have its investment admitted.

So far it has not been reported any case in which a SWF creates a subsidiary in the EU from which it undertakes FDIs in other EU countries thus benefiting of art. 49 seq. TFEU. As a result, the applicability of EU provisions on freedom of establishment in this case shall not be investigated further.

A final consideration needs to be made, against the applicability of EU provisions on freedom of establishment to SWFs operating in the EU. Although it cannot be excluded *a priori* that SWFs might in the future undertake to set up and operate branches and subsidiaries, it must be reminded that one of the main elements which allows to distinguish a SWF from a SOE is that a SWF does not carry out economic activities other than the management of its own financial assets and it is not directly involved in the direct management of firms. A SWF which directly carries out businesses for instance in manufacturing or in the provision of services, also by means of branches and subsidiaries, would be no more a SWF but it rather should be regarded as a SOE.

The discussion undertaken in the present paragraph confirms that, for the purposes of the study the applicability of EU investment law to the investments of SWFs, the focus should be on those EU law provisions governing the free movement of capitals.

5. **The articles of the TFEU concerning the free movement of capital and their applicability to SWFs**

The first part of the present paragraph will be devoted to a brief description of the EU provisions on the free movement of capitals. Then, their applicability to the investments of SWFs will be investigated.

First of all, it must be stressed that in EU law provisions on capital movements developed relatively later than provisions concerning other fundamental economic freedoms on which the EU internal market is based, i. e. those related to movements of goods, persons and services. For a long time EU law distinguished between the notion of payment and of capital movement *strictu sensu*, the difference residing in that a payment is related to the sale of goods or the supply of services.

Until the end of the 1980s, payments only were liberalised. This was also due to the instrumental character of payments relative to the free movements of goods and services. In fact, the possibility to maintain restrictions to payments would have made provisions on free movements of goods and services nugatory and useless.[102] On the contrary, in relation to movements of capitals different from payments, the old art. 67 of the Treaty of the European Economic Community (which was later replaced by the TEC) only required to progressively abolish restrictions to the extent necessary for the proper functioning of the Common Market. Such provision, differently from those concerning movements of goods, services and persons, had not direct effect.

This was stressed by the ECJ in the Casati case,[103] when the Court was required *inter alia* to give a preliminary ruling on the issue of the consistency with EU law of Italian legislation which subjected to criminal proceedings an Italian national who tried to export from Italy and without the authorization prescribed by Italian exchange control legislation, a certain amount of Deutsche Marks.[104]

The ECJ stressed that art. 67 was different from the provisions on the free movement of goods, persons and services. In fact, it argued that under art. 67 "there is an obligation to liberalize capital movements only 'to the extent necessary to ensure the

[102] On the distinction between payments, which needed to be liberalized at the expiry of the transitional period, and other capital transfers see: Judgment of the Court of 31 January 1984; *Graziana Luisi and Giuseppe Carbone v Ministero del Tesoro*; Joined cases 286/82 and 26/83. European Court reports 1984 Page 00377; par.18-26. In addition, according to the ECJ, current payments made in relation to supply of services, could have been lawfully subjected to controls in limited cases, for instance in order to verify that they are not used to circumvent national legislations on capital transfers (ibid. par. 27-34).

[103] Judgment of the Court of 11 November 1981; *Criminal proceedings against Guerrino Casati*; Case 203/80; European Court reports 1981 Page 02595.

[104] Judgment of the Court of 11 November 1981; *Criminal proceedings against Guerrino Casati*; cit.; par. 2.

proper functioning of the common market"'.[105] Member States were therefore allowed to maintain restrictions even after the expiry of the transitional period. The liberalization of movement of capitals would have occurred only by means of further acts adopted by the European Institutions and taking into consideration the delicate economic and monetary concerns that might be related to such liberalisation.[106]

Free movement of capitals was provided for only with directive 88/361.[107] Such act, now repealed, at art. 1 provided that "Without prejudice to the following provisions, Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States. [...]". The ECJ stressed that art. 1 of directive 88/361 was provided with direct effect and created rights and duties directly upon individuals.[108] Later, the Maastricht Treaty modified the TEC so that since January 1st 1994 EU primary law provides for free movements of capitals and payments both.[109]

Currently, such freedom is provided for in art. 63 of the TFEU, which reads as follows: "1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

[105] Judgment of the Court of 11 November 1981; *Criminal proceedings against Guerrino Casati*; cit.; par 10.

[106] Judgment of the Court of 11 November 1981; *Criminal proceedings against Guerrino Casati*; cit.; par. 11-13.

[107] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty; OJ L 178, 8.7.1988, p. 5–18. On the content of the directive see, supra, paragraph 3 of the present chapter.

[108] See for instance: Judgment of the Court of 23 February 1995; *Criminal proceedings against Aldo Bordessa, Vicente Marí Mellado and Concepción Barbero Maestre*. Joined cases C-358/93 and C-416/93. European Court reports 1995 Page I-00361. In particular, when discussing the elements to consider when assessing whether art. 1 of the directive had direct effect, the ECJ in par. 33 of the judgment declared that "[t]he requirement under Article 1 of the Directive for Member States to abolish all restrictions on movements of capital is precise and unconditional and does not require a specific implementing measure."

[109] For a more detailed historical overview of the liberalization of capital movements in the EU see, for instance: F. S. BENYON; cit.; p. 7-13; F. PICOD; *Libre circulation des capitaux et des moyens de paiement*; in *Europe Traité*; fasc 890; 2009; par. 1-16.

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

This provision, like the very similar articles of directive 88/361, has direct effect, as it has been declared by the ECJ in the Sanz de Lera case.[110] In that occasion the Court stated that provisions of the Treaty on free movement of capitals, "may be relied on before national courts and may render inapplicable national rules inconsistent therewith".[111]

The addressees of such obligation are member States, EU institutions and also individuals (be they physical or legal persons), as it occurs for the other provisions of the TFEU concerning the fundamental economic freedoms of the Union.[112] The persons which are entitled to enjoy the rights provided for in this article are both EU individuals and third country individuals. Capital flows covered are both intra-EU flows as well as capital movements between EU and non-EU States. This means that if an investor, also from a third country, transfers capitals from a third country to an EU country (for instance in order to initiate or finance an investment) or from the EU to a third country (for instance with a view to repatriating profits or to divesting), she shall enjoy the rights laid down by art. 63 TFEU. Since nothing in the TEU or in the TFEU can be construed so that to exclude State entities like SWFs from the coverage of art. 63, it follows that a SWF from a non EU country which invests in an EU member, for instance in Italy, if it is hindered by Italian State measures preventing it from moving its capitals to Italy for instance to purchase Italian assets, could claim that such measures, to the extent they are incompatible with art. 63 TFEU, shall not be applied.

As an abundant case-law of the ECJ has clarified, art. 63 prohibits restrictions to capital movements and payments based on the nationality or the residence of the

[110] Judgment of the Court of 14 December 1995; *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu*; Joined cases C-163/94, C-165/94 and C-250/94. European Court reports 1995 Page I-04821.

[111] Judgment of the Court of 14 December 1995; *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu*; cit.; par. 48.

[112] F. PICOD; cit.; par. 44-46.

persons involved or on the currency which makes the object of the transaction, or on the origin of transaction.[113] Such restrictions are justified, and therefore do not entail a breach of EU law, only if they fall within the scope of one of the exceptions envisaged at art. 64 and 65 TFEU (which provide for so called "express derogations" and will be studied more in depth below) and provided that they are applied in a proportional way and respecting the principle of necessity.

As it occurs in relation to the other fundamental freedoms of the EU, not only directly and indirectly discriminatory measures are prohibited under art. 63 TFEU. Also measures which substantially hinder access to market and make it less attractive the enjoyment of free movement of capitals are inconsistent with the obligation laid down at art. 63 TFEU irrespective of whether they entail a discrimination *de jure* or *de facto*.[114]

This concept is well explained for instance in the Commission v. France case concerning golden shares, where the ECJ states that the prohibition contained in current art. 63 TFEU "goes beyond the mere elimination of unequal treatment, on grounds of nationality, as between operators on the financial markets"[115] In fact, according to the Court, "[e]ven though the rules at issue may not give rise to unequal treatment, they are liable to impede the acquisition of shares in the undertakings concerned and to dissuade investors in other Member States from investing in the capital of those undertakings. They are therefore liable, as a result, to render the free

[113] For a concise but detailed review of the ECJ case law on this issue see: F. PICOD; cit.; par. 48-60; F. S. BENYON; cit.; p. 14-22.

[114] C. BARNARD; *The substantive law of the EU - the four freedoms*; 3rd ed.; Oxford; Oxford University Press; 2010.
p. 569-580; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 180-181.
For a critic of this stance see: F. SANDERS; *Case C-112/05, European Commission v. Federal Republic of Germany: The Volkswagen Case and Art. 56 EC - A Proper Result, Yet Also a Missed Opportunity*?; in *The Columbia Journal of European Law* 2008; p. 366- 369. The author of this article finds that the test of the deterrent effect on investors is "blurred and impracticable" and that it is to be criticised because it favours a psychological approach while neglecting more objective criteria.

[115] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 40.

movement of capital illusory"[116] The Commission v. France Judgement is consistent with previous cases in which the Court decided that violation of current art. 63 is caused by State measures which, although not formally discriminatory, nonetheless render the free movement of capital illusory.[117]

Policymakers in the EU member States should take these principles in due consideration. Even if they adopt legislation which does not discriminate against SWFs of certain countries or against SWFs in general, they could nonetheless act in a manner inconsistent with EU law. In fact, when a State acts in a way to reduce the possibility of SWFs to invest in the EU, it makes it less attractive the exercise of the right to free movement of capitals (included capital flows related to operations of SWFs) in the EU and therefore it can be found to be in breach of EU law also in the absence of formal discriminations. The conclusion which can be drawn is that the ability of EU member States to adopt particular measures restricting or even controlling the investments of SWFs, and thus resulting into a reduction of the attractiveness of capital movements in the EU, is significantly restricted.

State measures otherwise inconsistent with art 63 TFEU can be justified in two cases. Firstly, when they fall within one of the derogations provided for in art. 64, 65 and 66 (expressed derogations). Secondly, when they are justified by overriding requirements of general interest (non expressed derogations).[118] It must be noted that in this second case overriding interests of a State may be lawfully invoked "to the

[116] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 41.

[117] Judgment of the Court of 14 December 1995; *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu*; cit.; par. 25; Judgment of the Court of 1 June 1999; *Klaus Konle v Republik Österreich*; Case C-302/97. European Court reports 1999 Page I-03099; par 44.

[118] On this issue see, for instance: Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 45 "The free movement of capital, as a fundamental principle of the Treaty, may be restricted only by national rules which are justified by reasons referred to in Article 73d(1) of the Treaty [today art. 65 TFEU] or *by overriding requirements of the general interest* [emphasis added] and which are applicable to all persons and undertakings pursuing an activity in the territory of the host Member State. [...]" See also: Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 72. "The free movement of capital may be restricted by national measures justified on the grounds set out in Article 58 EC or by overriding reasons in the general interest" See also: H. SCHWEITZER; cit.; p. 285-286.

extent that there are no Community harmonising measures providing for measures necessary to ensure the protection of those interests".[119] In fact, it is deemed that once EU legislation is adopted, it is in principle able to adequately protect the basic interests not only of the EU itself but also of its members and therefore they have no need to keep on adopting measures protecting their interests in the area which makes the object of EU harmonising measures.

As to the issue of express derogations, those envisaged at art. 64 deal with the relation between art. 63 and international instruments relevant for the purposes of the free movement of capitals which have been concluded by EU members with third countries before the entry into force of the obligations arising out of art. 63 TFEU.[120] The analysis of such provision will be carried out in the following chapter, in relation to the study of the relation between EU law and BITs.

Art. 66 provides for a possibility not for the EU members, but for the EU institutions to depart from art. 63. It envisages the case in which, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union. Under such circumstances the Council, acting on a proposal from the Commission and after consulting the European Central Bank, is empowered to adopt safeguard measures with regard to third countries, provided that such measures are strictly necessary and applicable for a period not exceeding six months. EU members are required act in order to ensure the application and the implementation of such measures. This may impact, *inter alia*, on the BITs they have concluded with third countries and in particular with the capital transfer clause they may contain. For this reason, the implications of art. 66 will be studied more in detail in the next chapter, together with the application of art. 64.

On the contrary, the derogations provided for in art. 65 should be studied more carefully in this paragraph. First of all, tax provisions distinguishing between

[119] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.;par. 72

[120] H. SCHWEITZER; cit; p. 261-264.

taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested, although formally discriminatory, could nonetheless be justifiable. Other express derogations provided for in art. 65 refer to national measures necessary "to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information" Finally, States remain authorised to adopt measures "which are justified on grounds of public policy or public security".[121]

In any case, the principle of proportionality must be respected and possible derogations cannot be used in order to circumvent EU law fundamental economic freedoms. When elucidating the scope of the principles of necessity and proportionality, the Court have stated that "measures which restrict the free movement of capital may be justified on public-policy and public-security grounds only if they are necessary for the protection of the interests which they are intended to guarantee and only in so far as those objectives cannot be attained by less restrictive measures".[122]

It must be remarked that the above mentioned exceptions have no self-judging character: in fact EU Institutions are entitled to review whether State measures at issue respect art. 64 and 65 or whether the overriding interests-test is fulfilled and, in any case whether the principle of proportionality is respected.[123] This emerges clearly for instance in the Church of Scientology case, in which the ECJ first of all underlines that "while Member States are still, in principle, free to determine the requirements of public policy and public security in the light of their national needs, those grounds must, in the Community context and, in particular, as derogations from the fundamental principle of free movement of capital, be interpreted strictly, so that

[121] For a discussion of the content of art. 65 and for a review of case law applying it and in particular its "predecessor", art 58 TEC, see, for instance; C. BARNARD; cit.; p. 584-591; F. PICOD; cit.; par. 67-77.

[122] Judgment of the Court of 14 March 2000; *Association Eglise de scientologie de Paris and Scientology International Reserves Trust v The Prime Minister*; Case C-54/99. European Court reports 2000 Page I-01335; par. 18. See also: H. SCHWEITZER; cit.; p. 263.

[123] C. BARNARD; cit.; p. 581-582; F. S. BENYON; cit.; p. 31-32.

their scope cannot be determined unilaterally by each Member State without any control by the Community institutions". Then, the Court continues by declaring that "public policy and public security may be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society" which in any case shall not be limited to "purely economic ends." Finally, the Court requires that "any person affected by a restrictive measure based on such a derogation must have access to legal redress."[124]

On the non-self-judging character of the exceptions to the provisions on the free movement of capitals the Court has provided further insight in the Commission v. France case, when it argues that: "the requirements of public security, as a derogation from the fundamental principle of free movement of capital, must be interpreted strictly, so that their scope cannot be determined unilaterally by each Member State without any control by the Community institutions."[125] Pursuant to this approach, the Court in this case carefully reviews not only whether the interests referred to by the respondent may correctly fall within the notion of national security for the purposes of EU law, but also whether measures undertaken by France to protect them are necessary, proportional and do not constitute a mean to unduly circumvent EU provisions on free movement of capitals.[126]

The content of the notion of public security relevant for the purposes of the applicability of art. 65 TFEU, as well as of the notion of overriding national interests which could allow for a derogation of art. 63 TFEU has been further investigated in the golden share cases mentioned above.[127] For instance, in Commission v. Portugal case, the ECJ rejects the arguments of the respondent that the notion of overriding national interest might include the achievement of certain economic interests of

[124] Judgment of the Court of 14 March 2000; *Association Eglise de scientologie de Paris and Scientology International Reserves Trust v The Prime Minister*; cit.; par. 17.

[125] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 48.

[126] For a comment on these aspects see also: A. R. COSI; *Investimenti diretti stranieri e regime comunitario della libera circolazione dei capitali: il limite dell'ordine pubblico non giustifica disposizioni nazionali "troppo vaghe";* in *Diritto pubblico comparato ed europeo*; 2000; p.720-724

[127] See also: F. S. BENYON; cit.; p. 32- 36.

Portugal.[128] In that occasion Portugal, claims that the regime of golden shares it introduced within the framework of its privatization (or *rectius*, re-privatisation process) is necessary in order to ensure that such process could be properly implemented. In its view this corresponds to an overriding national interest of the State. In particular Portugal claims that Decree-Law No 380/93 (i. e. one of the laws governing the privatization in Portugal) was intended to enable it "when re-privatising an undertaking in stages, to make sure, with a view to safeguarding the general interest, that the economic policy objectives pursued by the re-privatisation are not frustrated in the course of the operation." The respondent goes even further by explaining that: "[d]epending on the operation in question, those objectives may involve choosing a strategic partner where the activities of the undertaking are to assume an international dimension, or strengthening the competitive structure of the market concerned, or modernising and increasing the efficiency of means of production".[129] In fact, another of the laws which was adopted by Portugal within the privatisation process and which is also quoted by the ECJ in its judgement provides that: "re-privatisations shall pursue the following main objectives: (a) to modernise economic entities and make them more competitive, and to contribute to strategies for restructuring the sector or undertaking concerned (b) to strengthen national business capacity; (c) to help reduce the role played by the State in the economy; (d) to contribute to the development of the capital market; (e) to permit widespread participation by Portuguese citizens in the share capital of undertakings, by means of an adequate capital spread, with particular attention being paid to workers in the undertakings concerned and small-scale shareholders; (f) to preserve the property interests of the State and to develop other national interests; (g) to help reduce the burden of public debt in the economy."[130]

[128] See also, on this topic: F. S. BENYON; cit.; p. 32-36.

[129] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; cit.;par. 31

[130] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; cit.; par. 9.

It is clear that the above mentioned objectives essentially have an economic nature. The ECJ pays due regards to this issue and correctly declares that "the general financial interests of a Member State cannot constitute adequate justification" for the adoption of measures inconsistent with current art. 63 TFEU "save in so far as they may fall within the ambit of the reasons set out in Article 73d(1) of the Treaty, [today art. 65 TFEU] which relate in particular to tax law." Then, the Court continues declaring that "it is settled case-law that economic grounds" like those explicitly laid down in the laws providing for re-privatisation, "can never serve as justification for obstacles prohibited by the Treaty". In conclusion, "such interests cannot constitute a valid justification for restrictions on the fundamental freedom concerned."[131]

On the contrary, in the Commission v. France case the ECJ finds that the French legislation on golden shares does not protect only economic interests of the host State, but also national interests concerning public security. In detail, the Court argues that "the objective pursued by the legislation at issue, namely the safeguarding of supplies of petroleum products in the event of a crisis, falls undeniably within the ambit of a legitimate public interest."[132] Since "public security is also one of the grounds of justification referred to in Article 73d(1)(b) of the Treaty", [art. 65 TFEU], *in principle*[133] a State may invoke the need to safeguarding supplies of petroleum products in the event of a crisis and this may lawfully justify State measures otherwise inconsistent with current art. 65 TFEU. The ECJ in the Commission v. Belgium case, confirms these findings even by making use of the same words.[134]

[131] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; cit.; par. 52. See also: F. S. BENYON; cit.; p. 32-36.

[132] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 47.

[133] I wrote "in principle" because this could be regarded as a necessary but not sufficient condition for effectively invoking art. 65 TFEU. in fact, as already explained above, the Court is entitled to review whether State measures at issue actually allow the State to protect national security interests at stake without constituting an undue and unjustified restriction to EU economic freedoms.

[134] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Kingdom of Belgium*; Case C-503/99. European Court reports 2002 Page I-04809; par. 46.

Also in the Commission v. Germany case,[135] the Court deals with the notion of overriding interests of a State which can justify capital restrictions. In particular, the judgement contains important elements which allow to better understand the notion of economic interests of a State whose pursuit does not justify a departure from the principle laid down in current art. 63 TFEU.

In the case at issue, ECJ finds that German legislation concerning golden shares adopted in relation to the car manufacturer Volkswagen is in breach of current art. 63 TFEU. Then, it turns to analyse whether the defendant can lawfully invoke justifications for the restrictive measures it has adopted. Germany submits that domestic law provisions at issue "are justified by overriding reasons in the general interest." The defendant in fact argues that the law on golden shares, "which is part of a particular historical context, established an ‘equitable balance of powers’ in order to take into account the interests of Volkswagen’s employees and to protect its minority shareholders. The Law thus pursues a socio-political and regional objective, on the one hand, and an economic objective, on the other, which are combined with objectives of industrial policy."[136]

The Commission argues that German provisions at issue do "not address requirements of general interest [...] but seek to satisfy interests of economic policy". This is further proved by the fact that they do not apply *erga omnes*, as measures aiming at pursuing general public interests may be supposed to do, but on the contrary they only apply to one company, i. e. to Volkswagen. The interests protected therefore "cannot constitute a valid justification for restrictions on the free movement of capital".[137]

[135] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.. For an introduction see: L. IDOT; *Prérogatives des acteurs publics et restriction à la libre circulation des capitaux*; in *Europe* 2007; Décembre Comm. nº 335 p.22-23.

[136] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 70.

[137] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 71.

The Court first analyses the issue of the protection of workers, which should represent in the view of the respondent an overriding interest of the State, and then it turns to the issue of the protection of the minority shareholders.

As to the first issue, the Court dismisses the arguments of the defendant.[138] It notes that "Germany has been unable to explain, beyond setting out general considerations as to the need for protection against a large shareholder which might by itself dominate the company, why, in order to meet the objective of protecting Volkswagen's workers, it is appropriate and necessary for the Federal and State authorities to maintain a strengthened and irremovable position in the capital of that company."[139] Moreover, since under German legislation, workers are themselves represented within the supervisory board of companies, the mandatory presence of representatives of State authorities in this organ is not indispensable to protect the interests of workers.[140]

The Court rejects the arguments of Germany also in relation to the second issue, i. e. the protection of minority shareholders. The Court recognises that "the desire to provide protection for such shareholders may also constitute a legitimate interest and justify legislative intervention, [...] even if it were also liable to constitute a restriction on the free movement of capital". However, in the view of the Court, the respondent has failed to "shown why, in order to protect the general interests of minority shareholders, it was appropriate or necessary" to confer to German authorities the special powers provided for in the golden share legislation.[141]

For these reasons the Court concludes that German provisions on golden shares are inconsistent with EU provisions on free movement of capitals.

[138] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 76.

[139] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 74.

[140] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 75. For a comment on this aspect see, for instance: F. SANDERS; cit.; p. 364.

[141] Judgment of the Court (Grand Chamber) of 23 October 2007; *Commission of the European Communities v Federal Republic of Germany*; cit.; par. 77-78.

The ECJ adopts a similar approach, which nonetheless brings it to different conclusions, in the Sint Servatius judgement.[142] In the case at issue, which concerns investments in the real estate sector, the ECJ has to assess whether the implementation and the management of public housing policy by a member State could fall within the notion of overriding interest of a State, thus justifying State measures otherwise inconsistent with art. 63 TFEU. In detail, the ECJ has to assess the consistency with EU law of a decision adopted, in accordance to Netherlands law, by the Netherlands Ministry for Housing, Districts and Integration. Such decision concerned the Minister's refusal to grant the to the claimant, Woningstichting Sint Servatius (which is an approved institution active in the public housing sector in the Netherlands) the authorisation to invest in a construction project in Liège, Belgium. The claimant claims that such decision is inconsistent, *inter alia*, with current art. 63 TFEU. The respondent argues that the measures which make the object of the claim aim at ensuring the protection of overriding interests related to the public housing policy of a member State and therefore that they are justified under EU law. The Court recognises that "requirements related to public housing policy in a Member State and to the financing of that policy can also constitute overriding reasons in the public interest and therefore justify restrictions such as that established by the national legislation at issue in the main proceedings."[143] Therefore, the Court considers the need of a State to implement and manage its public housing policy as amounting *in principle* to an overriding interest which may justify the adoption of measures otherwise inconsistent with EU provisions on free movement of capitals.[144] It seems that, at least *prima facie,* both expressed derogations and non expressed derogations, should apply to the investments of SWFs too.

[142] Judgment of the Court (First Chamber) of 1 October 2009; *Minister voor Wonen, Wijken en Integratie v Woningstichting Sint Servatius*; case C-567/07; European Court reports 2009 Page I-09021.

[143] Judgment of the Court (First Chamber) of 1 October 2009; *Minister voor Wonen, Wijken en Integratie v Woningstichting Sint Servatius*; cit.; par. 30.

[144] See also: L. IDOT; *Investissements immobiliers soumis à autorisation*; in *Europe* n° 12, Décembre 2009, comm. 459.

The exceptions which seem to be more relevant for the purposes of the present analysis are those which are justified on grounds of public policy or public security (express derogations *ex* art. 65 TFEU) or of other overriding national interests (non express derogation) as such notions have been defined by the ECJ in the judgements which have been surveyed in this paragraph.

In chapter 1 of the present research it has been discussed which are the main concerns risen by SWFs. It has also been argued that so far SWFs have not acted in a way such as to justify them. However it seems undeniable that if SWFs on the contrary behaved in one of the feared way mentioned in chapter 1, they would represent a threat to public policy and public security or, in any case, to other overriding interests of the host State recognised as such by EU law. In this case, EU law would justify measures which, although they restrict capital flows related to investments of SWFs, are nonetheless necessary to protect public policy public security or other overriding national interests of the host State.

On the contrary, EU law would not allow State measures which simply aim *de jure* or also *de facto* at protecting domestic companies from foreign investments in the sense that the interest pursued by the State would consist in protecting domestic controlling shareholders of a company from surrendering control of the company at issue to foreign investors like SWFs which are ready to lawfully purchase controlling shareholdings in the companies at issue. In fact this would be clearly against the same rationale and the same principles laying at the foundations of the EU, which, as it is well known, endorses the principles of openness to international trade and investments, free market and competition.

Therefore, the interests of the host State which, when they are threatened by the investments of SWFs, allow the host State to lawfully adopt measures inconsistent with art. 63 TFEU, should not have economic character, but they should rather regard essential social, political and security aspects of the host State and of its people.[145]

[145] H. SCHWEITZER; cit.; p. 276-277.

Moreover, general references to the fact that SWFs, since they are State entities, might be politically motivated in their business activities and therefore that they by their same nature actually or potentially represent a threat to national interests is insufficient. In fact, EU institutions are entitled to review the consistency of State measures with EU law. In particular, the Commission and the ECJ shall review whether the measures member States adopt actually aim at protecting their social, political and legal order from possible threats posed by SWFs, whether they are necessary and proportional, whether they do not represent a concealed circumvention of EU fundamental economic freedoms. The limitation of the discretion of EU member in screening the investments of SWFs (in their entry phase) and in eventually limiting and restricting them (in the post entry phase) makes even more important the development of the EU level of a mechanism which might properly regulate and control the capital inflows from SWFs, or, at least, of the coordination at the EU level of the mechanisms already existing or still to be put in place at the domestic level.

In other words, it is not sufficient for a State to declare that those measures it adopts, which affect investments of SWFs and which would otherwise be inconsistent with art. 63 TFEU, are nonetheless justified insofar as they aim at protecting overriding public interests of the host State.

As to the possibility that certain State measures could be adopted in order to protect national security from threats posed by the investments undertaken by SWFs, it must be remarked that such measures should also indicate in a precise and detailed way which restrictions in which precise cases they would enable, as well as the modality through which restrictions shall be implemented and the possible means of redress which are available to the affected investors.

There is a consistent case law of the ECJ on this issue, which needs to be quickly reviewed.

In the Commission v. France case the Court, after recognizing that in principle France is allowed to restrict capital movements insofar as this is necessary for the purposes of ensuring the supply of oil in case of crisis, turns to analyse whether

French legislation properly allows to protect such interest without unduly and abusively representing a restriction to economic freedoms provided for in EU law. The Court declares in fact that "it is necessary [...] to ascertain whether the obstacles resulting from the legislation in issue are such as to enable the Member State concerned to ensure a minimum supply of petroleum products in the event of a genuine and serious threat, and whether or not they go beyond what is necessary for that purpose."[146]

The French legislation on golden shares in force at that time provides that, in certain companies, any direct or indirect shareholding which exceeds certain limits, must first be approved by the Minister for Economic Affairs in respect of each of the persons participating in that holding. The Court correctly observes that according to such legislation, "the exercise of that right [by the Ministry] is not qualified by any condition, save for a reference, formulated in general terms in Article 1 of that decree, to the protection of the national interest." As a result, "[t]he investors concerned are given no indication whatever as to the specific, objective circumstances in which prior authorisation will be granted or refused. Such lack of precision does not enable individuals to be apprised of the extent of their rights and obligations deriving from Article 73b of the Treaty."[147] [art. 63 TFEU].

The lack of legal certainty, the excessive discretion in State powers as to the admission of investments in companies in which the State has a golden share in the view of the Court entails a "serious interference with the free movement of capital, and may have the effect of excluding it altogether." Pursuant to these findings the Court concludes that French legislation on golden shares "clearly goes beyond what is necessary in order to attain the objective pleaded by the French Government, namely the prevention of any disruption of a minimum supply of petroleum products

[146] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 49.

[147] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 50.

in the event of a real threat.".[148] Therefore the Court finds the French legislation on golden shares inconsistent with EU provisions on free movements of capitals.[149]

The Court adopts the same approach and the same principles also when it is required to adjudicate upon the issue of Belgian golden shares. If in that circumstances the Court judges that Belgian legislation is consistent with EU law, this occurs because it finds that Belgian provisions at issue are radically different from French ones, in the sense they guarantee a much higher level of predictability and stability for the investors. The Court takes into consideration different aspects of Belgian law on golden shares. Firstly, the regime at issue is one of opposition and not of prior authorization; moreover, in order for that power of opposition to be exercised, the public authorities are obliged to adhere to strict time-limits. Even more important, "the regime is limited to certain decisions concerning the strategic assets of the companies in question, including in particular the energy supply networks, and to such specific management decisions relating to those assets as may be called in question in any given case." The circumstances under which the Ministry is entitled to adopt decisions which might have restricted investments, as well as the modality according to which such decisions might be taken, are detailed out in relevant domestic legislation. In fact, "the Minister may intervene pursuant to Articles 3 and 4 of the Royal Decrees of 10 and 16 June 1994 only where there is a threat that the objectives of the energy policy may be compromised." Finally, "any such intervention must be supported by a formal statement of reasons and may be the subject of an effective review by the courts."[150]

The Court therefore concludes that Belgian legislation on golden shares "makes it possible to guarantee, on the basis of objective criteria which are subject to judicial review" the protection of strategic interests like "the effective availability of the lines and conduits providing the main infrastructures for the domestic conveyance of

[148] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 51.

[149] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; operative part, 1, b).

[150] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Kingdom of Belgium*; cit.; par. 49-51

energy products, as well as other infrastructures for the domestic conveyance and storage of gas, including unloading and cross-border facilities."[151] For this reasons it is consistent with EU provisions on free movement of capitals.

The Court adopts an approach similar to the one of Commission v. France and Commission v. Belgium in the more recent case Commission v. Italy.[152] In this judgement, Italy recognises " the alleged unforeseeability of the actual cases" in which State intervention could take place. However, it argues that unforeseeability cannot be avoided and it is for certain aspects necessary to ensure a proper level of flexibility and effectiveness to national legislation at issue, given the particular tasks it is required to achieve. In fact, Italy argues that "it is only when an investor appears that all the specific circumstances are identified and can be assessed" therefore "the conditions for the exercise of the special powers cannot be defined more precisely than they are in the Decree of 2004"[153] However, the Court dismisses these arguments and concludes that the discretion Italy may enjoy when exercising its rights under the golden share legislation, is inconsistent with EU law.[154]

The above mentioned Woningstichting Sint Servatius judgment[155] confirms this approach. In that case the Court has to assess, *inter alia*, whether a scheme of prior administrative authorisation (instead of a system of *ex post* controls) may be

[151] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Kingdom of Belgium*; cit.; par. 52.

[152] Judgment of the Court (Third Chamber) of 26 March 2009; *Commission of the European Communities v Italian Republic*; cit.. It must be remarked that, differently from other cases concerning golden shares the Court has not limited its analysis to the issue of compatibility with EU provisions on free movement of capitals but also with EU provisions on freedom of establishment. For a more in depth discussion on this last aspect, as well as for an overview of this judgment see: J. VAN BEKKUM; *Golden shares: a new approach*; in *European Company Law*; 2010; p. 13-19. See also: M. O'BRIEN; *Case C-326/07, Commission of the European Communities v. Italian Republic, Judgment of the Court of Justice (Third Chamber) of 26 March 2009, not yet reported*; in *Common Market Law Review* 2010 p. 245-261.

[153] Judgment of the Court (Third Chamber) of 26 March 2009; *Commission of the European Communities v Italian Republic*; cit.; par. 27.

[154] For a comment on this aspect of the judgement see, in particular: M. SALERNO; *Sulle golden shares l'Italia è costretta ad un nuovo passo indietro: troppa discrezionalità nell'esercizio dei poteri speciali*; in *Diritto pubblico comparato ed europeo*; 2009; p.1358-1362.

[155] Judgment of the Court (First Chamber) of 1 October 2009; *Minister voor Wonen, Wijken en Integratie v Woningstichting Sint Servatius;* case C-567/07. European Court reports 2009 Page I-09021.

consistent with the provisions on free movements of capitals even if it has already been recognised by the Court itself that it is devised to protect overriding interests of the concerned State and therefore even if in principle it may be justified under current art. 65 TFEU. The Court declares that a "scheme of prior administrative authorisation cannot render legitimate discretionary conduct on the part of the national authorities which is liable to negate the effectiveness of provisions of Community law. [...]Therefore, if such a scheme is to be justified even though it derogates a fundamental freedom, it must be based on objective, non-discriminatory criteria known in advance, in such a way as adequately to circumscribe the exercise of the national authorities' discretion"[156]

The Court stresses that the national provisions taken into consideration in the case at issue "make prior authorisation by the competent Minister dependent on a single condition, namely that the project concerned be in the interests of public housing in the Netherlands". The Court then adds that the Minister decides whether such condition is fulfilled by acting on a case by case basis. Also for this reason, "the check is not set within a legislative framework and [...] there are no other specific and objective criteria from which the institutions concerned can ascertain in advance the circumstances in which their application for authorisation will be granted and on the basis of which [national] courts, if an action is brought before them in respect of a refusal of authorisation, may exercise their powers of review to the full."[157]

As a result, according to the Court, the prior administrative authorisation scheme at issue in the present case "might be considered not to be based on conditions capable of adequately circumscribing the exercise, by the national authorities, of their discretion and, therefore, of justifying a derogation from the free movement of capital."[158]

[156] Judgment of the Court (First Chamber) of 1 October 2009; *Minister voor Wonen, Wijken en Integratie v Woningstichting Sint Servatius;* cit.; par. 35.

[157] Judgment of the Court (First Chamber) of 1 October 2009; *Minister voor Wonen, Wijken en Integratie v Woningstichting Sint Servatius;* cit.; par. 37.

[158] Judgment of the Court (First Chamber) of 1 October 2009; *Minister voor Wonen, Wijken en Integratie v Woningstichting Sint Servatius;* cit.; par 38.

In conclusion, the Court argues that, to be justified under current art. 65 TFEU, State measures restricting capital movements must be "based on objective, non-discriminatory criteria which are known in advance and which are capable of adequately circumscribing the exercise by the national authorities of their discretion [...]. Since the State measure at issue do not fulfil these requirements the ECJ concludes that they are inconsistent with EU provisions on free movement of capitals.[159]

Consistently with these findings, it would be incompatible with EU law any national legislation which, building upon the assumption that all SWFs might pose threats to national security, provides that SWFs could be subjected to restrictive measures whose exact content and application depends on a discretionary assessment made by domestic authorities on a case by case basis.

As the same Communication of the Commission seems to confirm, SWFs are not to be regarded as a threat, (at least, not only as a threat). EU members therefore should not base the laws and regulations governing foreign investments in their jurisdiction on the assumption that all SWFs always represent without doubt a threat to their national security in a way that member State authorities should be empowered to intervene in any time and with a high degree of flexibility to restrict or prohibit their operations.

In other words, if an EU member desires to introduce legislation with the aim of restricting the investments of SWFs in order to protect national security or other overriding interests, it should state very clearly the circumstances under which an investments of SWFs shall represent a threat to its national security or to its overriding national interests. In this way the SWFs should be put in the condition to know in advance with a certain degree of predictability if the investments they mean to undertake in an EU member will be restricted because of the particular features of the investment itself, or because of the particular sector targeted or because a combination of these motivations.

[159] Judgment of the Court (First Chamber) of 1 October 2009; *Minister voor Wonen, Wijken en Integratie v Woningstichting Sint Servatius;* cit.; par. 39.

Applicable legislation in force in EU members can also provide that an investor, in order to be authorised to purchase a share in a company, must fulfil certain requirements. Failure to fulfil such requirements may entail the prohibition to undertake the investment at issue. For instance, a State can prevent the operations of an investor, be her a domestic or foreign person, if she does not fulfil certain requirements as to the level of capitalisation, resources available, professionalism and respectability of certain managers and controlling shareholders, transparency, management techniques and existence of internal procedures which should ensure that the investor is able to conduct her business fairly and without endangering the interests of a plurality of persons which interact with her, like creditors, workers, minority investors, customers and suppliers.

EU law does not seem to prevent EU members from demanding to a SWF to comply, like any other investor, with requirements laid down in its legislation concerning the aspects listed above. EU law only imposes that requirements investors must fulfil be clearly stated in law where it must be also specified why such requirements are necessary to protect overriding interests of the State or its national security.

One of the reasons why certain SWFs may find it more difficult to comply with these requirements is related to their relative lack of transparency. If, for instance, they fail to disclose information which are necessary for domestic authorities in order to assess whether SWFs, as any other investor, fulfil the conditions to be authorised to purchase a stake in an EU- based company, then the EU host country may decide not to authorise the investment, or even to withdraw authorisation previously granted. It does not seem that SWFs investing in an EU member may take advantage of EU law to circumvent applicable laws of EU members imposing disclosure requirements.

After having discussed the applicability of the derogations for the protection of national security and for other overriding public interests of the host State, some observations must be made concerning the expressed derogations mentioned in art. 65 TFEU.

As it was anticipated above, in tax matters some discriminations between "taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested" are possible, provided that further requirements are met. Such requirements are explicitly laid down in art. 65, especially in par. 3, which provides that "[t]he measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 63". In addition, as already underlined above, the principle of proportionality must apply also in this case.

It may be discussed whether such provision may allow an EU member to tax a foreign SWF in a more burdensome way than other investors, without this might amount to a breach of EU law. Nevertheless this hypothesis would have scarce relevance. In fact, in practise it may occur more often that SWFs are subject to particularly favourable tax conditions, especially when the host State authorities deem that, due to their sovereign nature, they should be entitled to State immunity from taxation.[160] Issues of discrimination inconsistent with EU law could only arise when a State grants immunity from taxation to certain SWFs while it decides to subject other SWFs to ordinary taxation. As it has been studied above in chapter 5 countries like the UK, for the purposes of State immunity tend to treat SWFs constituted as part of Central banks differently from those which are established as investment companies with a separate legal personality. In this case SWFs belonging to the latter category could find they are subject to discrimination and therefore that the rights to which they should be entitled under art. 63 could be breached.

Another exception mentioned at art. 65 which should be stressed is the one concerning possibly restrictive State measures related to "the prudential supervision of financial institutions". In fact, as it has been stressed in the beginning of the present chapter, the majority of the investments of SWFs in the EU concern the banking and financial sectors, which is a particularly sensitive one.

The exception contained at art. 65, while in principle cannot be read as authorizing EU member States to generally restrict SWFs investments in their jurisdiction, on the

[160] This approach has been criticized in the present research. See, *supra*, chapter 5 and, in particular its paragraph 7 for a discussion of the issue of immunity from taxation of SWFs.

country could leave more room to EU members to adopt measures which aim at ensuring proper regulation and supervision of financial and banking sector although they might have restrictive effects on investments, included those of SWFs.

6. Golden shares, protection of strategic sectors and SWFs

SWFs, and the operations they undertake, represent one of the most innovative forms of State intervention in the economy. While State intervention which occurs by means of State ownership in certain undertakings is far from being a new phenomenon, with the creation of SWFs States not only purchase stakes of domestic companies, but they also invest in a large array of *foreign* assets. The element of novelty is therefore represented by the fact that, with the operations of SWFs, States no more limit the sphere of their intervention to their own economy, but they actively intervene in the economies of other States.

When studying the investments of SWFs in the EU, it is useful first of all to investigate the extent to which State intervention in the economy, when it occurs by means of State ownership of controlling or non-controlling stakes in companies, can be consistent with EU law.

To address this issue, it must be remarked that the ECJ has often ruled on cases in which an EU member State owns a stake in domestic undertakings. This can be a different situation than the one in which a foreign SWF invests in a company based in another State. However, the findings of the ECJ contain important elements for a discussion of the general stance of EU law, as it is interpreted by the ECJ, *vis-à-vis* the situation in which a State also acts as an investor as well as on the relation between State ownership and the EU fundamental economic freedoms. It deserves to be investigated whether these findings can be applied, *mutatis mutandis*, on the issue of the investments of SWFs.

First of all, it must be studied whether EU law could be construed in a manner to prevent States or State bodies from purchasing or from maintaining a stake in undertakings. To address this issue, reference must be made to art. 345 TFEU (former art. 295 TEC) which provides that: "[t]he Treaties shall in no way prejudice the rules in Member States governing the system of property ownership."

The provision was drafted having in mind the possibility that EU companies might have been participated by the same State in which they were based, as it often occurred in several EU countries especially until the massive privatisations undertaken in the 1980s and in the 1990s. However, nothing prevents that art. 345 TFEU could be construed in a way to ensure the right of a member State to decide whether to allow participation of other States, be they EU or extra-EU countries, in firms which are based in its jurisdiction. Therefore, art. 345 TFEU must be read so as to allow EU member States to decide whether or not to accept foreign SWFs ownership in the companies under their jurisdiction.

The relation between art. 345 TFEU with other provisions of EU law, and especially of those governing free movement of capitals, is extremely delicate, since incompatibilities and overlapping could occur. In principle, two opposing theories can be considered.

First of all, it could be suggested that art. 345 TFEU must be construed so that to allow member States to derogate the other provisions of EU law. If this interpretation prevails, this would have a relevant impact on the ability of EU members to restrict the investments SWFs may undertake in their jurisdiction. In fact, art. 345 TFEU would allow each member States to simply decide that any asset located on its territory or related to a company based in its jurisdiction cannot be owned by a foreign SWF, irrespective of the limitation this may entail to other rights provided for in EU law.

Alternatively, it could be argued that art. 345 TFEU must be exercised in a manner to ensure the respect of the other provisions of EU law. In this case EU members, in their attempt to restrict ownership of domestic assets by foreign SWFs, would not be entitled to derogate EU provisions on freedom of movement of capitals.

The ECJ has consistently upheld this second theory since the Konle case, in which the ECJ has to assess the consistency with EU provisions concerning the freedom of establishment and the free movement of capital of the Austrian legislation governing the purchase of land.[161] In the course of the proceedings it is invoked by the respondent that EU law (and precisely what has now become art. 345 TFEU) "leaves the Member States in control of the system of property ownership". This entails that Austrian legislation providing for a particular regime of authorizations in relation to the purchase of lands, since it allows EU members (at that time, EC members) to effectively control their system of property ownership, must be in any case authorised by EU law.[162] Nevertheless, the Court dismisses this arguments and it stresses that:"although the system of property ownership continues to be a matter for each Member State under Article 222 of the Treaty, [today art. 345 TFEU], that provision does not have the effect of exempting such a system from the fundamental rules of the Treaty".[163]

The Court has adopted the same approach in several cases concerning the golden share legislation In the Commission v. Portugal case, the ECJ argues that member States are not entitled "to plead their own systems of property ownership, referred to in Article 222 of the Treaty [today art. 345 FEU] by way of justification for obstacles, resulting from privileges attaching to their position as shareholder[s] in a privatised undertaking, to the exercise of the freedoms provided for by the Treaty." In fact, as the Court notes, "that article does not have the effect of exempting the Member States' systems of property ownership from the fundamental rules of the Treaty"[164] The ECJ draws the same conclusions (and adopts the same words) also in Commission v. France,[165] Commission v. Belgium[166] and Commission v. Spain.[167] This principle seems to be so clearly established that in later cases concerning golden shares or, more generally speaking, concerning State measures allegedly

[161] Judgment of the Court of 1 June 1999; *Klaus Konle v Republik Österreich*; cit.; par. 21.
[162] Judgment of the Court of 1 June 1999; *Klaus Konle v Republik Österreich*; cit.; par. 37.
[163] Judgment of the Court of 1 June 1999; *Klaus Konle v Republik Österreich*; cit.; par. 38.
[164] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; cit.; par. 48
[165] Judgment of the Court of 4 June 2002; *Commission of the European Communities v French Republic*; cit.; par. 44.
[166] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Kingdom of Belgium*; cit.; par. 44.
[167] Judgment of the Court of 13 May 2003; *Commission of the European Communities v Kingdom of Spain*; Case C-463/00; European Court reports 2003 Page I-04581, par. 67.

restricting EU fundamental freedoms, the respondents have not invoked art. 345 TFEU in order to justify their failure to comply with EU law.

In the present chapter, domestic legislation concerning golden shares has often been the object of judgements of the ECJ. Since golden shares can prove very useful in order to allow EU members to effectively deals with the challenges and opportunities related to the investments of SWFs, it is necessary to develop a more in depth discussion of this legal instrument. This will make it possible to discuss more in detail the consequences on the ability of EU members to deal with the investments of SWFs which derive from the limits EU law poses to the recourse to golden shares. What is important to understand is whether under EU law States are actually allowed to make recourse to golden shares, at least under certain conditions, or whether EU law prevents States from availing themselves of such instrument in their attempt to better regulate, control, or even forbid, investments of SWFs.

Golden shares are shares which are owned by a State or by its regional articulations and which provide the owners with rights and powers exceeding those that any other shareholder, owning a shareholding of the same size, may enjoy. The term golden shares is often used in a broader sense, so as to include all legal arrangements which ensure that in certain undertakings the State may exercise more powers and rights other than those to which it would have been normally entitled under company law or under the article of association of the undertaking at issue. Domestic legislation providing for golden shares can differ from one State to another. For instance, golden shares may allow the State to cast more votes in the general meeting or to elect more members of the board of a company in a way which is not proportional to the size of its shareholding. Moreover, golden shares could secure some veto powers to the State, including the faculty to prevent certain investors from purchasing a stake in the company at issue or to purchase an amount of shares beyond a certain threshold.

Golden shares are often used by States when they undertake a partial privatization of companies they regard as strategic for the domestic economy or for political reasons. Recourse to golden shares allows States to partially dismiss ownership, while retaining a degree of control which is not proportional to the amount of shares they continue to hold. The objective of the golden shares is therefore to ensure that a State might continue to exercise substantial control over companies whose direction should not be relinquished to other subjects, like foreign investors, especially when they are regarded as not transparent and when they are connected with or even owned by certain States. It follows that golden shares may be used by States to enhance the protection of sensitive companies from possible investments undertaken by "undesired" investors.[168]

In particular, golden shares should prove extremely useful in order to tackle the potential threats that the investments of SWFs (or, *rectius,* the investments of certain SWFs in certain sectors) may pose. In fact, as it has been repeatedly argued in the present research, the investments of SWFs represent at the same time a threat and an opportunity for recipient countries. Therefore, while a general prohibition of them would be a self-defeating strategy, on the contrary it would represent a much more viable option a selective prohibition exclusively of those investments which, because of the home country of the SWF which undertakes them or because of the targeted sector, actually rise justified concerns. If a State owns golden shares in an undertaking, it may be empowered, for instance, to veto investments in that undertaking when they are made by SWFs, or, at least, by those SWFs which do not satisfy certain criteria. Likewise, it could accept SWFs' investments, but it would effectively prevent SWFs from exercising a degree of control over the undertaking at issue which might be proportional to the size of their shareholding.

[168] For a broader discussion on golden shares and their compatibility with EU law according to the ECJ see: V. MICHEL; *Condamnation itérative des Golden Shares*; in *Revue Europe*; 2011; comm. 17; L. C. BACKER; *The Private Law of Public Law;* cit.; p. 1801-1832; J. VAN BEKKUM; cit.; p. 13-19; E. SZYSZCZAK; *Golden shares and market governance*; in *Legal issues of economic integration*; 2002; p. 255-284; L. SALERNO; *Golden Shares, interessi pubblici e modelli societari tra diritto interno e disciplina comunitaria*; in *Diritto del Commercio internazionale*; 2002; p. 671- 704; T. BALLARINO, L. BELLODI; *La Golden Share nel diritto comunitario. A proposito delle recenti sentenze della Corte comunitaria*; in *Rivista delle società*; 2004; p.2-42; S. M. CARBONE; *'Golden share' e fondi sovrani: lo Stato nelle imprese tra libertà comunitarie e diritto statale*; in *Diritto del commercio internazionale*; 2009; p. 503-546; N. RUCCIA; *Le privatizzazioni delle imprese pubbliche ed il rispetto dei principi funzionali alla realizzazione del mercato interno*; in *Diritto Comunitario e degli Scambi Internazionali*; 2009; p. 663-689; S. M. CARBONE; *Investimenti pubblici esteri e libera circolazione dei capitali*; cit.; p. 637-640.

In principle, it could be argued that such a system could rise problems of arbitrariness and lack of decent predictability. On the other side, it could ensure e good level of flexibility, which, also considering the protean nature of SWFs could represent an advantage.

If an attempt is made to apply the legal findings of the case law discussed in the present chapter to the issue of the regulation of the investments of SWFs, it could be concluded that EU law on one side does not bar member States from prohibiting foreign SWFs' ownership of assets located in their territory, but on the other side obliges the same States, when they decide to do so, to respect, *inter alia*, EU provisions of free movement of capitals. Therefore, while EU law does not oblige States to privatise State-owned companies, nevertheless it provides that, once they decide to open a certain sector to the market, then they must do so in a way to ensure the respect of EU law. Once companies are no more owned by the State, States cannot introduce or maintain into force arrangements which prevent or discourage foreign investors, included SWFs, from purchasing a stake in such companies except in the cases EU law authorises restrictions to movements of capitals.[169]

It follows that if an EU country desires to prevent foreign SWFs from purchasing assets located under its jurisdiction it has two options.

First, it must be able to prove that restrictions to the investments of SWFs fall within the scope of art. 64 to 66 TFEU, which provide for exceptions to the general principle of free movement of capital as enshrined in art. 63 TFEU. Alternatively, it must prove that the restrictions at issue are justified by overriding requirements of general interest (non expressed derogations) under the specific conditions which have been detailed out in paragraph 5 of the present chapter.

[169] This concpet was expressed very clearly in: Opinion of Mr Advocate General Poiares Maduro delivered on 7 September 2006; *Federconsumatori and Others (C-463/04) and Associazione Azionariato Diffuso dell'AEM SpA and Others (C-464/04) v Comune di Milano*; Joined cases C-463/04 and C-464/04; European Court reports 2007 Page I-10419; par 26. For further discussion on other relevant legal concepts contained in this opinion see, *infra*.

However, if a State is unable to prove this, it seems that the only way it can prevent certain investors, like SWFs, from purchasing stakes in certain undertakings, consists in achieving and maintaining public ownership of these undertakings. Once an EU State privatises an undertaking, its ability to prevent another State from seizing its control, e. g. by means of investments of its SWFs, is restricted by EU law. Therefore it seems that EU law has brought to the rather unexpected situation that, while the control of EU member States on assets under their jurisdiction has been reduced, on the other hand this has opened the way for an increased control over these same assets by non EU States.[170]

The potential of State ownership to deter investments in State-invested companies has made the object of further discussion in the Conclusions submitted to the Court by Advocate General Maduro in the Federconsumatori case which concerns golden shares owned by the Comune di Milano (i. e. by a local articulation of the State) in the partially privatized company, the AEM SpA (Azienda Elettrica Milanese SpA).

The AG first of all observes that EU member States have the duty to respect EU law not only when they act in the exercise of their public authority, but also when they act as investors. More precisely, Maduro points out that: "the provisions on free movement impose obligations on the national authorities of the Member States, irrespective of whether those authorities act in their capacity as a public authority or as a private entity." This brings the Advocate General to conclude that: "a public body such as the Comune di Milano cannot rely on the argument that its actions are essentially private in nature to avoid the application of the Treaty provisions on free movement."[171]

Then, the AG turns to discuss whether the same participation in a company by a public authority may prove inconsistent with EU law, and more in detail, with current art. 63 TFEU (at the time of the case at issue, art. 56 TEC). In fact, as it is well

[170] S. M. CARBONE; *'Golden share' e fondi sovrani: lo Stato nelle imprese tra libertà comunitarie e diritto statale*; cit.; p. 503-546.

[171] Opinion of Mr Advocate General Poiares Maduro delivered on 7 September 2006; *Federconsumatori and Others (C-463/04) and Associazione Azionariato Diffuso dell'AEM SpA and Others (C-464/04) v Comune di Milano*; cit.; par. 21-22.

established in the case law of the ECJ, a breach of art. 63 TFEU occurs every time a State measure is liable to make investments from other member States less attractive. Therefore if the purchase of a stake in a company by the State or by a State body is liable to dissuade investments from other Member States, then this kind of State intervention in the economy would be inconsistent with EU law.[172]

According to the AG,"[t]he mere fact that a public body owns shares in a company does not reduce the attractiveness of cross‑border investments in that company, as long as investors in other Member States can be sure that the public body concerned will, with a view to maximising its return on investment, respect the normal rules of operation of the market." Therefore, if States or State entities act like any other private investor, i. e. if they are commercially and not politically driven in their investment decisions, then their intervention in the economy by means of investments should not be *per se* inconsistent with EU law.

However, and this represents a very important argument for the purposes of the present analysis, the AG seems to suggest that this might hardly occur in practice. In fact, "as public bodies are subject to local or national mechanisms of political accountability, they are naturally inclined to adjust their conduct in light of the interests of those who are represented within the framework of those mechanisms." In other words, in the view of the AG, public authorities are necessarily politically driven, since their main task does not consists in carrying out investments, but in pursuing public policy goals. This does not exclude their possibility to undertake investments, but such investments should be regarded as instrumental to the achievement of the political objectives they are mandated to pursue. In fact a public investor may be (politically) accountable to other subjects and therefore act in a way different from a non sovereign investor. This would bring it to take investment decision and try to influence the management to take investment decisions which,

[172] Opinion of Mr Advocate General Poiares Maduro delivered on 7 September 2006; *Federconsumatori and Others (C-463/04) and Associazione Azionariato Diffuso dell’AEM SpA and Others (C-464/04) v Comune di Milano*; cit.; par. 23-24.

pursuing public aims, can be inconsistent with and detrimental to the interests of the other investors.

This reasoning could put in question the principle of neutrality of EU law as to the issue of the system of property ownership, which is provided for, *inter alia*, in former art. 295 TEC (today art. 345 TFEU).

The reasoning developed by Maduro has a very important impact on the present research. In fact, once it is deemed that States, when they intervene in the economy, are necessarily politically driven, then there must be a strong assumption that all the investments undertaken by SWFs aim at pursuing political objectives.[173] It must be remarked that this assumption applies both in case of opaque SWFs owned by undemocratic regimes and in case of transparent SWFs owned by democratic countries. Paradoxically, the latter ones risk to be the more politically driven. In fact, a SWF owned by an undemocratic regime is supposed to be less "subject to local or national mechanisms of political accountability" and therefore it could have more possibility to pursue investment strategies whose character is merely commercial. On the contrary, a SWF owned by a democratic country will be subjected to more pressures to act in a manner to pursue the political objectives of the State organs which own and control it and which are politically accountable to the People.

However, the implications of this reasoning are mitigated by the arguments put forward by the same AG in the following part of its conclusions. In fact, in his view, the risk to dissuade foreign investors and therefore to breach EU provisions on free movement of capitals actually rises "when a public body holds shares which give it a privileged position in relation to other shareholders as regards its powers of control in the company concerned". In other words, public ownership of a stake of a company

[173] SWF may pursue political objectives at least in the sense that they are established to pursue monetary and budgetary stabilization, proper management of domestic natural resources and of the reserves of foreign currency. On this point see *supra*: chapter 1 par 2.

would be inconsistent with EU law only so far as it is associated with the existence of golden shares.[174]

The Court, in its judgement, does not develop the reasoning of the AG as to the issue that public authorities, because they are (or, at least, they should be) politically accountable and because they are first of all mandated to pursue political objectives, can hardly behave in the same way as private investors when they undertake investments. It limits its discussion to the fact that the legal provisions, be they contained in law or in other act, which enable a State or a State body to obtain a power of control which is disproportionate to its shareholding in that company are to be regarded as golden shares, and therefore inconsistent with EU law rules concerning the free movement of capitals. [175]

It can be concluded that, in principle, the public ownership of shares by itself is not sufficient to dissuade foreign investors and therefore to result into a restrictions of the free movement of capital.

Only when the public investor is given special powers on the company which go beyond what it would normally enjoy under corporate law and given the size of its shareholding, then this might dissuade other investors.

The priority of EU law is to ensure the proper functioning of the common market. The modification of the existing system of ownership in member State is not an objective of the EU, which is satisfied with the fact that the regime of ownership may not be invoked to jeopardize the common market. The neutrality of EU law in the choice between private or public ownership is further confirmed by the fact that EU law does not provide for a set of rules which create a separate legal regime governing operations undertaken by State owned enterprises or, more generally speaking, to enterprises which are to different degrees participated by public investors. On the contrary, EU law subjects the interactions between member states and public as well

[174] Opinion of Mr Advocate General Poiares Maduro delivered on 7 September 2006; *Federconsumatori and Others (C-463/04) and Associazione Azionariato Diffuso dell'AEM SpA and Others (C-464/04) v Comune di Milano*; cit.; par 25.

[175] Judgment of the Court (First Chamber) of 6 December 2007; *Federconsumatori and Others (C-463/04) and Associazione Azionariato Diffuso dell'AEM SpA and Others (C-464/04) v Comune di Milano*; cit.; par. 22-43.

as private undertakings to essentially the same provisions, for instance those concerning state aids (art. 107 TFEU) and competition (art.101 to 103 TFEU). This approach is expressed very well in art. 106 TFEU which provides that: "[i]n the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in the Treaties, in particular to those rules provided for in Article 18 and Articles 101 to 109." [176]

[176] H. SCHWEITZER; cit.,p. 261-264.

CHAPTER 7.

THE EXTERNAL RELATIONS OF THE EUROPEAN UNION AND THE REGULATION OF SWFS

Introduction

Relevant provisions applicable to the investments in the EU can be found not only in EU law, as it has been studied in chapter 6, but also in those BITs which have been concluded by EU members with other EU members or with third countries.

Currently, EU members are contracting parties to a large number of IIAs and in particular they have concluded more than 1100 BITs.[1]

Economic studies have shown the existence of a positive correlation between FDIs from and to the EU, on one side, and, on the other side, the conclusion of BITs by EU countries with other EU countries and with third countries.[2]

The need to consider the role of BITs when studying the issue of the investments in the EU, and especially of the investments undertaken there by SWFs, is confirmed by the fact that the Commission explicitly refers to BITs when it declares in its communication titled "a common European approach to Sovereign Wealth Funds"[3] that a "combination of WTO and OECD rules, *bilateral and sectoral agreements* [emphasis added] provides a number of international obligations framing what the EU can do" in relation to the investments of SWFs." In the same occasion the Commission stresses that "[t]he EC and its Member States are bound by these obligations when considering measures on investment by SWFs as for measures pertaining to any other investment. At the same time, both the WTO and the EC

[1] P. J. K; *Foreign direct investment: the first test of the Lisbon improvements in the domain of trade policy*; in *Legal issues of Economic Integration*; 2010; p. 262.
[2] S. SARISOY GUERIN; *Do the European Union's bilateral investment treaties matter? The way forward after Lisbon*; CEPS Working Document No. 333/July 2010
[3] See chapter 6 par. 2 of the present research

bilateral agreements foresee exceptions for reasons of public order or of public security, which allow measures to be taken for genuine national security reasons."[4]

If, on one side, the Commission requires member States to govern the issue of the investments of SWFs relying, inter alia, on existing IIAs, on the other side it appears that the wording of EU investment law, which has made the object of the analysis developed in chapter 6, is quite different from the wording of IIAs which have been studied in chapter 4. Therefore, for the purposes of the study of the regulation of investments of SWFs in the EU, it is necessary to investigate the relation between EU law and IIAs to which EU members are contracting parties so that to understand, first, whether IIAs can be construed in a manner to provide more or less rights to SWFs when they invest in the EU and, second, whether EU law can provide member States with more or less instruments to properly govern the issue of investments undertaken in their jurisdictions by SWFs. In other words, it must be studied whether such differences in wording reflect real differences as to the rights and obligations upon the investor and the host State and whether such incompatibilities between IIAs and the EU legal order, when existing, can be properly addressed.

To this purpose, it must be preliminary underlined that the focus of the present analysis shall be on the relation between the EU law and IIAs after the entry into force of the Lisbon Treaty, which, as it will be discussed more in detail, has introduced important, although not very clear, changes in this field. An overarching discussion of the competences of the EU in the field of foreign investments, as well as of their relations with the EU Common Commercial Policy as they were before the entry into force of the Lisbon treaty shall not be undertaken in the present research.[5]

[4] EUROPEAN COMMISSION; *A common European approach to Sovereign Wealth Funds*; cit.; p. 5.

[5] On this issue, and on the complex development of the EU Common Commercial Policy before the entry into force of the Lisbon Treaty, see: J. STEENBERGEN; *The common commercial policy*; in *Common Market Law Review*; 1980; p. 229-249; R. LEAL-ARCAS; *Exclusive or Shared competence in the common commercial policy: from Amsterdam to Nice*; in *Legal Issues of Economic Integration*; 2003; p. 3-14; M. KRAJEWSKI; *External trade law and the Constitution Treaty: Towards a federal and more democratic common commercial policy?*; in *Common Market Law Review*; 2005; p. 91-127; J. CEYSSENS; *Towards a Common Foreign Investment Policy? – Foreign Investment in the European Constitution*; in *Legal Issues of Economic Integration*; 2005; p. 259-291; M. KLAMER, N. MAYDELL; *Lost in exclusivity: implied non-exclusive external competences in community law*; in *European Foreign*

Some references will be made to relevant judgements of the ECJ issued before the entry into force of the Lisbon Treaty and applying provisions of the TEC instead of those of the TFEU. However, this will be made with a view to clarifying the content of current provisions of the TFEU and of the changes they are expected to introduce.

Moreover, it must be pointed out that so far no case concerning an investment undertaken in the EU by a SWF has been brought before arbitral tribunals. Likewise, the ECJ has not dealt with any case concerning the investments of SWFs in the EU. For this reason, it will be necessary to study cases concerning investments undertaken by investors which are not SWFs. In principle, the legal concepts and principles developed in such cases could apply to SWFs as well, also consistently with the approach endorsed by the Commission in its communication titled "a common European approach to Sovereign Wealth Funds".

At the beginning of the present discussion, it is necessary to distinguish between extra-EU BITs and intra-EU BITs. Extra-EU BITs are those currently in force between one EU member and a third country. Intra-EU BITs are BITs currently in force between two EU member States: they can be concluded when all contracting parties are already members of the EU or they can be concluded between EU members and non EU members, the latter ones joining the EU after the conclusion of the BIT at issue. An example of this second case is represented by BITs currently in force between original members of the EU, on one side, and countries, especially of central and Eastern Europe, which joined the EU in relation to the enlargement occurred in 2004 and 2007. These BITs originally were non-intra EU BITs, and

Affairs Review; p. 493-513; F. AKANDJI- KOMBÉ; *La politique commerciale commune*; in A. FENET; ed.; *Droit des rélations exterieures de l'Union Européenne*; Paris; Litec; 2006; p. 155-178; F. VAN BEN BERGHE; *The EC's Common Commercial Policy revisited: what does Lisbon add*?; in *Global Trade and Customs Journal*, 2009; p. 275-279; A. DE MESTRAL; *The Lisbon Treaty and the expansion of EU competence over foreign direct investment and the implications for investor-state arbitration*; in *Yearbook on International Investment Law & Policy* 2009-2010; p. 369-374; T. EILMANSBERGER; *Bilateral investment treaties and EU law;* in *Common Market Law Review* 2009; p. 389-393; A. DIMOPOULOS; *The effects of the Lisbon Treaty on the principles and Objectives of the common Commercial policy*; in *European Foreign Affairs review*; 2010; p. 153-170.

became intra-EU BITs after the accession to the EU of some of the contracting parties.[6]

The distinction between intra-EU and extra-EU BITs has a great importance, since relevant provisions governing the relation between EU law and intra EU BITs are different from those governing the relation between EU law and extra EU BITs, as it will be explained in the following chapters.

As it was explained above, EU countries are recipients of large capital inflows from SWFs, while they essentially do not own any SWF. Therefore, since investments of SWFs in EU countries are undertaken by SWFs owned by third countries, it is necessary to study which are the rules governing investments from third States into EU members. In other words, the focus of the present analysis must be on extra-EU BITs. However, some references to the relation between EU law and intra-EU IIAs needs to be preliminarily made, essentially for the following three reasons.

First of all, some concepts and ideas developed within the framework of the discussion of the relation between EU law and intra-EU IIAs could prove useful to shed more light in the study of the relation between EU law and extra EU BITs. This may occur also because overlapping and inconsistency between specific provisions of EU law and BITs, both on substantive or procedural issues, could occur both in case of intra-EU BITs and extra-EU BITs, the main differences residing in the remedies available under international and EU law to address them. [7]

Secondly, it is possible (although, so far, this does not seem to have occurred in practise) that a third country SWF might establish a subsidiary in an EU country and

[6] Problem of the relation between intra-EU BITs and EU law is made more acute by the accession in the EU of many non-members eastern Europe States with which EU States had already entered into BITs. On this issue see: M. WIERZBOWSKI AND A. GUBRYNOWICZ; *Conflict of norms stemming from intra-EU BIT and EU legal obligations: some remarks on possible solutions*; in VVAA; *International investment law for the 21. century; essays in honour of Christoph Schreuer*; Oxford : Oxford university press, 2009 p. 544; M. POTESTÀ; *Il caso Eastern Sugar: accordi bilaterali sugli investimenti, Unione europea e diritto comunitario*; in *Rivista di diritto internazionale privato e processuale*; 2008; p. 1065-1069; M. POTESTÀ; *Bilateral Investment Treaties and the European Union. Recent Developments in Arbitration and Before the ECJ*; in: *The Law and Practice of International Courts and Tribunals*; 2009; p 230-231; For basic information on the EU enlargements see, for instance: U. DRAETTA; *Elementi di diritto dell'Unione Europea*; 5th ed. Giuffré Editore; 2009; p. 34.

[7] T. EILMANSBERGER; cit.; p. 383-429.

that such subsidiary might in turn invest in other EU countries. Although in this case it is not the third country SWF which is formally undertaking the intra-EU investment, *de facto* the investments at issue rise all the challenges and concerns traditionally related to investments directly undertaken by SWFs. In these cases such investments shall be governed by EU law as well as by intra-EU BITs.

Thirdly, it must be reminded that although massive investments undertaken in the EU by SWFs owned by EU member States seem unlikely for the time being and in the near future [8] a possibility cannot be completely excluded that in the years to come some States which have important surpluses might establish SWFs which might actively invest in the EU.

The entry into force of the Lisbon Treaty has introduced relevant changes in the field of the EU Common Commercial Policy (CCP) which now includes also FDIs. The conferral to the EU of competences in the field of FDIs has brought to the proposal to gradually replace current extra-EU BITs, which are concluded between one member State and one third Country, with BITs concluded between the EU, on one side, with a third country, on the other side (hereinafter referred to as EU BITs). However, it is not clear whether the EU shall have an exclusive competence in entering into such EU BITs or whether it will conclude them acting jointly with its members.

The study of the developments of an EU common investment policy, as well as of the possible options for future EU BITs is extremely important when it is investigated the issue of the regulation of investments undertaken in the EU by SWFs owned by third countries. In fact the adoption of EU BITs could increase the consistency of the legal framework which is applicable also to the investments of SWFs in the EU. The particular nature of SWFs, as well as the particular concerns their operations can rise, makes it even more urgent the need for increased coordination and consistency across investment policies of EU members. Recent and future developments concerning EU BITs could help to achieve this objective. In addition, it could be worth

[8] On the reasons why intra EU investments of SWFs do not represent today a relevant issue *supra* chapter 6 paragraph 4.

investigating whether the new EU BITs could be drafted in a manner to better take into consideration the particular issues raised by the investment of SWFs.

It must be remarked that BITs do not represent the only international instrument applicable to the investments of SWFs. In particular, in recent years efforts have been made by the international community to develop new instruments (in most cases of soft law) which can specifically address to the issue of the investments of SWFs. These instruments will be studied in depths in chapter 8, but what needs to be studied for the purposes of the present chapter is whether the EU has played a role in their elaboration. This would be consistent with the stance of the EU to increasingly become an actor actively engaged in international relations. Finally it must be stressed that the participation of the EU in the activity of international organisations attempting to elaborate sets of principles and standards for SWFs must be meant to be as complementary, rather than alternative to the elaboration of a common investment policy and the elaboration of the EU BIT. For these reasons, it can be interesting to study the way the EU is empowered to participate in the above mentioned activities of international organisations, the contribution it has given or can be expected to give, the way it can pursue its objective my mean of participation in such activities.

Consistently with the above mentioned findings, the present chapter will be organised as follows. Paragraph 1 will develop an analysis of the relationship between the substantive provisions of EU law and of BITs and it will study which are the different rights and duties upon the investors and the host States which are provided for in BITs and in EU law. In this stage of the research the focus will be on the relation between intra-EU BITs and EU law because the analysis will largely rely on the reasoning developed in two recent arbitral awards concerning the application of BITs in force between two EU members.

It will also be studied the impact the problems of compatibility between EU law and BITs may have on the ability of the EU to properly address the issue of SWFs undertaken in the territory of its member States. Finally it will be discussed when acts of the EU could bring to a situation in which an EU breaches a BIT to which it is party thus impairing the rights of a foreign SWF. The legal consequences this may entail will be discussed.

Paragraph 2 will study the relation between extra-EU BITs and EU law, which is of greater interest for the purposes of the present analysis, since in most cases SWFs investing in the EU originate from third countries and therefore the BIT which can apply to them are extra-EU BITs. An attempt will be made to apply the findings of paragraph 1 to extra -EU BITs. It will be explained that the remedies which are available to address possible incompatibilities between extra-EU BITs and EU law are different than those which could be used to address incompatibilities between intra-EU BITs and EU law. In this paragraph the focus will be on three recent judgements of the ECJ which dealt with the incompatibilities between EU law provisions on movement of capitals and provisions on capital transfers contained in BITs in force between an EU member and a third State.

Paragraph 3 will study the impact that the entry into force of the Lisbon Treaty may have on the relation between extra-EU BITs and EU law. It will study the important changes the Lisbon Treaty introduces to the EU Common Commercial Policy which now includes also foreign investments. A discussion will be developed on whether the EU today may have a competence in concluding BITs with third countries and whether this competence should have an exclusive character.

Paragraph 4 will study the stance of the EU Commission vis-à-vis the issue of its competence in relation to the conclusion of extra-EU BITs. To this extent it will undertaken an analysis of two documents recently adopted by the Commission: the Communication titled "towards a comprehensive European international investment policy" and the Proposal for a Regulation establishing transitional arrangements for bilateral investment agreements between Member States and third countries. The impacts that these documents may have on the operations of SWFs in the EU will also be investigated.

Paragraph 5 will discuss whether the EU should adopt a screening mechanism for foreign investments similar to the one already in force in some of its members or in other important recipients of in the capitals of SWFs, like the USA. It will be suggested that such a mechanism, which should be based on cooperation between the Commission and domestic authorities, should pay particular attention on the issue as to whether the foreign investment is undertaken by a private company or by a State entity like a SWF. Moreover, it will be underlined that such mechanism could be modelled on the one which is already applicable to the investments in the electricity and natural gas sectors and which is regulated in directives 2009/72 and 2009/73.

Paragraph 6 will study the manner in which disputes between a foreign SWF and the host State, when the latter is also a member of the EU, shall be settled. It will study the impact that EU law may have on the different kind of arbitral procedures through which the dispute may be settled.

Finally, paragraph 7 will study how the EU has participated in the activity undertaken by international organisation or by other international meetings in order to adopt a mutually agreed set of principles and rules applicable to the operations of SWFs and to the policies that recipient States may adopt in relation to them .

1. The possible incompatibilities between EU law and substantive provisions of BITs. The distinction between intra-EU and extra -EU BITs

In the introductory paragraph it has been explained that, although for the purposes of the present research it is particularly important to focus on the issue of the relation between the extra-EU BITs and EU law, nevertheless some references must be made also to the issue of the relation between EU law and intra-EU BITs.

In fact, in recent years a few awards have been issued, which concern the relation between intra-EU BITs and EU law. The analysis of the reasoning developed in these cases not only by arbitrators, claimants and respondents, but also of other intervening parties, *in primis* the Commission of the EU, provides useful elements for the discussion of the relation between substantive provisions contained in BITs and rules of EU law governing investments. In particular, it is useful to assess whether the different wording of BITs also entails that rights and duties upon investors and host States provided for in BITs are substantially different from those provided for in EU law.

Some of the elements which emerge from this analysis could be used when undertaking the discussion of the relation between EU law and extra-EU BITs, also in disputes concerning SWFs.

In case of intra-EU IIAs, it can be concluded quite easily that, in principle, when their provisions conflict with EU law, the latter shall prevail. This is consistent with the principle of primacy of EU law over domestic law and, as a result, over domestic laws which ratifies agreements to which member States are contracting parties.[9] EU law must take precedence over any other *inter se* regime. If intra-EU IIAs are not compatible with EU law, then EU members which, in order to comply with them, act in a manner inconsistent with EU law, violate, *inter alia*, their obligation to ensure primacy to EU provisions.[10]

This principle has been declared very early by the ECJ in a judgement of 1962 in a dispute between the Commission and the Italian Republic. In that occasion the Court, dealing with the issue of intra- EC trade agreements declared that: "in matters governed by the EEC treaty, that treaty takes precedence over agreements concluded between member States before its entry into force [...].[11]

It must be stressed that art. 351 TFEU (ex art. 307 TEC), which will be studied more in detail in the following pages, safeguards only IIAs (or other international treaties) concluded with one or more third countries before the accession to the EU. Therefore,

[9] A. FENET; *Le primat de l'engagement comunautaire sur les engagements internationaux des Etats membres*; in A. FENET; ed.; *Droit des rélations exterieures de l'Union Européenne*; Paris; Litec 2006; p. 128-129.

[10] The issue of the primacy of EU law have been broadly discussed in literature ad several judgments of the ECJ has stressed its importance. For an overview on this issue see for instance: U. DRAETTA; cit.; p. 295-301; L. DANIELE; *Diritto dell'Unione Europea*; 4th. ed.; Milano; Giuffré; 2010; p. 260-268; M. HORSPOOL, M. HUMPHREYS; *European Union Law*; Oxford; Oxford University Press; 2008; p. 179-204.

[11] Judgment of the Court of 27 February 1962. *Commission of the European Economic Community v Italian Republic*.
Case 10/61 European Court reports; page 1, par. 23.

it cannot apply to intra-EU BITs, since they are not (or they are no more) concluded between an EU member and a third country.[12]

For the principle of primacy of EU law to apply in case of intra-EU BITs, both of the two following conditions must be met. Firstly, a provision of an intra-EU BIT exists, which governs the same subject-matter which is regulated by a provision of EU law. Secondly, inconsistency between the two provisions at issue must be assessed.

Two arbitral awards in the Eastern Sugar[13] and Eureko[14] cases, help to shed more light on this issue (which at the time of the dispute already concerned intra-EU BITs[15]). It must be stressed that they do not attempt to settle the dispute from the point of view of EU law; on the contrary they are mandated to apply international law and in particular the provisions of relevant BITs. Also for this reason, they do not focus on the issue of primacy of EU law but on whether the latter should have prevailed over previous BITs according to the principle of public international law *lex posterior derogat priori* enshrined in art. 59 of the Vienna Convention of the Law of the Treaties of 1969 (VCLT).[16]

However, these awards are important for two reasons. Firstly, because of the discussion they develop as to whether BITs concluded by the Netherlands with the Czech Republic and the Slovak Republic respectively, should be deemed as

[12] A. DIMOPOULOS; *The validity and applicability of international investment agreements between EU member States under EU and international law*; in *Common Market Law Review*; 2011; p. 69-70; T. EILMANSBERGER; cit.; p. 398 and p. 421; F. S. BENYON; cit.; p. 105-110.

[13] *Eastern Sugar B. V. v. the Czech Republic*; UNCITRAL partial award of 27 March 2007.

[14] *Eureko B. V. v. the Slovak Republic*; UNCITRAL award on jurisdiction of 26 October 2010.

[15] It must be noted that when these disputes before arbitral tribunals started, the applicable BITs were intra-EU BITs, because of the recent accession to the EU of the two respondent States. more in detail, in the Eastern Sugar case the investor filed its notice of arbitration in June 2004, while the Czech Republic acceded the EU in May 2004. (see: *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 14-15). The Eureko case the dispute began in 2008, i. e. after the accession of the Slovak republic to EU which took place in 2004. (see *Eureko B. V. v. the Slovak Republic*; cit.; par. 10 seq.)

[16] Art. 59 of the VCLT reads as follows:
"1. A treaty shall be considered as terminated if all the parties to it conclude a later treaty relating to the same subject matter and:
(a) it appears from the later treaty or is otherwise established that the parties intended that the matter should be governed by that treaty; or
(b) the provisions of the later treaty are so far incompatible with those of the earlier one that the two treaties are not capable of being applied at the same time.
2. The earlier treaty shall be considered as only suspended in operation if it appears from the later treaty or is otherwise established that such was the intention of the parties."

covering the same subject matters which are also covered by EU law. Secondly, because they provide insight as to whether incompatibility exists between the provisions of BITs and of EU law.[17] In fact, if the EU and BITs cover the same subject matters but also govern them in the same way, i. e. if they provide for the same rights and obligations, in principle no problem of incompatibility should arise. On the contrary, a problem may arise when they provide for conflicting rights and obligations in relation to the same matters.[18]

If such rights which are provided for in EU law and in BITs are not in conflict but if they are simply different, in the sense that in some cases EU law offers higher protection to the investor or *vice versa*, this in principle should not entail incompatibility.[19] True, investors could undertake a sort of forum shopping, choosing on a case by case basis whether to invoke provisions of IIAs or of EU law depending on whether which of them can provide for better standards of treatment and higher levels of protection. The EU legal order should not be construed as prohibiting EU nationals from benefiting from rights that other instruments of international law or even municipal law provisions confer to them and which do not exist in EU law, provided that this does not result into a breach of other specific provisions of EU law. [20]

A distinction should be made between the case in which only some provisions of two treaties govern the same issues and the case in which there are two treaties whose subject matter and whose contracting parties are the same.

In this second case, if EU law governs exactly the same issues governed by BITs concluded before the entry into force of EU treaties, then, also consistently with art.

[17] Under this point of view however arbitrators themselves wanted to emphasizes in the Eastern Sugar case that their aim was to settle the specific case at issue, taking into consideration all its peculiarities, and not to provide general principles on the relation between BITs and EU law. (see. *Eureko B. V. v. the Slovak Republic*; cit.; par. 217-219).

[18] A. DIMOPOULOS; *The validity and applicability of international investment agreements between EU member States under EU and international law*; cit.; p. 74.

[19] C. SODERLUND; *Intra-EU BIT investment protection and the EC treaty*; in *Journal of International Arbitration*; 2007; p. 455-468.

[20] A. DIMOPOULOS; *The validity and applicability of international investment agreements between EU member States under EU and international law*; cit.; p. 73- 78; F. S. BENYON; cit.; p. 106-107.

59 VCLT, the TEU and the TFEU would implicitly abrogate BITs between EU member States,[21] or at least, would make them not applicable irrespective of whether they could be regarded as automatically terminated.[22] This is the position of the respondents both in the Eastern Sugar and in the Eureko case. Nevertheless, in both cases the tribunals find that EU law and BITs provisions could overlap only in limited cases. Therefore, it cannot be concluded that EU law and BITs govern exactly the same issues. As a result, EU Treaties which entered into force later than the BITs in the Czech Republic and in the Slovak Republic, do not implicitly terminate the two BITs at issue.

A more in depth description of the relevant parts of the eastern Sugar and Eureko cases will allow a better understanding of these concepts.

In the Eastern Sugar case the Czech Republic argues that "the BIT and the EU rules are competing legal frameworks addressing the same subject matter (i. e. the faculty of a party to invest assets on the territory of another State, and to freely dispose of the revenues)".[23]

The EU Commission, which presents its observations,[24] underlines that, since the accession of the Czech Republic in the EU, EU law must "automatically prevail" over any incompatible agreement the Czech Republic concluded with another EU country. The Commission find that the main risk of incompatibility rises in relation to the fact that BITs allow investors to initiate arbitral proceedings against the host State, while EU law does not. For this reason it argues that "in order to avoid any legal problem with regard to an arbitration procedure, existing BITs between member States should

[21] T. EILMANSBERGER; cit.; p. 424-426.

[22] M. BURGSTALLER; *European Law and Investment Treaties*; in *Journal of International Arbitration*; 2009; p.185.

[23] *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 101. See also: M. POTESTÀ; *Il caso Eastern Sugar: accordi bilaterali sugli investimenti, Unione europea e diritto comunitario*; cit.; p. 1056.

[24] The Arbitral Tribunal stressed nonetheless that such observations were not binding upon the tribunal but they "would at best have a persuasive force". See: *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 120 -124 and, in particular, par. 125. For a comment on the content of the observations of the Commission see: M. POTESTÀ; *Il caso Eastern Sugar: accordi bilaterali sugli investimenti, Unione europea e diritto comunitario*; cit.; p. 1057-1059; M. POTESTÀ; *Bilateral Investment Treaties and the European Union. Recent Developments in Arbitration and Before the ECJ*; cit.; p 229-230.

[...] be terminated". However, it clarifies that "the formal termination can only be done according to the provisions of the agreement in question".[25]

The same fact that, according to the Commission, member States which are parties to intra-EU BITs which in turn rise issues of incompatibilities with EU law, are required to undertake all the necessary steps to put an end to these incompatibilities, means that such BITs are not implicitly derogated by the entry into force of EU law.

Termination of any incompatible BIT should be carried out consistently with the procedure laid down at art. 65 of the Vienna Convention on the Law of treaties of 1969 (VCLT) or, where existing, according to the provisions governing the termination of the BIT which are contained in the text of the BIT itself.[26]

This concept seems confirmed in another note presented by the Commission in the Eastern Sugar case,[27] where it is stressed that although most of the content of intra-EU BITs "is superseded by Community law upon accession of the respective member state", some possible inconsistencies between EU law and such BITs may remain, especially since the latter provides for recourse to international arbitration, which seems to provide particular advantages to the foreign investor and in relation to which EU law could be hardly deemed to provide for similar and equally favourable remedies.[28] The main risk, according to the Commission, is that "arbitration instances, possibly located outside the EU, proceed with investor-to-state dispute settlement procedures without taking into account that most of the provisions of such BITs have been replaced by provisions of Community law".[29] The solution proposed by the Commission in the document at issue is the following one: EU members should

[25] *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 119, which entirely reproduces the Letter of the Commission of January 13, 2006. See also: T. EILMANSBERGER; cit.; p. 401.

[26] This last possibility is clearly envisaged in par. 4 of art. 65 VCLT, which states that: "Nothing in the foregoing paragraphs shall affect the rights or obligations of the parties under any provisions in force binding the parties with regard to the settlement of disputes."

[27] EC note of November 2006 on free movement of capital. Quoted in *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 126.

[28] On the fact that international investment arbitration may be a preferred option than domestic Courts also for EU investors see, for instance: A. RADU; cit.; p. 243.

[29] For a more detailed analysis of this last aspect see, *infra*, paragraph 6 of the present chapter.

"exchange notes to the effect that " intra-EU BITs "are no longer applicable, and also formally rescind such agreements".

The arbitral tribunal, therefore, "does not found that the Note of the European Commission supports the view that the intra-EU BITs are *automatically* superseded".[30] The tribunal fails to detail out the reasoning which lead it to adopt this conclusion, which however seems to be the correct one. In fact, if the Commission stresses the need for formal steps of EU members to rescind the BITs at issue, this means that, also in its opinion, they are not automatically terminated. Moreover, they cannot be merely disapplied in their entirety without undertaking an analysis of the compatibility with EU law of each single BIT provision whose application is required for the settlement of the dispute at issue. On the contrary, it seems that according to the Commission there would be only an obligation to disapply the specific BIT provisions which are inconsistent with EU law. In any case, it must be recalled that, while the existence of a duty to disapply rules incompatible with EU law is acknowledged by municipal Courts of EU members, it could be more debatable whether this duty applies also to arbitral tribunals settling investor-State disputes.

Finally, the same fact that the Tribunal undertakes a review of the issue of the incompatibility of EU law provisions with BIT provisions is a proof of its convincement that the BITs and the EU law have not the same scope. Had the Tribunal estimated that, as the respondent argued, BITs and EU law covered exactly the same subject matter, then the entry into force of the EU law would have entailed the automatic termination of the BITs and no need would have arisen to assess which of the provisions of the two legal orders were incompatible.

In the Eastern Sugar case, the Arbitral Tribunal finds that "the BIT and the EU Treaty are not incompatible".[31] In particular, the provisions contained in EU law and governing movement of capitals, on one side, and on the other side, the provisions

[30] *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 128.
On the complex issue of the renegotiation and termination of BITs and on the fact that, until they are formally in force arbitral tribunals could hardly disapply them see: M. POTESTÀ; *Il caso Eastern Sugar: accordi bilaterali sugli investimenti, Unione europea e diritto comunitario*; cit.; p. 1063-1064; M. BURGSTALLER; cit.; p.187; C. SODERLUND; cit.; p. 463-465.

[31] *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 168.

on the protection of investments contained in BITs "are different but complementary things".[32] The fact that they do not govern exactly the same issues and that, in any case, do not create upon investors incompatible rights, precludes the possibility to hold that BITs and EU law are entirely incompatible. As a result, this prevents EU law from automatically superseding intra-EU BITs.[33]

A more in depth analysis of the relation of EU law and provisions of BITs has been carried out in a later award, in the Eureko case. In an attempt to challenge the jurisdiction of the arbitral tribunal, the respondent argues that "the BIT and the EC Treaty relate to the same subject matter because they cover the same types of investors and investments, serve the same purposes, offer the same standards of protection, and provide for equivalent remedies"[34] Therefore, according to the Slovak Republic, the BIT should have been implicitly derogated by the entry into force of the TEU and of the TFEU also consistently with the above mentioned art. 59 VCLT.

The respondent, in particular, provides the tribunal with a summary of its submissions on the equivalence between the provisions of the BIT and the provisions of the EC Treaty. In detail, it states that the fair and equitable treatment clause (contained in art. 3,1 of the BIT) is equivalent to art. 12 TEC (today art. 18 TFEU) which provides a general prohibition not to discriminate between EU nationals. Moreover, in the view of the respondent, provisions concerning full security and protection as well as the issue of indirect expropriation, which are governed respectively by art. 3,2 and art. 5 of the relevant BIT, are equivalent to art. 43 TEC (today art. 49 TFEU). Moreover, in the view of the Slovak Republic, art. 4 of the BIT, which deals with the transfer of capital made in connection with the investment, is equivalent to art. 56 TEC (today art. 63 TFEU) on the free movement of capitals from and to EU countries. Finally, it suggests that even the arbitration clause laid down at art. 8 BIT provides the

[32] *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 169.
[33] *Eastern Sugar B. V. v. the Czech Republic*; cit.; par. 170 -172.
[34] *Eureko B. V. v. the Slovak Republic*; cit.; par. 65.

investors with the same rights as EU law, because under EU law investors are allowed to file damage claims against the host States before national courts.[35]

The Tribunal correctly dismisses all these arguments. First of all, it does not share the view that "the protection afforded by the BIT provision on fair and equitable treatment is entirely covered by a prohibition on discrimination." The Tribunal does not believe that the principle of fair and equitable treatment to be accorded to foreign investors is yet established in EU law". In fact, non discrimination is only an aspect of the fair and equitable treatment which, especially in the light of the interpretation it has been given by arbitral tribunals in investor-state disputes, must be construed in a much broader way and in a manner to encompass a larger array of acts and conducts of the host State which adversely affect the foreign investor.[36] For instance, as the tribunal argues, a conduct of the host State which is not discriminatory, i. e. which is applied to domestic and foreign investors both, can nonetheless be unfair.[37]

The tribunal also rejects the alleged equivalence between the BIT provision on full protection and security on one side and EU provisions on freedom of establishment on the other side. In particular, it argues that "the right to full protection and security subsists for as long as the investment remains in place, no matter how long after it has been established and no matter whether or not the treatment complained of is discriminatory. While the freedom of establishment under EU law entails various ancillary rights, the Tribunal does not consider that those rights cover the entire ground that the right to full protection and security might be said to cover".[38]

Also the submission that EU law concerning freedom of establishment covers the same subject matters of BIT provisions on expropriation is rejected.[39] The tribunal, in fact, also considering the main trends of case-law in investor-State disputes on

[35] *Eureko B. V. v. the Slovak Republic*; cit.; par. 247.

[36] On the content of the fair and equitable treatment standard see, *supra*, chapter 4 paragraph 6.

[37] *Eureko B. V. v. the Slovak Republic*; cit.; par. 250-258.

[38] *Eureko B. V. v. the Slovak Republic*; cit.; par. 260.

[39] For a further discussion on the relation between the clause of BITs concerning expropriation and EU provisions on establishment see: A. DE LUCA; *Potenziali conflitti tra giurisdizione comunitaria e istanze arbitrali istituite sulla base di accordi di promozione e protezione degli investimenti; quali possibili soluzioni*? in VVAA; *La funzione giurisdizionale nell'ordinamento internazionale e nell'ordinamento comunitario*; Napoli; Edizioni Scientifiche Italiane; 2010; p. 121.

indirect takings and the fact that the notion of protected investments is usually meant very broadly, concludes that the protection from indirect expropriation afforded by BITs is greater (and broader in scope) than the one afforded by EU law.[40]

Finally, the tribunal underlines that recourse to domestic courts of EU members for a claim for damages cannot be equated to the recourse to international arbitration to which foreign investors are entitled under BITs. In fact, some of the features of international arbitration which make it particularly attractive in case of disputes between the host State and the foreign investor, consist in that arbitration is a consensual mean of dispute settlement, which takes place in a neutral place and with a neutral appointing authority, under a well-established set of rules adopted by the UNCITRAL or agreed by States which entered into the ICSID convention. For this reason investor-State arbitration "cannot be equated simply with the legal right to bring legal proceedings before the national courts of the host state".[41]

In the light of the foregoing discussion, the Tribunal concludes that EU law and BITs constitute two separate legal orders. It argues that "EU law does not provide substantive rights for investors that extend as far as those provided by the BIT." It then specified that: "[t]here are rights that may be asserted under the BIT that are not secured by EU law." For these reasons, "it cannot be said that it is implicit in the text of the EC Treaties that Respondent and the Netherlands intended that it should supplant the BIT."[42] In addition, the Eureko Tribunal denies that "the provisions of the BIT are incompatible with EU law." In fact, "[t]he rights to fair and equitable treatment, to full protection and security, and to protection against expropriation at least, extend beyond the protections afforded by EU law; and there is no reason why those rights should not be fulfilled and upheld in addition to the rights protected by EU law."[43]

From the discussion of the Eastern Sugar and the Eureko cases, it emerges that arbitral tribunals have quite consistently stated that EU law and international

[40] *Eureko B. V. v. the Slovak Republic*; cit.; par.261.
[41] *Eureko B. V. v. the Slovak Republic*; cit.; par.264.
[42] *Eureko B. V. v. the Slovak Republic*; cit.; par. 262.
[43] *Eureko B. V. v. the Slovak Republic*; cit.; par. 263.

investment law are two complementary but separate legal systems.[44] More precisely: "EU law and intra-EU IIAs create two separate legal frameworks, which however do not operate in distinctly different areas of law, thus avoiding potential conflicts."[45]

Some of the issues addressed by the arbitral tribunals when they discussed the relation between the content of EU law and of BIT provisions should nonetheless be investigated more in depth. In fact, while the tribunals in the two above mentioned cases conclude that no complete incompatibility between EU law and BITs can be assessed, on the contrary some commentators have argued that there are circumstances in which the European legal order and international investment law can overlap and can provide for conflicting rights and obligations upon interested parties.

For instance, it has been argued that EU law provisions on freedom of establishment prevent States from restricting admission in their territory of investments from other EU nationals (and to EU nationals only), while no similar obligation can be found in BITs concluded by EU members, which do not provide for rights upon the investor which concern the pre-entry phase.[46] However, it does not seem that this might constitute a problem in the relations between EU law and BITs. Simply, in this case foreign investors from an EU State will enjoy under EU law more rights than they would have enjoyed under BITs.

An issue which deserves more attention is that, although EU law does not contain any rule explicitly providing for fair and equitable treatment and on indirect expropriation (regulatory takings), some principles have however developed in the EU case law, which have been consistently regarded as mandatory and which have

[44] M. WIERZBOWSKI AND A. GUBRYNOWICZ; cit.; p. 545.

[45] A. DIMOPOULOS; *The validity and applicability of international investment agreements between EU member States under EU and international law*; cit.; 2011; p. 64.

[46] M. WIERZBOWSKI AND A. GUBRYNOWICZ; cit., p. 547. In particular art. 63 TFEU provides for entry rights to foreign investors, in relation to issues concerning capital movements, not only when foreign investors are EU nationals, but also when they originate from third countries. This aspect will be studied more in depth in the next paragraphs, when the issue of extra- EU BITs shall be investigated. However, in this context it is sufficient to underline that usually BITs concluded by EU countries (both with other EU countries or with third States), do not provide for the right upon foreign investors to have their capitals admitted in an unrestricted way in other EU countries. On this aspect see: T. EILMANSBERGER; cit.; p. 399.

often been considered to assess, inter alia, the legitimacy of the acts adopted by the EU institutions as well as of member States. Such principles include, for instance, transparency, rule of law, respect of the legitimate expectations, proportionality etc... Their content, and the interpretation they have been given by the ECJ, is not identical to the interpretation of the fair and equitable and of the issue of indirect expropriation made by arbitral tribunals in investor-State disputes. However, it cannot be denied the existence of similarities or even overlaps between them.[47] In any case, this only proves that the tribunals in the Eastern Sugar and Eureko case may have underestimated the potential for overlapping between EU law and BITs, but it does not imply the existence of important incompatibilities. In fact, if Bits' fair and equitable treatment clause is able to provide for more rights upon the investors than EU law, then the investor should be entitled to enjoy from these additional right, without this might imply, in principle, a violation of EU law.

More serious problems could rise in the specific case in which EU law imposes on EU members to terminate State measures which provide a foreign investor with particular rights or benefits. In fact, this could give rise to a claim of the investor that the fair and equitable treatment clause contained in the IIA has been violated. When this implies a complete destruction of the value of the investment of the foreigner, the latter can even claim that her assets have been subjected to indirect expropriation. It must be stressed that in this case indirect expropriation or violation of the fair and equitable treatment are more likely to be assessed when the host State has previously and consistently guaranteed that the benefits granted to the investors would have been maintained and when the investor acting in good faith relied on this promises when it chose to undertake the investment or any important operation connected with such investment.[48] In practise, this can occur if EU law on subsidies

[47] M. WIERZBOWSKI AND A. GUBRYNOWICZ; cit.; p. 549.

[48] In other words, the frustration by the host State of the legitimate expectations of the investors, when such frustration is the consequence also of its obligation to abide by EU rules, is an element to be taken into consideration when assessing the existence of the violation of BITs provisions on indirect expropriation and on fair and equitable treatment. For an analysis of the relation between fair and equitable treatment clause, indirect expropriation and frustration of legitimate expectations of the investors see, *supra*, chapter 4 paragraph 6 and 7 of this research.

(art. 107 TFEU) or EU competition law (art. 101-102 TFEU) or other EU policies for instance on agriculture, obliges a member States to withdraw certain measures it has previously adopted and which, for instance, constituted an incentive to attract the foreign investment. In particular, if such State measures were regarded by the foreign investor as extremely important and if they had a fundamental impact in its decision to invest in that EU country in a way that the investor relied on the maintenance of such measures when she estimated the future profitability of her investment, withdrawal of such measure could be regarded as tantamount to frustration of legitimate expectations of the investor. When this is combined with severe losses suffered by the investor, this could provide evidence of the existence of a violation of the fair and equitable treatment clause or of indirect expropriation.[49] A similar problem rises in the Micula case,[50] when the claimant argues that partial withdrawal by Romania of certain investment incentives it previously granted, adversely affects the business operations of the foreign investors and is in breach of the provisions of the applicable BIT. Romania stresses that the withdrawal of the incentives at issue is the consequence of its obligation under EU law. Exemptions from custom duties and taxes, which were part of the above mentioned incentive scheme, would have risked to be regarded as State aid under art. 87 TEC (today art. 107 TFEU) and thus incompatible with EU law. Therefore, it would have been impossible to reintroduce the incentive scheme whose withdrawal damaged the investor. Therefore, Romania argues that, given these elements, it is not under an obligation to pay compensation to the foreign investor. The analysis of the tribunal in the award on jurisdiction does not deal with these arguments, which are more likely to be discussed in the award on the merits which is still to come.[51] Therefore, so far, no decision of arbitral tribunal has been reported, which might shed more light on these aspects.

[49] A. Radu; cit.; p. 256; A. De Luca; *Potenziali conflitti tra giurisdizione comunitaria e istanze arbitrali istituite sulla base di accordi di promozione e protezione degli investimenti; quali possibili soluzioni*?; cit.; p. 121-122.

[50] *Ioan Micula, Viorel Micula, S.C. European Food S.A, S.C. Starmill S.R.L. and S.C. Multipack S.R.L. v. Romania*; ICSID Case No. ARB/05/20; Decision on Jurisdiction and Admissibility of 24 September 2008.

[51] M. Burgstaller; cit.; p.194 -195.

An arbitral tribunal may nonetheless find that the investor could have possibly foreseen that the State in which it was investing would have been obliged by EU law to adopt measures which might have deprived the investor of certain rights or privileges on which it previously relied in its investment decisions.[52] In this case it could be argued that the expectations of the investors are no more so legitimate and therefore that their frustration does not entail a breach of the FET standard.[53] The Saluka case seems to confirm these findings. The Tribunal, in order to assess whether some regulatory changes in the banking sector which adversely affected the foreign investor, could be regarded as inconsistent with the applicable BIT, and especially with the fair and equitable treatment clause, has to investigate whether they occurred in a way to frustrate the legitimate expectations of the foreign investor. This implies, *inter alia*, an assessment of the legitimacy and reasonableness of these expectations. The Tribunal argues that regulatory changes in the banking industry, which were undertaken also in order to bring the Czech regulatory regime in line with EU law in the view of the accession to the EU, should have been expected by the respondent when it started its investment.[54]

The "temporal aspects" have therefore a great importance, although only in intra EU-IIAs. In fact, if certain investment incentives granted to the foreign investor are adopted or implemented in breach of EU law when the latter is already in force, then they are illegal and therefore they are not covered by IIAs. Foreign investors cannot rely on these investment incentives, also because they are expected to familiarise with EU law when they invest in EU countries. Since EU law forms part of the legal order of EU members, a foreign investor must be sure that its activities comply with

[52] T. EILMANSBERGER; cit.; p. 415-417.

[53] On the fact that the fair and equitable treatment clause is violated only when investor's expectation which are frustrated are legitimate expectations see *supra*, chapter IV paragraph 6.

[54] *Saluka Investments BV (The Netherlands) v. The Czech Republic*; cit; par. 350-358. See, in particular par. 358 which provides that: "Nomura [the claimant] was, therefore, not justified to expect that the CNB would not introduce a more rigid system of prudential regulation and thereby change the framework for Nomura's investment in IPB shares". See also: M. BURGSTALLER; cit.; p. 193-194.

EU law as well. Therefore, it cannot be regarded as a legitimate expectation the reliance on host State measures in breach of EU law. [55]

The situation in which an incentive scheme has been illegally adopted by the host State (in the sense that incompatible provisions of EU law existed before its adoption) is different from the situation in which a similar incentive scheme has become incompatible with EU law later, i. e. as a result of the entry into force of new provisions of EU law inconsistent with the subsidies scheme at issue. In fact, in this second case the situation is more blurred.

In this case some authors suggest that it should be applied, *mutatis mutandis*, the doctrine which developed out of the discussion of relevant case law of the European Court of Human rights. Pursuant to this approach, member States remain responsible for acts of an international organization which are adopted in the exercise of those powers which have been granted to it by the same member States.[56] This would imply that if the EU law obliges a member State to terminate a subsidy scheme in a way resulting into a breach of an applicable IIA, the adversely affected investor may start legal proceeding against the host State and she may be awarded a compensation by the arbitral tribunal competent to adjudicate upon the dispute at issue. It could be argued that the same payment of a compensation could be regarded as tantamount to a subsidy and therefore EU law could be even construed as preventing it.[57]

These findings are important for the purposes of the present analysis for the following reasons.

So far, instruments adopted by the EU do not contain neither binding nor restrictive provisions on SWFs. Therefore, member States which desire to attract the

[55] T. EILMANSBERGER; cit.; p. 418-419.

[56] T. EILMANSBERGER; cit.; p. 418-419. For a broader discussion on this topic see: J. M. SOBRINO HEREDIA; *La articulación de la responsabilidad internacional entre la Unión Europea y sus estados miembros a la luz del Art. 300,7 CE*; in VV AA; *Derecho internacional público y derecho comunitario y de la Unión Europea; obra homenaje al profesor Julio D. Gonzales Campos*; Madrid; Editer; 2005; p. 1061-1080 and A. PÉREZ GIRALDA; *Relaciones entre derecho internacional y comunitario en materia de tratados*; VV AA; *Derecho internacional público y derecho comunitario y de la Unión Europea; obra homenaje al profesor Julio D. Gonzales Campos*; Madrid; Editer; 2005; p. 1041-1060.

[57] T. EILMANSBERGER; cit.; p. 422-424.

investments of SWFs might adopt certain incentives to favour their investments. If in a second stage the EU decides to adopt legally binding provisions which, for instance, forbid certain incentives member States have granted to SWFs, the latter would be required to withdraw them. In this case SWFs could claim that a violation of the FET clause has occurred and they could claim for a compensation. On the contrary if the same incentives are granted after the adoption of EU provisions with which they are inconsistent, then frustration of legitimate expectations of the SWF is unlikely to occur.

A more specific case of frustration of legitimate expectations, which concerns in detail SWFs, can rise in the particular circumstances in which a SWF relies in its investment decisions on official statements of the EU institutions and then when the EU member States or the EU institutions themselves adopt acts which run against such statements. For instance, if the SWF legitimately relies on the Communication of the Commission "A common European approach to Sovereign Wealth Funds" and if the EU or its members later adopt acts inconsistent with the principles laid down in this official document, the SWF could claim that its legitimate expectations have been frustrated. For instance, it emerged from the reading of the above mentioned Communication that EU institutions have in general a welcoming stance *vis-à-vis* the investments of SWFs and that they pledge for applying to these State-owned investment vehicles the same rules currently applicable to any other investor.[58] In can be argued that a sudden and unexpected change of this attitude, which brings to the adoption in EU countries of a set of special and restrictive measures against SWFs, should frustrate the legitimate expectation of those SWFs which, given the content of the Communication, have already undertaken their investments in the EU relying on the fact that the EU environment would have remained open to their investments.

Another EU provision which can be taken into consideration when assessing the issue of expropriation in the EU is current art. 345 TFEU (former art. 295 TEC), which

[58] See, *supra,* chapter 6 paragraph 2

provides that the TEU and the TFEU "shall in no way prejudice the rules in Member States governing the system of property ownership."

Prima facie, this article could be read as allowing EU member States to undertake privatizations, expropriations and nationalizations in order to govern the issue of property in their territory and to determine which assets shall be owned by the State or by other public entities, in order to allow the State to pursue its own economic, social and political goals. Such an interpretation of art. 245 TFEU might result into a waiver of BITs provisions concerning expropriation.

However, as it has been previously explained,[59] the ECJ has consistently declared that art. 295 TFEU cannot be construed in a manner to allow States to waive provisions of EU law like those concerning freedom of establishment and free movement of capitals. In other words, the rights member States derive from art. 345 TFEU must be always exercised in a manner consistent with the other provisions of the TEU and the TFEU. Even though the issue of the limits to the applicability to art. 345 TFEU has been discussed in cases concerning the application of EU provisions on free movement of capitals and freedom of establishment, there is no element suggesting that the same interpretative principle could not apply also to address the relation between art. 345 TFEU and art. 207 TFEU (and the measures governing foreign investments that the EU is empowered to adopt pursuant to such article).[60]

Another aspect of the relation between EU law and BITs which deserves attention is the issue of non discrimination. For instance, in the Eastern Sugar case the respondent argues that, if the entry into force of EU treaties had not automatically repealed the BIT between the Czech Republic and the Netherlands, the maintenance of the BIT would have entailed discriminations between EU nationals. In particular, discrimination would have occurred between nationals of States which have concluded BITs and nationals of States which have not. Since the principle of non discrimination between EU nationals is enshrined in EU law and explicitly provided

[59] See, *supra*, chapter 6 paragraph 6

[60] P. J. K cit.; p.. 269-270.

for in art. 12 of the EC Treaty (today art. 18 TFEU) the maintenance into force of the BIT itself would be inconsistent with EU law.[61]

This risk rise as far as BITs lay down more rights upon the investors than EU law.[62] In this case, even if BITs contain a regional economic integration organisation (REIO) clause, this can provide little help. In fact, REIO clauses are designed to prevent the automatic extension to third country nationals, by mean of the MFN clause contained in BITs, of all benefits and rights to which only persons from States belonging to a regional economic integration organisation are entitled.[63] However, in the present

[61] *Eastern Sugar B. V. v. the Czech Republic*; cit.; cit.; par. 105-108. On the principle of non discrimination in EU (and previously EC) law see: C. W. A. TIMMERMANS; *The basic principles*; in P. J. G. KAPTEYN, A. M. MCDONNEL, K. J. M. MORTELMANS, C. W. A TIMMERMANS, L. A. GEELHOED; ed.; *The law of the European union and the European Communities*; Kluwer Law International; 2008; p. 157-166.

[62] Some authors deny that this might occur, thus supporting the view that BITs do not provide added value to investors than EU law. On this argument see: M. POTESTÀ; *Il caso Eastern Sugar: accordi bilaterali sugli investimenti, Unione europea e diritto comunitario*; cit.; p. 1060; M. POTESTÀ; *Bilateral Investment Treaties and the European Union. Recent Developments in Arbitration and Before the ECJ*; cit.; p 232. However, in the present chapter it will be endorsed the opposite argument, i. e. that BITs and EU, while provide for similar rights and duties in some cases, actually represent two separate and different legal orders, which implies, *inter alia*, that some of the rights provided for in BITs are not provided for in EU law (e. g., recourse to international arbitration; see *infra* paragraph 6 of the present chapter) and *vice versa* (e. g. the right of investors from one EU country to have their investment admitted in the territory of the other EU member States)

[63] An example of REIO clause is represented by art. 7 of the BIT between the United Kingdom and China, which reads as follows: "[t]he provisions of Article 3 and 4 of this Agreement" (dealing with MFN and national treatment, as well as with compensation for losses) "shall not be construed so as to oblige one Contracting Party to extend to the investors of the other the benefit of any treatment, preference or privilege resulting from (a) any existing or future customs union, organisation for mutual economic assistance or similar international agreement, whether multilateral or bilateral, to which either of the Contracting Parties is or may become a party".

Art. 3,3 of the BIT between Kazakhstan and Italy offers another example. It provides that: "[l]e disposizioni dì cui ai punti I. e 2. del presente Articolo" (which ensures national treatment and MFN treatment to investors of the other contracting party) "non si applicano ai vantaggi ed ai privilegi che una Parte Contraente riconosce agli investitori di Paesi Terzi per effetto di una sua partecipazione ad Unioni Doganali od Economiche, ad un Mercato Comune, ad un'area di Libero Scambio, ad un Accordo regionale o sub-regionale, ad un Accordo economico multilaterale internazionale ovvero in base ad Accordi conclusi per evitare la doppia Imposizione o per facilitare gli scambi transfrontalieri."

It is apparent that the REIO clauses quoted above, when they mention custom unions, clearly include the EU. In fact, according to art. 28 TFEU, "the Union shall comprise a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries."

For an overview of the REIO clause see: UNCTAD; *The REIO exception in MFN treatment clauses*; cit.; 2004. For a discussion of the relation between the REIO clause and the MFN clause see: A.

case the problem does not consist in granting to third country nationals the benefits and the rights to which EU nationals are entitled under EU law. It rather consists in the contrary situation, i. e. in a situation in which failure to grant to EU nationals the same rights and benefits of nationals of the other contracting party to the BIT results into a form of discrimination between EU nationals and therefore into a breach of EU law.[64]

This problem can be solved if a member State unilaterally extends to nationals of all the other EU members the MFN contained in a BIT it concluded with another EU member. Therefore, the potential for incompatibility between IIAs and EU law could be removed as to the issue of non discrimination without the need to renegotiate or terminate the BIT itself.[65]

It should be noted that the risk that BITs might entail discrimination between EU nationals may rise also in case of extra EU BIT, although in this case discrimination would be more likely to occur outside of the EU, and precisely in the third country with which the BIT has been concluded by an EU member. For instance, if France enters into a BIT with Bahrain but Italy does not, then French nationals investing in Bahrain shall enjoy the rights provided for in the BIT, while Italian investors shall not. However, it is debatable whether this discrimination which is rather hypothetical and which could actually occur only in case of specific conduct of the host State (in this case, a non-EU country), could entail the existence of a breach of art. 18 TFEU. However, this hypothesis, since it concerns the investments of EU nationals in third countries, shall not be investigated further, because the focus of the present chapter is on the investments of SWFs, and precisely of third countries SWFs, in the EU.

Further observations need to be made on the relation between non discrimination provisions contained in BITs and EU law. It has already been stressed that in the Eureko case the tribunal rejected the allegation that the content of the fair and

FALSAFI; *Regional trade and investment agreements: liberalizing investment in a preferential climate*; in *Syracuse Journal of International Law and Commerce*; 2008; p. 43-86.

[64] A. RADU; cit.; 2008; p. 48.

[65] A. DIMOPOULOS; *The validity and applicability of international investment agreements between EU member States under EU and international law*; cit; p. 71.

equitable treatment clause could be limited to the obligation not to discriminate. However, what was not discussed in the award, perhaps because the tribunal did not have the opportunity and the need to do so, was that BITs contain two provisions which more expressly and specifically deal with the issue of non discrimination. They are the NT clause and the MFN clause.[66] Neither in the TEU nor in the TFEU a MFN or a NT clause can be found, which are worded with the same terms which are used in BITs. However, the principle of non discrimination on ground of nationality is enshrined in EU law.[67] Art.18 TFEU, in fact, provides that: "[w]ithin the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited." It further provides that "[t]he European Parliament and the Council, acting in accordance with the ordinary legislative procedure, may adopt rules designed to prohibit such discrimination." The article does not further specify what must be meant as discrimination. However, lacking further clarifications, discrimination must be intended to occur both when a State treats a national of another EU member differently from one national of its and when it treats in different ways two nationals of two different EU members. The first aspect of the EU principle of non discrimination would be close to the NT clause contained in BITs, while the second aspect would be rather similar to the MFN clause of BITs.

More specific provisions of the TFEU prohibit discrimination between nationals of different member States when they carry out certain economic activities. For instance, art 49,2 TFEU provides that "[f]reedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, *under the conditions laid down for its own nationals by the law of the country where such establishment is effected*, subject to the provisions of

[66] For a discussion of the relation between the provisions preventing discrimination in EU law and in BITs see, for instance: A. RADU; cit.; p. 246-250.

[67] This issue should not be mistaken with other form of non discrimination the EU aims at combating, for instance discrimination "based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation" (art. 10 TFEU)

the Chapter relating to capital." [emphasis added]. The wording "under the conditions laid down for its own nationals by the law of the country where such establishment is effected" clearly refers to the application of the national treatment standard.

The articles of the TFEU concerning free movement of capital do not contain an explicit prohibition of discrimination. However, the prohibition of any restriction to capital movement laid down in art. 63 TFEU, must be meant as encompassing also the prohibition of discrimination. In fact, discrimination can be clearly regarded as one, although not the exclusive, cause of restrictions of movements of capitals. The fact that art. 63 includes a prohibition to discriminate is confirmed when, in the following articles, some exceptions to the principle laid down in art. 63 are provided and they specify the cases in which certain forms of discriminations are not to be regarded as inconsistent with art. 63 itself. For instance, art. 65,1 a) states that "[t]he provisions of Article 63 shall be without prejudice to the right of Member States [...] to apply the relevant provisions of their tax law *which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested*" [emphasis added]. In this case the term "distinguish" actually means "discriminate" on the ground of the residence of the investor or of the place where its investment is made. Paragraph 3 of art. 65 is even clearer when it specifies that the measures which member States may lawfully adopt under par. 1 and 2 of art. 65 in derogation of art. 63, "*shall not constitute a means of arbitrary discrimination* or a disguised restriction on the free movement of capital and payments as defined in Article 63." [emphasis added]. The ECJ has ruled consistently with this interpretation, when, in the Commission v. Portugal case of 2002 argued that "[a]rticle 73b of the Treaty [today art 63 TFEU] lays down a general prohibition on restrictions on the movement of capital between Member States. That prohibition goes beyond the mere elimination of unequal treatment, on grounds of nationality, as between operators on the financial markets."[68]

[68] Judgment of the Court of 4 June 2002; *Commission of the European Communities v Portuguese Republic*; cit. par. 44. Of the same judgment see also par. 45 and 46, for a discussion of the content of the notion of restrictions to movement of capitals under current art. 63 TFEU.

2. The relation between EU law and extra-EU BITs.

The situation is significantly different in case of IIAs concluded between EU and non EU member countries.

In this case, in principle art. 351 TFEU (ex art. 307 TEC) provides that "the rights and obligations arising from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of the Treaties". In other words, EU law cannot be construed in a way so as to prejudice the rights and duties laid down in IIAs concluded between EU members before their accession to the EU with third countries. This has been clarified by the ECJ since the Burgoa case in 1980. In that occasion the Court rules that "article 234 of the treaty [current art. 351 TFEU] must be interpreted as meaning that the application of the treaty does not affect either the duty to observe the rights of non-member countries under an agreement concluded with a member State prior to the entry into force of the treaty or, as the case may be, the accession of a member state, or the observance by that member State of its obligations under the agreement and that, consequently, the institutions of the Community [today the EU] are bound not to impede the performance of those obligations by the member State concerned."[69] This principle, which on one side represents a derogation to the principle of primacy of EU law, aims at ensuring the conformity of the European integration process with public international law. Was EU law entitled to automatically prevail over agreements concluded before the entry into force of the TEU and the TFEU, this would run counter to the basic foundations of public international law, and in particular to the principle *pacta sunt servanda*.[70]

However, art. 351 at paragraph 2 adds that "[t]o the extent that such agreements are not compatible with the Treaties, the Member State or States concerned shall take all

[69] Judgment of the Court of 14 October 1980; *Attorney General v Juan C. Burgoa*; Case 812/79; European Court reports 1980 Page 02787; par. 11 a).

[70] N. LAVRANOS; *Protecting European law from international law*; in *European Foreign Affairs Review*; 2010; p. 267.

appropriate steps to eliminate the incompatibilities established. Member States shall, where necessary, assist each other to this end and shall, where appropriate, adopt a common attitude."[71]

The ECJ has clarified which shall be the "appropriate steps to eliminate the incompatibilities" in two cases of 1999 and 2000. Although they have been issued before the entry into force of the Lisbon Treaty and even if they concern bilateral agreements on maritime transport between EU members and third countries, the findings of the Court can apply in the present time to extra-EU IIAs as well. In fact, the provision whose interpretation was at issue in those cases, i. e. art. 307 TEC, has not undergone substantial changes with the entry into force of the Lisbon Treaty. more precisely, art. 307 TEC has become art. 351 TFEU, but no relevant changes in the wording of the provision has intervened.

In Commission v. Belgium[72] the Court of Justice finds incompatibilities between the Agreement of 5 March 1981 on maritime transport Belgium concluded with the Democratic republic of Congo and regulation 4055/86 of 22 December 1986, applying the principle of freedom to provide services to maritime transport between Member States and between Member States and third countries.[73] The respondent does not deny the existence of incompatibilities as well as of its duty to rearrange the Agreement in order to eliminate them. Therefore, it does not "contest the existence of the obligation to amend the provisions at issue" however, it submits "that political developments in the Congo made it impossible to arrange negotiations." As a result Belgium declares that it would have undertaken the necessary steps "to finalise the adjustment of the Agreement" in a way to eliminate incompatibilities with EU law as soon as the political situation of Congo would have permitted it.[74] However, the ECJ rejects this argument and states that: "[t]he existence of a difficult political situation in

[71] On these points, see also: M. BURGSTALLER; cit.; p.189; A. FENET; cit.; p. 129-132.

[72] Judgment of the Court (First Chamber) of 14 September 1999; *Commission of the European Communities v Kingdom of Belgium*; Case C-170/98. European Court reports 1999 Page I-05493

[73] Judgment of the Court (First Chamber) of 14 September 1999; *Commission of the European Communities v Kingdom of Belgium*; cit.; par. 1-21.

[74] Judgment of the Court (First Chamber) of 14 September 1999; *Commission of the European Communities v Kingdom of Belgium*; cit.; par. 41.

a third State which is a contracting party, as in the present case, cannot justify a failure to fulfil obligations. If a Member State encounters difficulties which make it impossible to adjust an agreement, it must denounce the agreement."[75]

This approach has been confirmed in the two judgments, both opposing the Commission and Portugal,[76] which dealt with the incompatibility with the same regulation 4055/86 of the bilateral agreements concerning merchant shipping Portugal concluded with, respectively the Federal Republic of Yugoslavia (entered into force in 1981) the Republic of Angola and the Democratic Republic of São Tomé and Príncipe (both entered into force in 1979). The Court argues that EU members have an obligation to eliminate incompatibilities by making use of any instrument consistent with international law. Such instruments, could be the renegotiation as well as the negotiation of the Agreements at issue. According to the Court, if renegotiation is not possible, also because of the particular political situation of the third countries involved, it is "incumbent on the Member State concerned to denounce" the incompatible treaties at issue.[77] The Court also rejects the submission of the respondent that "such denunciation would involve a disproportionate disregard of foreign-policy interests of the Portuguese Republic as compared with the Community interest". In fact, the Court notes that "the balance between the foreign-policy interests of a Member State and the Community interest is already incorporated in Article 234 of the Treaty, [current art. 351 TFEU] in that it allows a

[75] Judgment of the Court (First Chamber) of 14 September 1999; *Commission of the European Communities v Kingdom of Belgium*; cit.; par. 42.

[76] Judgment of the Court of 4 July 2000; *Commission of the European Communities v Portuguese Republic*; Case C-84/98. European Court reports 2000 Page I-05215 and Judgment of the Court of 4 July 2000. *Commission of the European Communities v Portuguese Republic*; Case C-62/98. European Court reports 2000 Page I-05171. For comments on these judgments see: C. HILLON; *Case law. A. Court of Justice*; in *Common Market Law Review*; 2001; p. 1269-1283.

[77] Judgment of the Court of 4 July 2000; *Commission of the European Communities v Portuguese Republic*; Case C-84/98; cit.; par. 40-48. This concept is repeated at par. 58, when the Court declares that "the Member States have a choice as to the appropriate steps to be taken, they are nevertheless under an obligation to eliminate any incompatibilities existing between a pre-Community convention and the EC Treaty. If a Member State encounters difficulties which make adjustment of an agreement impossible, an obligation to denounce that agreement cannot therefore be excluded." See also: Judgment of the Court of 4 July 2000; *Commission of the European Communities v Portuguese Republic* Case C-62/98; cit.; par. 34 and 49. For the doctrine, see: C. HILLON; *Case law. A. Court of Justice*; cit.; p. 175.

Member State not to apply a Community provision in order to respect the rights of third countries deriving from a prior agreement and to perform its obligations thereunder. That article also allows them to choose the appropriate means of rendering the agreement concerned compatible with Community law."[78]

In conclusion, current art. 351 TFEU not only has a declaratory effect, since not only it repeats the well established principle of law "*pacta sunt servanda*" when it safeguards previous agreements entered into by EU members. On the contrary, it is also prescriptive and as a result member States are required to achieve, by means of renegotiation or denunciation, the elimination of inconsistencies between EU law and international agreements with third countries to which EU members are contracting parties.[79]

The case-law of the ECJ analyzed so far in this paragraph allows to conclude that if EU provisions governing investments are in contrast with extra EU IIAs, then there is a duty upon member States to renegotiate or even to denounce and terminate such IIAs. However, it does not allow to draw conclusions as to whether extra EU IIAs actually are in contrast with EU law, and, in detail, in which circumstances. Two recent judgments, Commission v. Austria[80] and Commission v. Sweden.[81] may help to clarify this issue.[82] Once again, it must be remarked that they have been issued before the entry into force of the Lisbon Treaty, which, as it will be explained in the next pages, introduces important changes to the issue of the relation between EU law and extra-EU BITs. However, an analysis of these judgements is important to

[78] Judgment of the Court of 4 July 2000; *Commission of the European Communities v Portuguese Republic*; Case C-84/98. cit. ; par. 59. See also: Judgment of the Court of 4 July 2000; *Commission of the European Communities v Portuguese Republic*; Case C-62/98; cit.; par. 50.

[79] C. HILLON; *Case law. A. Court of Justice*; cit.; p. 1280.
N. LAVRANOS; *Protecting European law from international law*; cit.; p. 267-268.

[80] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; Case C-205/06. European Court reports 2009 Page I-01301.

[81] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; Case C-249/06. European Court reports 2009 Page I-01335.

[82] For an overview of the issue see: F. S. BENYON; cit.; p. 99-105; A. DE MESTRAL; cit.; p. 382; M. POTESTÀ; *Bilateral Investment Treaties and the European Union. Recent Developments in Arbitration and Before the ECJ*; cit.; p. 239-245; M. BURGSTALLER; cit.; p.197-200; N. LAVRANOS; *Protecting European law from international law*; cit.; p. 278-282.

better understand the (potential) changes that the Lisbon treaty might introduce, as well as the precise extent of the legal problems that it might help to address.

The two cases at issue concern an infringement procedure initiated by the Commission which deem that Austria and Sweden, "by not having taken appropriate steps to eliminate incompatibilities concerning the provisions on transfer of capital" contained in some of the investment agreements they concluded with third countries, have failed to fulfil their obligations under art. 307,2 TEC (today, art. 351,2 TFEU).[83] In particular, the Commission considers that the clause providing for free transfer of capitals, which is contained in the IIAs at issue, could be incompatible with art. 57 TEC, 59 TEC and 60 TEC (today, respectively, art. 64 TFEU 66 TFEU 75 TFEU). Such articles provide for the possibility for EU institutions, and in particular for the Council, to introduce restrictions to capital transfers EU members may be mandated to implement without delay. Since the provisions on free capital transfers contained in IIAs do not expressly reserve for the respondents the possibility to apply measures with the aim to ensuring the respect of the restrictions to capital movements decided by EU institutions, then they are regarded as incompatible with articles 57 TEC, 59 TEC and 60 TEC.[84] It could be argued that, in principle, when the implementation of the restrictions at issue had been necessary, member States would have had the duty to renegotiate or even terminate the IIAs in order to ensure proper application of EU measures. However, renegotiation or termination of the BITs at issue would have taken time. As the Commission rightly points out "the period of time required for the denunciation or renegotiation of the agreements at issue would have the consequence that" the respondents "would be obliged, in the intervening period, under international law, to continue to apply the agreements in question, including

[83] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; Case C-205/06. European Court reports 2009 Page I-01301; par. 1 and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; Case C-249/06. European Court reports 2009 Page I-01335; par. 1.

[84] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par. 16 and Judgment of the Court (Grand Chamber) of 3 March 2009. Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par. 16.

their respective transfer clauses, in accordance, moreover, with the first paragraph of Article 307 EC." As a result, until the renegotiation or denunciation of the relevant BITs, measures undertaken by the Council pursuant to art. 57 TEC, 59 TEC and 60 TEC could have not applied. This means, as it is also stressed by the Commission, that those "measures adopted by the Council would not be uniformly applied within the Community".[85]

The respondents reject the arguments of the Commission, noting that the obligation to ensure consistency between IIAs to which they are contracting parties and restrictions on capital transfers possibly adopted by the Council under art. 57 TEC 59 TEC and 60TEC could arise only when such measures are actually adopted. On the contrary, "in the absence of restrictions on movements of capital and on payments decided upon by the Council," they remain "free to regulate the movement of capital with third countries on the basis of Article 56 EC" (art. 63 TFEU). In fact, "so long as no restriction has been decided upon by the Council, the question of the compatibility of the agreements at issue with a provision of the Treaty which has not been the subject of any application does not arise."[86]

Several States support the arguments laid down by the respondents and in particular they submit that "the failure to fulfil obligations relied on by the Commission is purely hypothetical in nature" and that the aim of the infringement procedure is not "to review situations in which the alleged failure is hypothetical, but to remedy actual failures by Member States to fulfil their obligations." [87] Some States also add that "a potential future incompatibility with secondary Community legislation on the part of an agreement entered into with a third country does not fall within the scope of application of Article 307 EC and can, if at all, be confirmed only if the Council

[85] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par.17 and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par. 17.

[86] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par. 18; and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par. 18.

[87] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par. 19-20; and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par. 19-20.

actually exercises its competence within the area covered by that article." If restrictions to capital transfers from and to third countries are not actually introduced, no incompatibility between IIAs and EU law can be assessed.[88]

The Court, sharing the view expressed by the Commission, remarks that the effectiveness art. 57 TEC 59 TEC 60 TEC relies on the fact that "measures restricting the free movement of capital must be capable, where adopted by the Council, of being applied *immediately* [emphasis added] with regard to the States to which they relate, which may include some of the States which have signed one of the agreements at issue" with the respondents.[89]

Therefore, the incompatibility between the extra-EU IIAs and EU law, is not an incompatibility with EU measures which have already been enacted, but it resides in the fact that the IIAs at issue do not contain provisions allowing the Member States concerned to ensure the application, *without delays,* of such measures in case they are adopted. The effectiveness of measures adopted pursuant to art. 57 TEC, 59 TEC and 60 TEC depends on the possibility to implement them immediately and uniformly in the EU. The renegotiation or denunciation of international treaties is a process which might require months or even years and this time lag would prevent EU measures at issue from being implemented in a way which might ensure their effectiveness. In order to avoid this, EU members have the duty to take measures to eliminate inconsistencies between BITs and EU law before they might arise in practise and obstacle the application of EU law. If States starts to undertake the necessary steps to eliminate incompatibilities only when they arise in practise, this would be too late, and compliance with EU law would not be guaranteed.[90] For this reason, the incompatibility is not *strictu sensu* a hypothetical one.[91]

[88] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par. 21-23 and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par. 21-24.

[89] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par. 36 and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par. 36.

[90] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par. 37 -40; and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par.37-41. On this

The Court therefore concluded that the respondents "by not having taken appropriate steps to eliminate incompatibilities concerning the provisions on transfer of capital contained in the investment agreements" they entered into with certain third countries, failed to ensure compatibility between these IIAs on one side and art. 57 TEC 59 TEC and 60 TEC and, as a result, failed to fulfil their obligations under art. 307,2 TEC, today art. 351,2 TFEU.[92]

As a final remark, it should be noted that once the ECJ assesses the existence of an incompatibility, although potential, with EU law, member States should be interested in undertaking the necessary steps to eliminate such incompatibilities. In fact, if the EU adopted emergency measures restrictive to capital flows under 64 TFEU 66 TFEU 75 TFEU, a member State would be in any case obliged to abide by them and this would bring it to breach the capital transfer clause contained in BITs. As a result, it would risk to be convened by the adversely affected investors before an arbitral tribunal and finally required to pay compensation. For this reason, renegotiation of the BITs could be in the interest of the EU member themselves.[93]

In the Commission v. Finland case,[94] the Court confirms the findings of the Commission v. Austria and Commission v. Sweden judgements. Finland, before its

very important point of the judgments see also: M. POTESTÀ; *Bilateral Investment Treaties and the European Union. Recent Developments in Arbitration and Before the ECJ*; cit.; p. 241-243.

[91] For an in depth discussion of this aspect see: S. EL BOUDOUHI; *L'avenir des traités bilatéraux d'investissement conclus par les Etats membres de l'Union européenne avec des Etats tiers*; in *Revue trimestrielle de droit européen*; 2011; p. 87-90.

[92] Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Republic of Austria*; cit.; par. 45; and Judgment of the Court (Grand Chamber) of 3 March 2009; *Commission of the European Communities v Kingdom of Sweden*; cit.; par. 45. For a quick comment of the judgments see also: A. DE LUCA; *Potenziali conflitti tra giurisdizione comunitaria e istanze arbitrali istituite sulla base di accordi di promozione e protezione degli investimenti; quali possibili soluzioni*?; cit.; p. 117-120.

It must be remarked that these judgments have given rise to some perplexities. In particular it is argued that, in requiring the elimination of potential incompatibilities with EU law, they impose an excessive burden upon member States. It is suggested that the incompatibility between BITs and EU law could be excluded once it is taken into consideration that EU members would be able to effectively suspend the BITs at issue by invoking the *rebus sic stantibus* principles which is *inter alia* contemplated in art. 62 of the Vienna Convention of 1969 on the Law of Treaties. On this point see: N. LAVRANOS; *Protecting European law from international law*; cit.; p. 280-281.

[93] T. EILMANSBERGER; cit.; p. 410.

[94] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; Case C-118/07. European Court reports 2009 Page I-10889.

accession to the EU had entered into several BITs. The Commission finds that the provisions on capital transfers contained in such international agreements are incompatible with EU provisions on free movement of capitals. In its judgement the Court distinguishes between the BIT Finland concluded with Russia and the other BITs concluded by the respondent, the difference residing in the fact that the BIT with Russia does not contain a clause which guarantees the protection of investments "within the limits authorised by the laws of the Contracting Party" while the other BITs do.[95]

The Court first of all analyses the issue of the compatibility of the BIT between Finland and Russia with EU law. The arguments of the parties at the dispute are very similar to those of the above mentioned Commission v. Austria and Commission v. Sweden cases, especially when the respondent points out that "the infringement alleged by the Commission is purely hypothetical".[96] Also the reasoning developed by the Court and the conclusions it reaches are very similar to those of the above mentioned cases. In fact, once again the Court regards as inconsistent with EU law those provisions contained in a BIT which guarantee to the foreign investors the free transfer of capitals without leaving the possibility to contracting parties to implement without delays restrictive measures adopted by the Council pursuant to EU law. Since the respondent have not taken appropriate steps to eliminate such incompatibilities, the Court finds it failed to fulfil its obligations under art. 307,2 TEC.[97] In other words, the issue as to whether the incompatibilities are essentially hypothetical is to be rejected also because "the exercise of the powers conferred on the Council in relation to the movement of capital might be hindered by the very

[95] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 5.

[96] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 15-17.

[97] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 18-35.

existence of the bilateral agreements at issue and by the terms in which they are drafted".[98]

Then, the Court turns to assess whether the other BITs concluded by Finland could on the contrary ensure compatibility with EU law provisions on possible restrictions on transfer of capitals, since they contain a clause according to which the protection of investments is guaranteed "within the limits authorised by the laws of the Contracting Party." For the purposes of determining whether such clause could ensure the compatibility with EU law of those IIAs which contain it, so that to exclude the need for a renegotiation or denunciation of such IIAs, it is therefore necessary to understand the exact scope and meaning of the expression "within the limits authorised by the laws of the Contracting Party". According to the Commission, it only refers "to the laws and administrative provisions of the States parties to those agreements as they were in force at the time when the agreements were concluded, that is, in this case, prior to the accession of the Republic of Finland to the Union." Therefore, these clauses "do not, by themselves, offer that Member State the option to implement without delay restrictive measures that the Community may be led to adopt."[99] The respondent, supported by the Republic of Lithuania which also submits its observations to the Court, "argue[s], to the contrary, that those provisions may be applied because the restrictive measures adopted by the Council, by virtue of the direct effect of Community law, form part of Finnish law, within the meaning of those provisions."[100] In other words the terms "laws of the contracting party" should be meant to include not only domestic law but also EU law.

The Court, while initially supporting the view of the Respondent that EU law forms part of the Finnish legal order[101] observes that the aim of the provisions of the IIAs

[98] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 49.

[99] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 36.

[100] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 37.

[101] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 38-39.

challenged by the Commission in the present case is to ensure freedom of payments in respect of investments, "and that as quickly possible." Therefore, the Court finds it "debatable whether the provision which guarantees the protection of investments within the limits authorised by the laws of the Contracting Party contained in the bilateral agreements concerned would allow either party to limit payment entitlement pursuant to decisions – whether national or otherwise – taken after the entry into force of the agreements, especially as in some agreements it is also stated that each Contracting Party is required to act 'in accordance with international law'."[102]

In conclusion, the Court finds that the clauses on transfer of capitals which are contained in the BITs concluded by Finland are not sufficient to guarantee that measures restricting the free movement of capital, which can be adopted by the Council, might be implemented by Finland effectively and without delays, thus ensuring compliance with EU law. In other words, since such clauses are unable to ensure the compatibility of the IIAs at issue with EU law, according to the Court the respondent is under the duty to take the necessary steps to eliminate all incompatibilities according to art. 307,2 TEC (today art. 351,2 TFEU). Having failed to do so, Finland is found in breach of that provision.[103]

A last aspect of the Commission v. Finland case needs to be noted. In the course of the proceedings it is argued that the consequence of the decision of the Court that Finland is under the duty to put an end to the incompatibilities between EU law and BITs, is to undermine "'the principle of competition on the internal market and the principle of non-discrimination". In fact, "the Republic of Finland and the citizens and undertakings of the Union which are covered by the agreements concluded by that Member State would be at a disadvantage in comparison with other member States

[102] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 40-41. With this argument, it seems that the ECJ underestimates the principle of the direct effect of EU law, i. e. a key principle it has contributed to promote. In fact, if it is deemed that EU law, provided it is meant as including the measures that the Council may adopt pursuant to art. 66 TFEU, directly forms part of the legal orders of the member States, then the BITs concluded by Finland would allow restrictions to capital movements provided for in EU law. On this aspect see: S. EL BOUDOUHI; cit.; p. 91.

[103] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 42-43.

and the citizens and undertakings covered by investment agreements which are not criticised by the Commission."[104] In other words, it is argued that if the ECJ requires only some EU members to renegotiate their BITs, the members which have similar BITs but which are not required to do the same would obtain an unfair advantage. In order to prevent this discrimination, the ECJ should have discussed at the same time the issue of the compatibility with EU law of all the BITs concluded by all EU members.

The Court, sharing the view of the Commission, dismisses this argument and reminds that "a Member State may not rely on the fact that other Member States have also failed to perform their obligations in order to justify its own failure to fulfil its obligations under the Treaty" also because in the EU legal order "the implementation of EU law by the Member States cannot be made subject to a condition of reciprocity".[105] This statement implicitly suggests that in principle other BITs could be incompatible with EU law. The fact that the present case or the previous judgments Commission v. Austria and Commission v. Sweden have dealt with the BITs concluded by certain States only, is without prejudice to the possibility of the EU institutions to take further steps in order to address the problems possibly related to incompatibilities between EU law and extra-EU BITs concluded by any other EU member.

For sake of completeness, it must be added that the Commission instituted an infringement procedure under current art. 258 TFEU also against Denmark. In this case, however, Denmark decided to eliminate the incompatibilities with EU law of the BIT it previously concluded with the Netherlands. To achieve this aim, it terminated the BIT with Indonesia, and negotiated a new agreement which would have ensured a higher degree of compliance with EU law.[106] This seems to confirm what was argued so far, that while incompatibility between BITs and EU law do not entail an

[104] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.; par. 44.

[105] Judgment of the Court (Second Chamber) of 19 November 2009; *Commission of the European Communities v Republic of Finland*; cit.

[106] M. BURGSTALLER; cit.; p.196-197.

automatic termination of BITs (be they intra-EU or extra-EU BITs), on the other side it may make it necessary to renegotiate or to terminate BITs in order to eliminate such incompatibilities.[107]

3. The Lisbon Treaty, the changes in the Common Commercial Policy and the new competences of the EU in the field of FDIs.

The entry into force, on December 1st 2009, of the Lisbon Treaty introduced important changes in the relation between EU law and IIAs. In particular art. 133 TEC was replaced by art. 207 TFEU, which for the first time includes FDIs in the scope of EU Commercial policy.[108] In fact, according to art. 207,1 "[t]he common commercial policy shall be based on uniform principles, particularly with regard to changes in tariff rates, the conclusion of tariff and trade agreements relating to trade in goods and services, and the commercial aspects of intellectual property, *foreign direct investment*, the achievement of uniformity in measures of liberalisation, export policy and measures to protect trade such as those to be taken in the event of dumping or subsidies." [emphasis added]. This is consistent with the more general objectives of the Common Commercial Policy as laid down in art. 206 TFEU which provides that: "by establishing a customs union [...]the Union shall contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and on *foreign direct investment*, and the lowering of customs and
other barriers." [emphasis added]

[107] On this issue see also: A. RADU; cit.; p. 240.

[108] For a comment on the innovation of EU provisions concerning the common commercial policy introduced by the Lisbon treaty see: F. S. BENYON; cit.; p. 79-82. See also: A. DE MESTRAL; cit.; p. 374-376. On the inclusion of investment issues in the Common Commercial Policy, with a focus on the issue of the protection of non commercial values in the new EU investment policy see: A. PERFETTI; *La tutela di valori non commerciali nella politica dell'Unione europea in materia di investimenti esteri diretti*; in *La comunità internazionale*; 2011; p. 247-260.

Under art. 207 TFEU the European institutions have both an internal and an external competence in the field of the common commercial policy and, therefore, in the regulation of issues related to FDIs.

As to the internal competence, par. 2 of art. 207 provides that: "[t]he European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, shall adopt the measures defining the framework for implementing the common commercial policy."

As to the external competence, art. 207 provides for the possibility for the EU to enter into international agreements with a view to implementing the EU common commercial policy. To this end, it must be added that art. 216 TFEU provides the EU with a general competence "to conclude an agreement with one or more third countries or international organisations where the Treaties so provide or where the conclusion of an agreement is necessary in order to achieve, within the framework of the Union's policies, one of the objectives referred to in the Treaties, or is provided for in a legally binding Union act or is likely to affect common rules or alter their scope." The possibility for the EU to enter into international agreement is also related to the fact that it is provided with international legal personality, as it is clearly stated in art. 47 TEU.[109]

As art. 216 points out, both the internal acts adopted by the EU and the international agreements it concludes within the framework of the common commercial policy and the custom Union on which the EU itself is based, should be consistent with the objective of the EU to "contribute, in the common interest, to the harmonious

[109] More precisely, art. 47 TEU states that "the Union shall have legal personality" without clarifying whether this consists in international legal personality or in legal personality in the legal order of States. However, in order to clarify the content on this provision, reference could be made to art. 335 TFEU which provides that "[i]n each of the Member States, the Union shall enjoy the most extensive legal capacity accorded to legal persons under their laws". For this reason, it can be argued that while art. 335 TFEU should be construed as providing the EU with legal personality in the legal order of its member States, art. 47 TEU on the contrary provides the EU with international legal personality. The fact that, in practice, the EU participates in international relations with other subjects of the international community, also by concluding international agreements, represents an even more important element supporting the argument of the existence of the legal personality of the EU. On these issues see: U. DRAETTA; cit.; p. 210-214.

development of world trade, the progressive abolition of restrictions on international trade *and on foreign direct investment*, and the lowering of customs and
other barriers" [emphasis added]

According to art. 217 par. 3, the procedure for the negotiation and conclusion of such agreements is the same provided for in art. 218 TFEU, except when otherwise provided in art. 207 itself. More in detail, "the Commission shall make recommendations to the Council, which shall authorise it to open the necessary negotiations. The Council and the Commission shall be responsible for ensuring that the agreements negotiated are compatible with internal Union policies and rules. The Commission shall conduct these negotiations in consultation with a special committee appointed by the Council to assist the Commission in this task and within the framework of such directives as the Council may issue to it. The Commission shall report regularly to the special committee and to the European Parliament on the progress of negotiations."[110]

According to par. 4 of art. 207 TFEU, "for the negotiation and conclusion of the agreements which concern trade in services and the commercial aspects of intellectual property, as well as foreign direct investment, the Council shall act unanimously where such agreements include provisions for which unanimity is required for the adoption of internal rules." In all the other cases the "Council shall act by a qualified majority."

Art. 3,1 of the TFEU specifies the areas in which the EU shall have exclusive competence and the common commercial policy is included. In addition, par. 2 of art. 3. provides that "[t]he Union shall also have *exclusive competence* for the conclusion of an international agreement when its conclusion is provided for in a legislative act of the Union or is necessary to enable the Union to exercise its internal competence, or in so far as its conclusion may affect common rules or alter their scope." [emphasis added]. According to art. 2,1 TFEU "when the Treaties confer on the Union exclusive competence in a specific area, only the Union may legislate and

[110] For a general overview of the issue of the conclusion of international agreements by the EU see: U. DRAETTA; cit.; p. 214-220.

adopt legally binding acts, the Member States being able to do so themselves only if so empowered by the Union or for the implementation of Union acts."

The reading of art. 207, art. 3 and art. 2,1 allows to conclude that since the entry into force of the Lisbon Treaty the EU has an exclusive competence in the field the commercial aspects of foreign direct investments[111] and therefore also in the field of IIAs or, *rectius*, of certain aspects of IIAs. This implies that member States are no more competent to enter into IIAs with third States, except, possibly, when they are explicitly empowered to do so by EU institutions. Such a development might have important consequences as to the issue of the regulation of SWFs in the EU. In fact, as it has been stressed also in the communication of the Commission titled "a common European approach to Sovereign Wealth Funds", the peculiarities of the investments of SWFs make it particularly important a common, or at least a well coordinated, response by EU member States. Currently, as it has been pointed out in chapter 4 of the present work, most IIAs do not contain provisions explicitly addressing SWFs and establishing *ad hoc* regimes governing their operations. However, if in the future there would emerge a trend towards a more stringent regulation of SWFs by means of IIAs[112], the fact that IIAs should be negotiated at the EU level, and not by EU members acting individually, should ensure that differences and inconsistencies in their regulation across the EU might be eliminated or at least mitigated.

However, some problems arise as to whether the EU may be deemed to have an exclusive competence in relation to every provision which is normally included in IIAs. In particular, as it was pointed out in chapter 4 par. 3, the scope *ratione materiae* of IIAs in most cases includes both portfolio and direct investments, while, as explained above, art. 207 art. 3 and art. 2.1 TFEU, when they are read jointly, provide the EU with an exclusive competence to enter into international agreements which concern

[111] A. PERFETTI; cit.; p. 248.

[112] Against this possibility, it must be remarked that this might represent a departure from the principle laid down in the communication of the commission according to which existing rules should be applied to SWFs without the need to create special legal regime whose explicit aim is to regulate SWFs only.

direct investments only.[113] In addition, the TFEU do not provide for guideline to distinguish between FDIs and portfolio investments.[114]

This issue is particularly important when the focus of the discussion is on the investments of SWFs since the large majority of them are, as it is well known, portfolio investments.

Therefore, different interpretations are possible *prima facie*.

First of all it could be argued that the EU lacks an exclusive competence in the field of IIAs concerning portfolio investments. This would imply that the EU would be empowered to negotiate and conclude IIAs covering FDIs only, while individual member States would remain allowed to negotiate and conclude IIAs governing portfolio investments. This solution seems hardly feasible and even less desirable, also because it would increase inconsistencies instead of reducing them. In fact, while inconsistencies between EU law and IIAs concluded by individual EU members would persist, this solution would also generate inconsistencies as to the treatment afforded to portfolio and direct investments.

A more appropriate approach which can be followed if it is deemed that neither the TEU nor the TFEU provides the EU with an exclusive competence in the field of portfolio investments, consists in that the EU negotiates and conclude IIAs with third countries, acting jointly with all its member States.[115] The agreements which are concluded in this way, which are referred to as mixed agreements, allow to avoid addressing the complex issues of defining in detail and in each single, specific case, which are the competences of the member States and of the EU and which are to be regarded as exclusive or as shared competences.

This practise has already been followed in relation to the participation of the EU in the WTO as well as in the negotiation and conclusion of the agreements concluded within the WTO.[116] Moreover, it has been widely followed in relation to the conclusion

[113] T. EILMANSBERGER; cit.; p. 394-396.

[114] A. DE MESTRAL; cit.; p. 380.

[115] This argument is supported, *inter alia*, in: S. EL BOUDOUHI; cit.; p. 97.

[116] On the need for a mixed membership of both the EU (initially, the EC) and all its member States see, in particular, the reasoning developed by the ECJ in: Opinion of the Court of 15 November 1994;

of agreements with third countries. Such international instruments, which will be referred to in broad terms as cooperation agreements are quite heterogeneous, they include for instance agreements with Latin American countries, the Conventions with ACP countries, the association agreements with EU neighbours in Northern Africa and Middle East concluded within the framework of the Mediterranean Partnership (also known as Barcelona Process) and consistently with art. 217 TFEU (ex art. 310 TEC).[117] A review of these agreements clearly falls outside the scope of the present research. However It must be pointed out that they also deal with foreign investments, in the sense that they aim at creating favourable condition for the development of investment flows and for the conclusion of IIAs with each EU member. Therefore, far from implying an exclusive competence of the EU to enter into IIAs with such third countries, the economic cooperation agreements explicitly aim at promoting the conclusion of IIAs by EU member States acting individually. In other words, current economic integration agreements not only are consistent with the idea that EU members are competent to enter into IIAs but also aim at facilitating it. The conclusion of IIAs by single EU members, far from impairing or jeopardising the action of the EU is regarded as a tool to complete it and to further the achievement of the purposes of the economic integration agreements at issue.

Competence of the Community to conclude international agreements concerning services and the protection of intellectual property; Opinion 1/94; European Court reports 1994 Page I-05267.

[117] For an overview of the different forms of cooperation the EU adopts with third country, as well as for a better understanding of the legal instruments it adopts in this framework see: J. AKANDJI-KOMBÉ; *La Coopération avec les Etats tiers*; in A. FENET; ed.; *Droit des rélations exterieures de l'Union Européenne*; Paris; Litec; 2006; p. 219-232.

For a better understanding of the political and "soft law" framework within which these agreements are often negotiated see: C. NOVI; *Il concetto di partenariato e le relazioni esterne economiche dell'Unione europea*; in A. LIGUSTRO AND G. SACERDOTI; ed.; *Problemi e tendenze del diritto internazionale dell'economia. Liber amicorum in onore di Paolo Picone*; Napoli; 2011; p. 79-110. For more information on the Mediterranean Partnership see, for instance: B. KARRAY; *L'évolution du partenariat euro-méditerranéen*, in *Journal du droit international* (Clunet); 2008, p. 753-770; J. M. GALDUF; *Balance y perspectivas de la Asociación Euromediterránea. Una mirada española*; in *Cuadernos de Integración Europea* 2005; p. 3-23; VV AA. *La Asociación Euromediterránea una década después*. Real Instituto Elcano- FRIDE, Madrid 2005; VV AA. *Dossier: diez años del Proceso de Barcelona. Balance y Perspectivas*; Instituto Europeo del Mediterráneo. Barcelona, 2005. For a broader discussion of the mixed character of the agreements which are concluded by the EU in the framework of its cooperation with third countries see: F. S. BENYON; cit.; p. 89-90; A. DE MESTRAL; cit.; p. 381; M. KLAMER, N. MAYDELL; cit.; p. 493- 494; R. LEAL-ARCAS; *The European Community and mixed agreements*; in *European foreign Affairs Review*; 2001; p. 483-513.

Therefore, it can be expected, as a future development, that current art. 207 might allow the EU to negotiate and conclude, together with its members, mixed agreements which might contain more precise and more stringent provisions on investments.[118] In other words, the provisions of such agreements governing investments will be no more limited to the declaration of the intent to further investment relation also by means of the conclusion, by EU members and not by the EU itself, of new IIAs. On the contrary, thanks to the changes introduced by the Lisbon treaty, the EU should be empowered to conclude with third countries mixed cooperation agreements containing substantive provisions on the treatment of foreign investors and of foreign investments, whose extent, scope and content should be similar to the one of IIAs in force between each EU members and the third States. Such developments should be consistent with the idea that the provisions on IIAs contained in the TFEU as modified by the Treaty of Lisbon, might enhance cooperation between EU institutions and member States. Therefore, consistency between EU law and BITs should be assured not by the centralisation in the hands of the EU institutions of all the competences concerning FDIs between the EU and third countries, but by cooperation (also through mixed agreements governing, *inter alia*, the issue of foreign investments) between the EU and its members.[119]

This would represent a natural development of the trend EU institutions seem to have followed in recent years, in order to increase the consistency of provisions contained in mixed agreements, applicable to the issue of foreign investments. A landmark in this process is represented by the adoption by the Commission, in 2006, of a minimum platform on foreign investments. The document in which such platform is provided[120] is not a legally binding act but rather a document devised for internal circulation. In fact, it must be underlined that it has never been officially published but it has been informally circulated and it got available on the website of some NGOs.

[118] A. DE MESTRAL; cit.; p. 377-381.

[119] A. DE MESTRAL; cit.; p. 381-382.

[120] EUROPEAN COMMISSION; NOTE FOR THE ATTENTION OF THE 133 COMMITTEE; Minimum platform on investment for EU FTAs – Provisions on establishment in template for a Title on "Establishment, trade in services and e-commerce"; 28 July 2006, available online at: http://www.iisd.org/pdf/2006/itn_ecom.pdf page visited on 01/06/2011

The minimum platform aims at providing guidelines for the drafting of provisions concerning investments which may be included in cooperation agreements the EU and its members conclude with third countries. The objective is to enhance consistency, firstly, across cooperation agreements and, secondly, between such agreements and other international instruments concluded by member states and concerning foreign investments.

However, it must be remarked that the minimum platform can hardly be regarded as tantamount to a model BIT. In fact, first of all it is not designed to provide a basis for the negotiation of international instruments exclusively addressing investment issues, but, on the contrary, it is designed to form part of FTAs agreements or of other cooperation agreements covering a broader array of issues. Moreover, the subject matters covered by the minimum platform are much less than those covered by BITs. In particular, the minimum platform only addresses issues like national treatment, most favoured nation treatment, movement of personnel related to the investments and market access, but its excludes from its scope other very important aspects like fair and equitable treatment, expropriation, settlement of investor-State disputes by means of international arbitration. Moreover, it covers only FDIs which originate from establishment in the territory of the other contracting parties. Finally, portfolio investments, which, as it is well known, are covered by most BITs, are not taken into consideration. [121]

4. The attempt of the Commission to establish an exclusive competence of the EU to conclude BITs with third countries.

The position of the Commission on the relation between EU law and BITs, and in particular on the competence of the EU in concluding such instruments, differs from the approach which has been suggested in the previous paragraph. The Commission

[121] For a concise study of the content of the minimum Platform see: M. KLAMER, N. MAYDELL; cit.; p. 511-513; A. DE MESTRAL; cit.; p. 373-374; T. EILMANSBERGER; cit.; p. 393-394; M. BURGSTALLER; cit.; p. 204-206; S. EL BOUDOUHI; cit.; p. 105.

has made it public in a communication of 7 July 2010 titled "towards a comprehensive European international investment policy".[122] The reasoning developed in this document are consistent with the traditional distrust of the EU in relation to mixed agreements, which have traditionally been considered as excessively burdensome, complicated and liable to hinder clarity, uniformity and efficiency.[123] Therefore, the Commission supports the view that the competence of the EU in entering into international agreements governing FDIs must be exclusive.[124]

The communication declares that its task is also to "explore how the Union may develop an international investment policy that increases EU competitiveness". The Commission therefore confirms its view that investments are an important tool to promote competitiveness of the EU economy and the adoption of a common stance of the EU towards investments may help to minimize the differences and incompatibilities concerning provisions governing investments in EU countries and then maximize the positive effects on competitiveness that such investments may entail. The communication also makes a significant reference to SWFs and in particular to those owned by non western countries. In fact, it recognises that in recent years, emerging market economies have not only improved their ability to attract foreign investors but they also "become increasingly active" as investors "including through state-sponsored investment like Sovereign Wealth". In conclusion, the importance of foreign investments, also to enhance the competitiveness of the recipient economies, and the fact that such investments, and even more the entities, like SWFs, which undertake them, have recently assumed certain characteristics,

[122] EUROPEAN COMMISSION; *Communication from the commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the regions; Towards a comprehensive European international investment policy*; Brussels; 7.7.2010; COM(2010)343 final. For a comment see: P. J. K; cit.; p. 262-270; A. PERFETTI; cit.; p. 247-260.

[123] A. DE MESTRAL; cit.; p. 381; J. CEYSSENS; cit.; p. 269.

[124] For a critic to this approach see, for instance. J. A. BISCHOFF; *A little BIT mixed? – The EU's External Competences in the field of International Investment Law*; in *Transnational Notes*; 2011; available online at: http://blogs.law.nyu.edu/transnational/2011/02/a-little-bit-mixed-%e2%80%93-the-eu%e2%80%99s-external-competences-in-the-field-of-international-investment-law/ page visited on 01/06/2011

brings the Commission to the awareness that "the EU cannot afford to take a backseat in the global competition to attract and promote investment from and to all parts of the world".[125]

The Commission, in the communication, acknowledges that the decision to invest in a certain country or in a certain sector largely depends on market considerations; however, the legal, political and economic environment of the potential recipient States are also taken into consideration. The development of a common investment policy at the EU level could contribute to the improvement of such environment.[126] Investment policy has been so far developed by EU member States acting individually, mainly through the conclusion with third countries of IIAs and especially of BITs. The Commission underlines that domestic investment policies display relevant differences since not all EU members have concluded such BITs and since, in spite of the relatively high level of standardisation achieved by such international instruments, BITs concluded by different EU members may contain different provisions. The Commission focuses on the negative consequences this situation may entail for EU investors when they carry out their operations in a third State. According to the Commission, in fact, this leads to an uneven playing field, since the treatment such investors may expect when operating abroad will not be affected by their EU nationality but will only depend "on whether they are covered as a 'national' under a certain Member State BIT". Moreover, it is undeniable that also investors from third countries may be discouraged by the existence of different investment policies across EU members, because this would reduce their ability to invest in the EU as in a single and coherent economic environment (as the EU common market is supposed to be). These problems could be overcome when the EU adopts a common policy governing foreign investments, which, however, shall not merely consist in replacing "the investment promotion efforts of Member States" at least "as long as they fit with the common commercial policy and remain consistent with EU

[125] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 1-4.

[126] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 4.

law." The Communication also underlines that the EU should make particular efforts to enhance investment negotiations with those countries with which investment inflows to EU companies and investment outflows from EU companies are particularly important, according to the principle that: "the Union should go where its investors would like to go, just like it should pave their way abroad, through the liberalisation of investment flows".[127]

As to the competences of the EU in entering into IIAs or into agreements which also contain substantial provisions governing foreign investments in a way similar to IIAs, the Commission states that the Lisbon Treaty "grants the Union exclusive competence" to "contribute to the progressive abolition of restrictions on foreign direct investment".[128] This wording is considered as attributing to the EU an exclusive competence in the field of FDIs and this is clarified in a note of the communication of the Commission which specifies that: "[a]rticle 207 includes foreign direct investment as one of the areas covered by the common commercial policy of the Union. The common commercial policy is an area of exclusive competence pursuant to Article 3(1) of the TFEU."

As to the issue of IIAs governing portfolio investments, which in principle cannot fall within the scope of art. 207 TFEU[129], the Commission argues that "to the extent that international agreements on investment affect the scope of the common rules set by the Treaty's Chapter on capitals and payments, the exclusive Union competence to conclude agreements in this area would be implied." This means that although art. 63 to 66 TFEU do not expressly devise an exclusive competence of the EU to conclude international agreements concerning movement of capital and payments from and to third countries, nevertheless the existence of such a competence should be ensured by art. 3.2 TFEU which provides that “the Union shall also have exclusive competence for the conclusion of an international agreement when its conclusion is

[127] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 6.

[128] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 1-2.

[129] On this point see also: S. EL BOUDOUHI; cit.; p. 105-106.

provided for in a legislative act of the Union or is necessary to enable the Union to exercise its internal competence, or in so far as its conclusion may affect common rules or alter their scope."[130]

In conclusion, in the view of the Commission, the EU would have an exclusive competence to conclude international agreements with third countries concerning both FDIs, consistently with art. 207 TFEU, and portfolio investments, in accordance with art. 63 to 66 read jointly with art. 3.2 TFEU. Then, the Communication studies which can be the substantive rules which could be introduced in investment agreements concluded by the EU and concerning investments from and to third countries. It studies the main rules contained in IIAs and especially in BITs and it quickly compares them with EU provisions.

First of all, the Commission focuses on the BIT provisions of MFNT and NT, which should be consistent with the EU principle of non discrimination. Then, the Commission refers to umbrella clauses and to clauses providing for fair and equitable treatment and full protection and security (in both cases, after the admission of the investment at issue.) In this case, the Commission does not go on further by clarifying the relation with EU law of such provisions, while it is satisfied with observing that "they have been traditionally used in Member States BITs and *are an important element* among others *that should inspire the negotiation of investment agreements at the EU level.*" [emphasis added]. Likewise, in the Communication it is stressed the need to include in future EU IIAs also provisions "ensuring the free transfer of funds of capital and payments by investors".[131] The Communication does not focus on the issue as to whether such clauses, differently from those contained in many BITs concluded by EU members with third countries, should specify the exceptions to these provisions. However, in the light of the above mentioned judgements Commission v. Austria, Commission v. Sweden and Commission v. Finland, it should be expected that the EU institutions, when entering into IIAs with

[130] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 8.

[131] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 9.

third countries, might include clauses which ensure EU members to derogate from the IIAs in order to ensure compliance with art. 64 to 66 TFEU.[132]

Then, the Commission turns to study the issue of those clauses of BITs "which place certain conditions upon the exercise of the host country's right to expropriate." They should not be regarded as incompatible with EU law and in particular with art. 345 TFEU, which provides that "[t]he Treaties shall in no way prejudice the rules in Member States governing the system of property ownership". In fact, while art. 345 can be read as ensuring member States that EU law shall not be construed so as to prevent them from carrying out expropriations or nationalizations, on the other side it cannot be interpreted in a manner to allow them to derogate from other EU provisions. In other words, as a well settled ECJ case law confirms, while EU law "does not affect a Member State's right to decide whether a given asset should be in public or private ownership" this does not allow member States, when they carry out expropriation measures, to depart "from the fundamental rules of the Treaty, including those on freedom of establishment and free movement of capital." In particular, it must be remarked that some of the requirements that must be fulfilled both under EU investment law (as interpreted by the ECJ) and under IIAs (as interpreted by arbitral tribunals) in order to ensure lawfulness to expropriation measures in the EU have quite a similar content. For instance, both in the EU legal order and in IIAs, expropriatory measures should be non discriminatory and proportionate to attain their legitimate objective.[133]

Consistently with these findings, the future EU IIAs should include provisions governing the issue of expropriation and nationalisation, which should be worded in a way similar to expropriation clauses contained in existing BITs. For the reasons States above, they should not rise issues of incompatibility with art. 345 TFEU.

[132] This solution is consistent with what is proposed in: S. EL BOUDOUHI; cit.; p. 93-95.

[133] The issue of the relation between art. 345 TFEU on one side and, on the other side, EU fundamental freedoms and BIT provisions on expropriation has been investigated *supra* in paragraph 1 of the present chapter and in paragraph 6 of chapter 6.

Finally, the Communication addresses the issue of the enforcement of the commitments undertaken by EU when concluding international instruments containing provisions on investments.

It recalls that recent FTAs and other cooperation agreements the EU recently concluded with third countries provided for an "effective and expedient state-to-state dispute settlement system" which, in the future, could also "cover the investment provisions of EU trade and investment agreements."

However, since one of the most important features of existing IIAs is that they also provide for an investor-State dispute settlement system, mainly by means of international arbitration, a similar system should also be envisaged in EU IIAs. The Commission recognises that this might present some difficulties essentially related to the fact that in many cases investor-State arbitration concerning foreign investments is organised under the ICSID. In case of IIAs concluded with third countries by the EU, the latter could be required to participate, in the capacity of the respondent, in arbitral proceedings before an ICSID tribunal. However, the Washington Convention "is open to signature and ratification by states members of the World Bank or party to the Statute of the International Court of Justice" and the "European Union qualifies under neither". [134] Although the communication contains the promise of the Commission to "explore with interested parties the possibility that the European Union seek to accede to the ICSID Convention, some potential obstacles to this are envisaged. In particular, it is stressed that accession of the EU to the ICSID "would require amendment of the ICSID Convention", but on the other side it also argued that the EU has already been able to successfully undertake negotiations with a view to amending the statute of international organisations and later to become a member of theirs, as it occurred, for instance, in the case of the World Custom Organisation.[135]

[134] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 8-9.

[135] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 10. On the difficulties related to the fact that the EU is not a member of the ICSID Convention and

In must be argued that ICSID arbitration, in spite of the increasing success it has obtained in the last decade, does not represent the sole form of arbitration available to settle investment disputes between the host State and the foreign investor. For instance, *ad hoc* arbitration or commercial arbitration under UNCITRAL rules could be available.[136] Nevertheless, the Communication does not consider these arguments and limits itself to mention the main challenges that the creation of a proper mechanism for addressing investor-State disputes may encounter. In particular, efforts must be made in order to increase transparency in relation to different phases of the dispute settlement procedures, like requests for arbitration, submissions, open hearings, *amicus curiae* briefs and publication of awards. It seems therefore that, under this point of view, the Commission shares the concerns of some critics of international arbitration on the alleged opacity of arbitral proceedings, while it partially neglects the importance of confidentiality which is one of the elements which has contributed to the success both of commercial arbitration and of international investment arbitration. Moreover, the Commission is concerned about the risks of atomisation of disputes and interpretations, which can reduce the consistency and predictability of the system as a whole and, as a result, its reliability and its attractiveness. To address these issues the Commission quickly mentions the possibility to make recourse to "quasi-permanent arbitrators (as in the EU's FTA practice) and/or appellate mechanisms."[137]

Finally, the Communication quickly addresses the issue of international responsibility. It is argued that, given the current exclusive external competence of the EU in the field of foreign investments, when BITs concluded by the EU with third countries will replace the BITs between member States and third countries, the EU will also be the sole defendant regarding any measure taken by a Member State which affects investments by third country nationals or companies falling within the scope of the

on the proposal that the EU might become a contracting party to that important international instrument see also: A. DE MESTRAL; cit.; p. 384-385.

[136] The complex issue of the relation between EU law and international investment arbitration will make the object of a more detailed analysis in paragraph 6 of the present chapter

[137] EUROPEAN COMMISSION; *Towards a comprehensive European international investment policy*; cit.; p. 10.

agreement concerned.[138] However, if the EU is not equipped to stand as a defendant before the appropriate jurisdictions, e. g. before ICSID arbitral tribunals because of the impossibility for the EU to be a member of ICSID, then it could be discussed whether the foreign investor should have the possibility to convene before ICSID tribunals EU member States.[139]

The Commission does not address some more implications the enunciation of such a principle might entail. In particular, it does not clarify whether member States, when they act inconsistently with investment agreements concluded by the EU (the latter exercising an exclusive external competence) may entail the international responsibility of the EU and, possibly, the existence of an obligation upon the latter to pay compensation to the adversely affected investor. Moreover, the communication does not make it clear whether such a conduct of an EU member may trigger an infringement procedure against it under art. 258 TFEU. However, also according to the wording of art. 216 par. 2 TFEU, "agreements concluded by the Union are binding upon the institutions of the Union *and on its Member States*". It follows that failure of a member State to comply with such agreements is tantamount to a failure to comply with EU law; therefore, what provided for in art. 258 to art. 260 TFEU must apply.[140]

A hypothetical example may allow to explore more in detail the application and the implications of the above mentioned concepts. If, for instance, Italy, as the recipient of the investments of the Chinese SWF, adopts measures which adversely affect the Chinese investments and are at the same time inconsistent with a hypothetical BIT concluded by the EU with China, then, first of all, the Chinese SWF should be entitled to initiate arbitral proceedings in accordance with the dispute settlement procedure

[138] On this issue, see also: J. A. BISCHOFF; cit..

[139] For a discussion on the possibility to invoke the international responsibility of members of the EU in the case it is impossible to invoke the responsibility of the EU see the reasoning developed in: J. M. SOBRINO HEREDIA; cit.; p. 1061-1080. In any case, it must be stressed that any attempt to apply the findings of this article to the case at issue should be made very carefully. In fact the article of Sobrino Heredia mainly deals with the issue of the responsibility of the EU with third countries and not with foreign investors. Moreover, it was written having in mind a legal framework which was quite different from the current one.

[140] A. FENET; cit.; p. 129-132.

laid down in the EU-China BIT and to ask compensation to the EU. Moreover, since the acts adopted by Italian authorities in breach of the BIT in force between the EU and China also entail a breach of EU law, then a procedure for infringement under art. 258 TFEU may be initiated by the Commission against Italy. Against this background, essentially hypothesis can be envisaged.

Firstly, it can occur that the procedure under art. 258 TFEU finishes before the initiation of an arbitral proceeding between the EU and the third country investor. In this case, the State complies with the judgement of the ECJ, put an end to the conduct which is in breach of the EU BIT and eventually agrees to pay a compensation to the affected investor in order to offset the damages she has suffered. In this case, arbitration between the EU and the affected investor, based on EU BITs, could be avoided and the EU would not be liable to pay compensation.

A second hypothesis consists in that the arbitral proceedings are concluded, and the EU is held liable to pay compensation to the affected investor. In this case, the EU would be required to pay for breaches (of the applicable BITs, but, for the reasons stated above, also of EU law) committed by one members of its. In addition, it must be remarked that if a State is found in breach of EU law by the ECJ under art. 258 is not required to pay to the EU a penalty payments, which, *in abstracto* could be used by the EU to pay the compensation to the investor as an outcome of the arbitral proceedings. In fact, the possibility to require a member State which fails to respect EU law to pay a penalty payment is limited to the circumstances of so called double condemnation under art. 260 TFEU. However the problems mentioned in the analysis of this second hypothesis would hardly rise in practise for the following reasons.

First of all, recourse to arbitration, as to any form of dispute settlement, occurs only when there is a dispute, in the case at issue between the EU and the third country investor. However, if the EU too is convinced that the conduct of the host State (which is also its member State) is actually in breach of one or more of the provisions of the EU BIT, then no dispute between it and the foreign investor could rise. In this case, the member State which wishes to avoid to be subjected to the infringement procedure of the ECJ under art. 258 TFEU could put an end to the conduct which adversely affect the third country investor, possibly agreeing with the latter a sort of compensation.

Moreover, it must be recalled that foreign investors in the EU could also opt for a recourse to domestic Courts of EU member States in order to ensure the enforcement of the provisions of BITs concluded by the EU. In this case, if it is deemed that EU BITs shall have direct effect in the EU legal order, then national Courts shall be required to disapply any legal act of the host State inconsistent with EU BITs. In addition, since EU legal order ensures a higher level of protection to investors, this could even imply that it is possible that third country investors might found it convenient to address not international arbitral tribunals but, on the contrary the domestic Courts of the host State directly. In fact, it must be argued that one of the reasons for the success of international arbitration, is that it was conceived in order to ensure alternative fora for dispute resolution to foreign investors operating in countries where independence of Courts was not ensured and where the legal framework governing economic operations was not very investor-friendly and property rights insufficiently protected. Since in the EU independence of Courts is ensured and standards of protection of investors (including in this notion domestic, EU and third country investors) are high, foreign investors could find it attractive recourse to domestic Courts instead of to international investment arbitration.

Finally, what has been argued in chapter 4 paragraph 2 of the present research applies also in case of investments undertaken by foreign SWFs in the EU. In fact, once it is found it more appropriate to define disputes between a foreign SWF and the host State as interstate disputes, it is likely that the best instrument to settle them should be interstate arbitration instead of investor State arbitration (be it ICSID or commercial arbitration) or recourse to domestic Courts. For this reason, in order to ensure that EU BITs shall effectively apply also to investments undertaken by third country SWFs in the EU it is necessary that they include provisions for the settlement of inter-State disputes alike. Alternative, if it is conceded that investment disputes between a third country SWF and the EU might be qualified as investor-State disputes, then the EU BITs should pay attention to include in the notion of covered investor also an explicit reference to State entities like SWFs themselves. Moreover, as it was clarified in chapter 4 par. 2, it is likely that disputes concerning SWFs, given their high level of politicisation, might be settled through political and diplomatic means, and not by mean of recourse to international or domestic adjudication. In this case the EU BIT could serve as a useful basis for negotiations which are likely to involve representatives of the SWF, of the government of the State which owns the SWF, of the government of the recipient country and of EU institutions (probably of the Commission).

It must be stressed that the reasoning developed above is a hypothetical reasoning which will apply in a future in which EU BITs will become a reality. The communication of the Commission pledging for a common EU approach governing investments from and to third countries is just the first step of a very long and complex process which could encounter important resistances from EU members, which could oppose the attempts of the EU institutions, and in particular of the Commission, to completely deprive them of their competence to enter into BITs with third countries. For this reason it is possible that a compromise might be found, whose terms should be similar to the approach which have been proposed in the previous paragraph of the present chapter. According to this compromise, the EU shall enter into BITs with third countries together with EU members. In other words, it is possible that future EU BITs will be mixed agreements, differently from the solution envisaged in the Communication of the Commission discussed above but consistently with the reasoning developed in the previous paragraph.

Also if the approach proposed by the Commission is accepted by EU members, it is however reasonable to expect a very long transitional period in which currently existing BITs will be gradually replaced by EU BITs. This is probably the main reason why the Commission, when it drafted the communication which has been analysed above, also adopted a proposal for a regulation establishing a transitional regime governing bilateral investment agreements between Member States and third countries (hereinafter referred to as "the proposal").[141] The importance of such a document is even greater since, as it is stressed in paragraph 3 of the proposal, the Treaty of Lisbon does not contain any explicit provision regulating the transition to the EU common investment policy. Art. 207 par. 2 TFEU only specifies that EU institutions shall have a competence in adopting rules governing such transition. In fact, it provides that "the European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, shall adopt the measures defining the framework for implementing the common commercial policy". This provision must be construed in a way to authorise the European institutions, acting in order to implement the transitional regime, even to derogate on a temporary base the principle laid down in art. 207,1 TFEU according to which the EU has an exclusive competence in the field of IIAs since the entry into force of the Lisbon Treaty.[142]

The Commission is in fact aware that transition from a situation in which BITs with third countries are concluded by member States to a situation in which such instruments are concluded by the EU only, can be extremely long and complex. This transition may present important similarities with the transitional period which started in the 1960s with the gradual establishment of the Common Commercial Policy.[143] At that time, the introduction of an exclusive competence of the EU (or, *rectius,* of the

[141] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries* * COM/2010/0344 final - COD 2010/0197 */; Brussels; 07-07-2010.

[142] The exclusive competence of the Union in the field of FDIs is confirmed paragraph 1 of the preamble of the proposal as well as in point 1 of the explanatory memorandum attached to the text of the proposal. In addition, the second paragraph of the preamble puts the base for including also portfolio investments in the scope of the proposal of regulation and, as a second stage, in the scope of EU BITs. In fact, consistently with what has been declared in the Communication mentioned above in the present paragraph, also in the proposal it underlines that "Part Three, Chapter 4 of Title IV of the Treaty [i. e. art. 63 et seq.] lays down common rules on the movement of capital between Member States and third countries, including in respect of capital movements involving investments. Those rules can be affected by international agreements relating to foreign investment concluded by Member States". When international agreements may affect common rules of EU law, then the EU has an exclusive competence in entering into such agreements.

[143] The common commercial policy at that time was essentially limited to external trade and did not include investments which, as explained above, has been concerned only after the entry into force of the Lisbon Treaty.

European Economic Community) in the field of the common commercial policy, required the replacement of agreements in force between EU member States and third countries governing issues like tariffs, custom duties, etc...[144] Therefore, the Commission refers to the transitional arrangements envisaged in that occasion in order to develop a transitional regime towards the establishment of a common EU investment policy and, more in detail, towards the replacement of BITs with third countries negotiated and concluded by member States with EU BITs.

To achieve this aim, the Commission argues that instruments of soft law can prove ineffective and therefore the most suitable instrument of EU law should be a regulation. As it is stressed in the first paragraph of the explicatory memorandum, the proposal of regulation only aims at addressing "the transitional aspects of the management of the new EU competence on investment". On the contrary, "the objectives, criteria and content of the new EU investment policy" included the content and the wording of the provisions of EU BITs which will be concluded, must be "developed on the basis of the newly-gained exclusive competence on foreign direct investment". For these reasons, they are not addressed in the proposal of regulation at issue but in the communication of the Commission which has already been studied above. In other words, according to par. 3 of the same memorandum, putting in place a transitional regime means to lay down the conditions and the requirements under

[144] It must be remarked that in 1969 the Commission opted for a great flexibility and forbearance as to the issue of the obligation of EU members to terminate intra-EU trade agreements. The agreements authorized by the Commission amounted to several hundreds and they were included in a list of the Commission which needed to be updated every five years. the Commission urged for a termination or a renegotiation only of those agreements which were most blatantly inconsistent with EU law. In 2004 such approach changed dramatically and this could be regarded as an indirect consequence of the enlargement of the EU. The Commission found that almost all trade agreements concluded by candidate countries were incompatible with EU law and it urged them to renegotiate or terminate such international instruments. Since candidate countries correctly argued that this treatment was discriminatory, and since the Commission did not mean to change its stance on this issue, it decided not to renew the authorization for the agreements in force to which EU members were contracting parties. The result was that since April 30th 2005, trade agreements which may have been autorised since 1969 could no more derogate EU law. If they were not terminated, a State could not invoke compliance with such instrument to exculpate a conduct of its incompatible with EU law. on this issue see: P. J. K; cit.; p. 267-368. It must be remarked that it is quite unclear whether the Commission, in the issue of investment agreements, will act as it did in the case of trade agreements between 1969 and 2004 or as it did after 2004.

which it is possible to "authorise the continuation in force of international agreements relating to investment concluded between Member States and third countries and to establish conditions and a procedural framework for the negotiation and conclusion by Member States of such agreements". This implies that, in the transitional period, States shall still be allowed to negotiate or renegotiate BITs with third countries, provided they do so in a manner consistent with the regulation which is expected to be adopted pursuant to the present proposal, and even though in the view of the Commission, art. 207 TFEU would otherwise exclude their competence to do so.

Pursuant to the above mentioned reasoning, after the establishment, with the entry into force of the Lisbon Treaty, of an exclusive competence of the EU in the field of BITs, BITs concluded by member States remain in force until they are replace by EU BITs. However, as far as BITs concluded by member States remain in force, member States may be required to renegotiate them in order to eliminate incompatibilities with EU law. In principle art. 207 should have barred States from doing so, as they would not have a competence in the field of investments with third countries anymore.[145] Therefore the objective of the proposal is to lay "down the conditions under which Member States should be authorised to maintain in force or to permit to enter into force international agreements relating to investment" and under which they "are empowered to amend or conclude international agreements relating to investment."It must be remarked once again that, when such authorization is granted , this represents a sort of derogation of the principle laid down in art. 207 TFEU according to which only the EU would be competent to negotiate, conclude or amend agreements concerning investments from and to third countries.[146]

[145] It must be remarked that, since the Commission holds that the EU has an exclusive competence in the field of foreign investments, the possibility for States to maintain IIAs they have previously concluded represents a clear derogation from the principle according to which the EU should be the sole subject enabled to conclude such agreements. In fact, the proposal of EU regulation "establishing transitional arrangements for bilateral investment agreements between Member States and third countries" emphasises at art. 3 that the possibility for States to be authorized to maintain in force their agreements is envisaged "[n]otwithstanding the Union's competences relating to investment.

[146] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries*; cit.; par. 4-8 of the preamble.

The transitional regime applies both to IIAs with third countries which are already in force at the date of the entry into force of the regulation at issue and to agreements which still are to be negotiated and concluded.

First of all, the regulation will lay down an obligation upon member States to notify the Commission of all bilateral agreements on investments which are signed or concluded with third countries before the entry into force of the Regulation and which member States "either wish to maintain in force or permit to enter into force"[147] If EU members abide by this obligation to notify, they are allowed to maintain in force such agreements.

The Commission will be entrusted with the task of publishing in the Official Journal of the European Union a list of the agreements which have been notified according to the procedure specified above.[148] In addition, it will review them and will assess, in particular, whether they:

"(a) conflict with the law of the Union other than the incompatibilities arising from the allocation of competences between the Union and its Member States, or

(b) overlap, in part or in full, with an agreement of the Union in force with that third country and this specific overlap is not addressed in the latter agreement, or

(c) constitute an obstacle to the development and the implementation of the Union's policies relating to investment, including in particular the common commercial policy"[149]

The Commission is entitled to withdraw its authorization to the notified agreement. The circumstances under which this can occur are detailed out in art. 6 and, given their importance for the purposes of the present research, they need to be quoted in full:

[147] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries*; cit.; art. 2.

[148] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries*; cit.; art. 4,1.

[149] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries*; cit.; art. 5.

"1. The authorization provided for in Article 3 may be withdrawn where:

(a) an agreement conflicts with the law of the Union other than the incompatibilities arising from the allocation of competence between the Union and its Member States, or

(b) an agreement overlaps, in part or in full, with an agreement of the Union in force with that third country and this specific overlap is not addressed in the latter agreement, or

(c) an agreement constitutes an obstacle to the development and the implementation of the Union's policies relating to investment, including in particular the common commercial policy, or

(d) the Council has not taken a decision on the authorisation to open negotiations on an agreement which overlaps, in part or in full, with an agreement notified under Article 2, within one year of the submission of a recommendation by the Commission pursuant to Article 218(3) of the Treaty."

Withdrawal of the authorization may occur only after the mandatory consultation between the Commission and the EU fails to resolve the problems and the incompatibilities mentioned above. In this case, the decision of the Commission to withdraw authorization "shall include a requirement that the Member State takes appropriate action, and where necessary terminate the relevant agreement". Moreover, the agreement is deleted from the list of notified and authorized agreements.[150] Although the proposal of regulation does not explicitly state this, an agreement which is no more authorized by the Commission does no more fall into the derogation to art. 207 provided for by the transitional regime laid down in the present proposal of regulation. As a result, it should not be regarded as legal anymore.

The proposal of the Commission also deals with the procedures pursuant to which member States shall be authorised to amend existing BITs or even to negotiate and

[150] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries*; cit.; art. 6,3 and art. 6,4.

conclude new BITs with third countries during the transitional period. Member States have an obligation to notify the Commission of their intention to amend existing BITs to which they are parties or to negotiate new agreements of this kind. The proposal specifies that "[t]he notification shall include relevant documentation and an indication of the provisions to be addressed in the negotiations, the objectives of the negotiations and any other relevant information. In the case of amendments to an existing agreement, the notification shall indicate the provisions that are to be renegotiated."[151] Negotiations between the EU member States and the third countries with a view to amending an existing BIT or to conclude a new BIT can start only after the authorization of the Commission which shall not be granted if certain circumstances occur. They are listed in art. 9 par. 1 and they are very similar to some of the circumstances under which authorization to maintain in force an existing agreement can be withdrawn according to art. 6 of the proposal of regulation. Authorization to open negotiations with the third countries is denied when the negotiations themselves are deemed by the Commission to :" (a) be in conflict with the law of the Union other than the incompatibilities arising from the allocation of competence between the Union and its Member States"

(b) undermine the objectives of negotiations underway or imminent between the Union and the third country concerned, or

(c) constitute an obstacle to the development and the implementation of the Union's policies relating to investment, including in particular the common commercial policy."

The EU member State concerned is required, at the end of the negotiations, to inform the Commission of their outcome and in particular of the text of the agreement which has been drafted. The signature and conclusion of the agreement is subject to the authorization of the Commission, which can deny it in case it finds that it does not meet the requirements laid down in art. 11,3 and which, being very similar to those

[151] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries*; cit.; art. 8.

laid down in the relation to the authorization to open negotiations, will not be repeated.

In addition, the Commission may participate to the negotiations.[152] This provision is particularly important, since it really favours a gradual passage from a situation in which BITs with third countries are concluded by member States to a situation in which they are concluded by the EU. in fact, participation of the Commission in negotiations on BITs modified or concluded by its members may enhance the skills of the Commission to negotiate BITs on its own, when it will start doing so. Finally, the participation of the Commission to negotiations should help to minimize the risk of incompatibilities between the content of the BIT and EU law.

In conclusion, it appears that the Commission exerts a threefold control over the negotiation or renegotiation of BITs between EU members and third countries during the transitional period. In fact, it exerts its control before the inception of negotiations (by means of deciding whether to authorise them or not) during the negotiations (since it must be constantly informed and can even be involved in the negotiating process itself,) and after the conclusion of the negotiations (when it decides whether the EU member shall be authorized to sign and ratify the agreements thus negotiated).

Finally, it must be remarked that the continuous control of the Commission over such BITs would be enhanced by the fact that art. 13 of the proposal lays down a framework which ensures that the Commission shall be informed "of all meetings which take place under the provisions of the agreement" concerning the application and implementation of the agreement at issue, especially when they can affect the common commercial policy of the EU.

[152] EUROPEAN COMMISSION; *Proposal for a Regulation of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries*; cit.; art. 10.

5. The issue of the establishment at the EU level of a screening mechanism of investments from third countries

The above mentioned documents of the Commission do not discuss the possibility to establish at the EU level a screening mechanism which might allow to control and possibly restrict in their pre-admission phase the investments undertaken by third State investors in the EU which are liable to rise particular concerns.

On one side it can be argued that these documents are limited to the relation between EU law and BITs. As it is well known, BITs in principle do not contain provisions on screening procedures, which, when existing, are rather provided for in domestic legislation of the host State.[153] On the other side, since the stance of the Commission is to develop a common EU investment policy, it must be remarked that the elaboration of proposals for the establishment of an EU screening mechanism which would replace the existing screening procedures in force in (certain) member State, should be consistent with the recent efforts undertaken by the Commission in this area. In fact, the existence in EU countries of different screening mechanisms subjecting the admission of foreign investments (essentially of third country nationals) to different procedures and rules, undeniably reduces the consistency of the legal framework governing foreign investments in the EU and it finally can jeopardise and frustrate any attempt of the Commission to develop not only a common investment policy, but even to achieve a decent level of consistency as to the aspect of the investment policy concerning the issue of the admission of foreign investments.

In addition, it must be once again reminded that once a third country investor is admitted in the EU, especially when she has established a company or purchased a controlling stake in an EU company, then she is in principle entitled to enjoy the fundamental economic freedoms provided for in EU law. In the previous chapter the hypothetical example has been provided of a third country SWF establishing a subsidiary in one of the EU members and then investing in other EU countries

[153] BITs, when they contain provisions on admission and establishment, may on the contrary lay down limitations to the ability of the host State to adopt the screening procedures at issue.

through such subsidiary, i. e. through this company incorporated in an EU member. The EU-incorporated subsidiary of the third country SWF, when it invests in other EU countries, should be in principle entitled to enjoy the rights provided for by the so called fundamental economic freedoms of EU law, included the right to undertake investments (direct and indirect both) in the territories of the other member States, taking advantage in particular of the provisions of EU law which govern the freedom of establishment and the free movement of capital. This could mean that a SWF, in order to circumvent the screening procedure of an EU country, could invest, by creating a subsidiary, in another EU member in which there is no screening mechanism for foreign investments or whose screening mechanism is less strict. Then, such subsidiary would invest in the other EU countries, included in those whose screening mechanism would have otherwise prevented the investment of the foreign SWF. This would be possible also because the screening procedures for foreign investments established in the domestic legislation of many EU members actually apply to investments from third country only, also in order to avoid that restrictive measures affecting intra-EU investments might be inconsistent with EU provisions on freedom of establishment and free movement of capitals. In this way, the admission of investments of the subsidiary of the SWF, as it qualifies as an EU company, should not be subjected to those restrictions which would have been otherwise applied had the same investment been carried out directly by the SWF itself.

In conclusion, given the high level of integration achieved by EU member States under EU law, the establishment at the EU level of a screening mechanism of investments from third country investors should be highly recommendable. Such a mechanism could be similar to the one put in place in the US and which has been briefly described above.[154]

[154] S. R. LINDBERG; cit.; p. 122-125. For an overview of the US screening procedure of foreign investments and for a discussion of its suitability in case of investments of SWFs, see, *supra*, chapter 4, paragraph 6 and paragraph 10

It can be noted that the EU has already put in place a screening mechanism, which nevertheless is conceived to apply exclusively to certain kinds of investments in certain sectors and precisely in the field of electricity and gas. These screening mechanisms are laid down in directives 2009/72[155] and 2009/73[156] respectively and in particular in their art. 11. A quick review of such acts needs therefore to be undertaken, in order to assess whether they could serve as a model for the elaboration of an EU mechanism entrusted with the task of deciding which investments from third countries, not only in the electricity and gas sectors, can be admitted and, possibly, under which special and additional requirement.[157]

The aim of the two directives is to lay down the rules relating to the organisation and functioning of the electricity and the natural gas sectors in the EU. They attempt to govern in particular the generation, transmission, distribution and supply of electricity as well as for the transmission, distribution, supply and storage of natural gas. They contain, *inter alia*, provisions on the protection of consumers, [158] the obligation to provide universal service,[159] the issue of unbundling, i. e. on the separation between the undertakings which operate in the field of the production of electricity and gas from the undertakings operating in the field of the transmission and distribution.[160]

They also provide for a mechanism according to which competent national authorities entrusted with the task of controlling and regulating the electricity and gas sectors shall provide transmission system operators with the certificate necessary for them to operate and manage the facilities for the transmission of electricity and natural gas. Both domestic and foreign investor shall be subjected to such procedure in order to

[155] Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC (Text with EEA relevance); OJ L 211, 14.8.2009, p. 55–93

[156] Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC (Text with EEA relevance); OJ L 211, 14.8.2009, p. 94–136

[157] H. SCHWEITZER; cit.; p. 280-281.

[158] Directive 2009/72; cit.; annex 1 and Directive 2009/73; cit.; annex 1. The texts of the directives contain several references to the issue of the protection of the consumers, which can be regarded as one of the main objectives of the directives themselves.

[159] Directive 2009/72; cit.; art. 3,3.

[160] Directive 2009/72; cit.; art. 9 and Directive 2009/73; cit.; art. 9.

obtain the certificate which allows them to operate electricity and gas transmission facility. The procedure is detailed out in art. 10 of directive 2009/72 and in art. 10 of directive 2009/73 which are worded in an almost identical way. It must be remarked that the national competent authorities shall not only verify whether the conditions are fulfilled to grant the certificate, but they also control whether, after the granting of the certificate, the conditions mentioned above are still respected. These conditions are laid down in art. 9 of both directives (which mainly concern the issue of unbundling). In spite of the broad competence of national authorities in this procedure, art. 10 provides for an involvement of the EU Commission, when it provides at par. 6 that the "explicit or tacit decision on the certification of a transmission system operator shall be notified without delay to the Commission by the regulatory authority, together with all the relevant information with respect to that decision". In addition, par. 7 of art. 10 enables the Commission, together with national regulatory authorities to "request from transmission system operators and undertakings performing any of the functions of production or supply any information relevant for the fulfilment of their tasks."

In can be concluded that procedure laid down in art. 10 could be understood not only as a procedure for granting a certificate, but also as a screening mechanism, which applies in a non discriminatory way to domestic and EU investors as well. Under this procedure a control is carried out, which allow to decide which investors are able to fulfil the above mentioned requirements and therefore which investors, by being granted the certificate, may be admitted in the market at issue.

What is of more interest for the purposes of the present research is the procedure laid down in art. 11 of both directives, which provides for a greater participation of the Commission in a screening mechanism applicable to investments undertaken by entities based in third countries.

In fact, par 1 of art. 11 provides for a duty upon the national regulatory authorities to notify the Commission when the certification referred to in art 10 "is requested by a transmission system owner or a transmission system operator which is controlled by a person or persons from a third country or third countries" i. e. in case of a direct investment undertaken by a third country national in a company operating as transmission system operator in the electricity and gas sectors.

The national regulatory authorities shall adopt a draft decision they are mandated to notify to the Commission. The directives specify which are the elements that the national authority needs to take into account. More precisely, "it shall refuse the certification if it has not been demonstrated:

(a) that the entity concerned complies with the requirements of Article 9; and

(b) to the regulatory authority or to another competent authority designated by the Member State that granting certification will not put at risk the security of energy supply of the Member State and the Community. In considering that question the regulatory authority or other competent authority so designated shall take into account:

(i) the rights and obligations of the Community with respect to that third country arising under international law, including any agreement concluded with one or more third countries to which the Community is a party and which addresses the issues of security of energy supply;

(ii) the rights and obligations of the Member State with respect to that third country arising under agreements concluded with it, insofar as they are in compliance with Community law; and

(iii) other specific facts and circumstances of the case and the third country concerned."[161]

Moreover, before the national authority adopts the decision on the certification, the national regulatory authority shall request an opinion from the Commission on whether:

"(a) the entity concerned complies with the requirements of Article 9; and

(b) granting certification will not put at risk the security of energy supply to the Community."[162]

[161] Directive 2009/72; cit.; art. 9 and Directive 2009/73; cit.; 11 par. 3.

[162] Directive 2009/72; cit.; art. 9 and Directive 2009/73; cit.; 11 par. 5.

The notion of risk to the security of energy supply to the Community is then clarified when it is provided which are the elements that the Commission shall consider when it is asked to provide the opinion to the domestic authority. They are:

"(a) the specific facts of the case and the third country or third countries concerned; and

(b) the rights and obligations of the Community with respect to that third country or third countries arising under international law, including an agreement concluded with one or more third countries to which the Community is a party and which addresses the issues of security of supply."[163]

The directives specifies the details and the timing of the procedure and clarifies that "in the absence of an opinion by the Commission within the period provided for in art. 11, the national authority can decide on its own and in this case the Commission will not raise objections to such decision.[164]

After having received the opinion of the Commission (or after the expiry of the terms before which such opinion had to be provided), the national regulatory authority shall adopt its final decision on the certification. In doing so, it "shall take utmost account of the Commission's opinion."

In any case, it does not seem that the opinion of the Commission shall be binding upon the national authority. In fact, the directive underlines that "in any event Member States shall have the right to refuse certification where granting certification puts at risk the Member State's security of energy supply or the security of energy supply of another Member State." Therefore, if such authority decides not to conform to the opinion of the Commission, it shall only have the obligation to publish, together with its final decision and the opinion of the Commission, the reasons why the former diverges from the latter.[165]

[163] Directive 2009/72; cit.; art. 9 and Directive 2009/73; cit.; art. 11 par. 7.
[164] Directive 2009/72; cit.; art. 9 and Directive 2009/73; cit.; 11 par. 6.
[165] Directive 2009/72; cit.; art. 9 and Directive 2009/73; cit.; 11 par. 8.

Finally it must be underlined that, according to par. 9, nothing in art. 11 shall affect "the right of Member States to exercise, in compliance with Community law, national legal controls to protect legitimate public security interests".

It seems therefore that under directives 2009/72 and 2009/73 member States retain a large discretion when they decide whether to grant certification, i. e. whether to admit or not, the investments from third countries in the electricity and gas transmission industry. The role of the Commission essentially consists in ensuring a higher level of consistency, also with a view to promoting the development of an EU single market in the energy sector. The Commission is not expected to replace national regulatory authorities in their task of deciding whether to grant certification to third country investors. However, the fact that the national authorities, when their decision diverges from the opinion of the Commission, are required to publish the reasoning underlying their choice, should put pressure on them to conform to the Commission's opinion or, at least, should discourage arbitrariness.

The screening mechanism envisaged in art. 11 of directives 2009/72 and 2009/73 could serve as a model for a screening mechanism at the EU level and forming part of the EU common investment policy, which might be used in case of all the investments undertaken in the EU by third countries investors.

First of all, it does not provide a centralised competence of the Commission which excludes any role of member States. On the contrary, it would be based on the cooperation between member States and the Commission. If it is supported the view that, even after the entry into force of the Lisbon Treaty, the EU does not have an exclusive competence in all the aspects concerning foreign investments from third country investors,[166] then an EU screening mechanism similar to the one envisaged in art. 11 of the above mentioned directives would allow to avoid the problems related to the definition of what constitutes a competence of the EU and what a competence of its member States.

[166] see, *supra*; chapter 7 par. 3

Also if it is supported the approach of the Commission, according to which the EU has an exclusive competence in the field of investments from third countries,[167] then the screening mechanism explained above could constitute the most suitable option during the transitional period, because of its flexibility and the fact that it promotes cooperation between the Commission and competent authorities of member States.

Another provision should be included in a future EU screening mechanism which should be inspired by dir. 2009/72 and 2009/73. It is the provision which allows States to retain their power to refuse the admission of a foreign investment because of threats to their own national security, but which also requires them to take into account the opinion of the Commission, especially when the latter focuses on the issue as to whether the investment might represent a threat to the national security *of the EU as a whole*.[168] In fact, given the existence of an internal market, it is undeniable that once a third country investor is admitted into one EU country it can then invest in other countries possibly circumventing some of the restrictions that other States may maintain. For this reason, admission of a third country SWF could entail risks to the national security not only of the State which has admitted it, but also to other EU members or to the EU as a whole. The Commission is deemed to be better equipped than individual EU member States in assessing whether an investment from a third country entity is able to put at risk the national security of the EU. It must be underlined that, in the directives 2009/72 and 2009/73, the focus is on energy security, but a screening procedure applicable to all investments from third country investors shall adopt a broader notion of national security which should be consistent with the finding of chapter 4 paragraph 8 to 10 of the present thesis.

Moreover, attention should be paid to art. 11 par. 7 a) of directives 2009/72 and 2009/73, according to which the Commission, when assessing the existence of threats to energy security shall consider "the specific facts of the case and the third

[167] see, *supra*; chapter 7 par. 4

[168] It could be argued that the term national security should be used when referring to States and not to the EU. However, in this case the national security of the EU shall not be meant as the national security of the EU meant as an international organization (which would not make sense) but of the EU countries as a whole and not considered individually.

country or third countries concerned". This allows, or more probably even obliges, the Commission to undertake strategic and security considerations. For instance, in the case of energy, the risk is that third country entities, which are owned by States which in turn are the main importers of gas in the EU and own the undertakings which extract the same gas, might also purchase controlling stakes in EU undertakings operating the facilities from the transmission of gas. This would give to such countries (it is especially the case of Russia) the possibility to affect the supply of energy to the EU, the same energy policy of the EU and finally to indirectly exert and undue influence over the EU itself also in fields different from energy.

A screening mechanism taking directives 2009/72 and 2009/73 as models should therefore enable and require the Commission to assess whether the third country investor, given the political situation of the third country which owns it and the political and economic relations of such country with the EU, might represent a threat to the national security of the EU. Moreover, the Commission should also consider the private or public ownership of the third country investor. It can also provide for specific controls in case the investor is a SWF or a State owned entity.

6. International investment arbitration and EU law: which options for the settlement of disputes concerning SWFs?

An issue which rises particular problems of compatibility between EU law on one side and BITs (both intra-EU and extra-EU BITs) on the other side is constituted by the possibility to settle disputes concerning the application and interpretation of BITs by means of arbitration. In fact, only BITs ensure that foreign investors might have access to international investment arbitration, while EU law only provides that investors, as well as any other individual or company, shall have the right to have EU law applied by domestic Courts of EU member States. Since the possibility to refer a dispute to arbitration is regarded as providing particular advantages to investors, then an issue of discrimination between investors which are nationals of different EU countries may arise. In other words, it can occur that certain EU investors may enjoy the right to refer disputes to arbitration by virtue of a BIT concluded between the EU host country and the country of which they are nationals, while other EU investors have not a similar possibility because no BIT has been concluded between the same EU host State and their own home State. This would result into a discrimination between the former investors and the latter ones: this would be clearly inconsistent with EU law as explained in paragraph 2 of the present chapter.[169]

The Commission is aware of this situation and in the observations it presented in the proceedings of the Eastern Sugar case, it pointed out that the main problems in the relation between EU law and BITs could rise out of the issue of arbitration.[170]

Also if there may be partial overlapping of the content of the substantive provisions of BITs and EU law, the principle of primacy of EU law (in case of intra-EU BITs) or the obligation to eliminate incompatibilities between EU law and agreements with third countries (in case of extra-EU BITs) do not prevent the offer to arbitrate made by the host country, which is implied in the arbitration clause contained in applicable BITs, from producing its effects.[171]

It must be remarked that investor-State arbitration is not the only kind of arbitration which exists and which could be relevant for the purposes of the present analysis. Broadly speaking, and not limiting our discussion to the issue of disputes concerning foreign investments, three kinds of international arbitral proceedings exist, according to the nature of the parties to the dispute. [172]

The first one to be mentioned is inter-State arbitration, in which an international arbitral tribunal is required to settle a dispute between two States.

The second one is investor-State arbitration, when the parties to the dispute are a foreign investor and the host State respectively. It can be organised under ICSID

[169] M. POTESTÀ; *Il caso Eastern Sugar: accordi bilaterali sugli investimenti, Unione europea e diritto comunitario*; cit.; p. 1060-1069; M. POTESTÀ; *Bilateral Investment Treaties and the European Union. Recent Developments in Arbitration and Before the ECJ*; cit.; p 232-238.

[170] see, *supra*, paragraph 1 of the present chapter.

[171] C. SODERLUND; cit.; p. 458.

[172] On this issue see also: A. RADU; cit.; p. 257. For a discussion of the issue of the recourse to international arbitration in case of disputes between a foreign SWF and the host State see chapter 4 par. 2 of the present research.

rules or under different sets of rules. For instance investor-State arbitration can take place also applying the same rules of international commercial arbitration. In this second case it should be regarded as investor-State arbitration if the focus is on the nature of the parties to the dispute, but as international commercial arbitration if the elements which are considered are the rules of procedure to be adopted. In the next pages it will be referred to as non-ICSID investor-State arbitration.

International commercial arbitration finally applies in case of disputes between two (or more) private parties (physical or more often legal persons) which are nationals of different countries.

In this paragraph it will be studied which of the following arbitral procedures could be more appropriate in order to settle disputes between SWFs and host countries which also are members of the EU. In addition, a discussion on the impact of EU law on these kinds of arbitration, or even on the possibility to make recourse to them to settle investor-State disputes in the EU will be undertaken.

In the light of the findings of chapter 4 paragraph. 2 of the present research, where it has been concluded that foreign SWFs are to be regarded more as States than as investors, inter-state arbitration is probably the most suitable remedy for the settlement of disputes between the host State and the foreign SWF. In this paragraph it is necessary to study whether EU law might represent an obstacle to this. It must be recalled that art. 344 TFEU (former 292 TEC) provides that: "Member States undertake not to submit a dispute concerning the interpretation or application of the Treaties to any method of settlement other than those provided for therein." To better understand the scope and the implications of this article, it is necessary to quote a recent judgment of the ECJ, the so called Mox case,[173] which does not concern international investments, but which nonetheless deals with the issue of the compatibility with EU law of recourse to *ad-hoc* inter-State arbitration between to EU member States and for issues concerning (at least in part) EU law.

[173] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; Case C-459/03; European Court reports 2006 Page I-04635.

In order to ensure a better understanding of the legal issues risen in this case, a brief summary of the factual and legal background is needed. The EU (at that time of the Mox dispute, the European Community) is, jointly with its members, a contracting party to the Convention on the law of the sea, signed at Montego Bay on 10 December 1982 (hereinafter referred to as "Montego Bay Convention". Such Convention provides in part XV, which concerns the settlement of disputes, and especially at art. 287 that "when signing, ratifying or acceding to this Convention or at any time thereafter, a State shall be free to choose, by means of a written declaration, one or more of the following means for the settlement of disputes concerning the interpretation or application of this Convention". The available means are:

"(a) the International Tribunal for the Law of the Sea established in accordance with Annex VI;

(b) the International Court of Justice;

(c) an arbitral tribunal constituted in accordance with Annex VII;

(d) a special arbitral tribunal constituted in accordance with Annex VIII for one or more of the categories of disputes specified therein."[174]

Pursuant to this provision, Ireland submitted to an *ad hoc* arbitral tribunal a dispute with the United Kingdom concerning the application of the Montego Bay Convention. The dispute arose in relation to the activity of the Mox plant. It was a facility, situated on the coast of the Irish Sea, designed to recycle plutonium to produce a new kind of fuel. It was operated by a UK company, under the needed licenses and permissions of UK authorities.[175]

[174] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 1-19 for a more in depth description of the legal background of the dispute.

[175] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 20-49. For an overview of the factual background and of the proceedings before the arbitral tribunal see also: F. MARIATTE; *Accords mixtes et arbitrage: première sanction du «devoir de loyauté au système judiciaire» communautaire*; in *Europe* n° 7, Juillet 2006, comm. 207. See also: B. KWIATOWSKA; *The Ireland v. United Kingdom (Mox Plant). Case: applying the doctrine of treaty parallelism*; in *the international journal of marine and coastal law*; 2003; p. 1-59; C. P. R. ROMANO; *Commission of the European Communities v. Ireland. Case C-459/03. Judgment*; in *American Journal of International Law*; 2007; p.171-172; N. SCHRIJVER; *Case C-459/03, Commission of the European Communities v. Ireland, Judgment of the Court (Grand Chamber) of 30 May 2006*

The Commission holds that the subject matter of the dispute falls within the competence of EC law (today EU law) and therefore that the ECJ must have an exclusive competence to settle such dispute under art. 292 TEC (today art. 344 TFEU).

The Court first notes that, although the Montego Bay Convention has been concluded as a mixed agreement, i. e. both by the EC and its member States, in principle it has the same status in the European legal order as a purely Community agreement. This implies, *inter alia*, that member States have a duty to the EU to abide by such Convention.[176]

However, since the Montego Bay Convention is a mixed agreement, it is necessary to examine whether "the provisions of that agreement relied on by Ireland before the Arbitral Tribunal in connection with the dispute concerning the MOX plant come within the scope of Community competence". [177] As the dispute between Ireland and the UK, and which has been brought before the arbitral tribunal by Ireland, concerns the protection of the maritime environment, the ECJ concludes that it falls within the competence of EU law (current art. 191 to 193 TFEU, former art. 174 to 176 TEC). It must be noted that art. 176 TEC (current art. 193 TFEU) provides that the EC, and today the EU, have shared and not exclusive competences in this matter.[178] However, as the ECJ points out, this is irrelevant for the purposes of determining the existence

[2006] ECR I-4635; in *Common Market Law Review*; 2010; p. 863-865; N. LAVRANOS; *The Epilogue in the MOX plant dispute: an end without findings*; in *European Energy and Environmental Law Review*; 2009; p. 180-184.

[176] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 80-85. For a more general discussion on the fact that if member States do not abide by an international agreements concluded by the EU, not only are they responsible before the other contracting parties to that agreement, but they also violate EU law see: J. M. SOBRINO HEREDIA; cit.; p. 1061-1080; A. FENET; cit.; p. 129-132.

[177] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 86.

[178] In fact, art. 193 TFEU provides that "the protective measures adopted pursuant to Article 192 shall not prevent any Member State from maintaining or introducing more stringent protective measures. Such measures must be compatible
with the Treaties. They shall be notified to the Commission."

of an EU competence in this field.[179] In fact, the Court argues, "the question as to whether a provision of a mixed agreement comes within the competence of the Community is one which relates to the attribution and, thus, the very existence of that competence, and not to its exclusive or shared nature".[180].

The Court continues its reasoning by reminding "that an international agreement cannot affect the allocation of responsibilities defined in the Treaties and, consequently, the autonomy of the Community legal system, compliance with which the Court ensures under Article 220 EC" (this article has been repealed with the entry into force of the Lisbon treaty, but its content is essentially reproduced in art. 19 TEU). The Court then adds that its exclusive jurisdiction (also in case, it seems, of shared competences and mixed agreements) "is confirmed by Article 292 TEC" (today art. 344 TFEU).[181] Such exclusive jurisdiction, and the more general principle according to which the ECJ must have the monopoly over EU law,[182] cannot be affected by an international agreement such as the Montego Bay Convention.[183] In this way the Court tries to assert to the maximum its exclusive jurisdiction and attempts to reduce the risk of fragmentation of EU law which would be the consequence of allowing other jurisdictions than the ECJ to interpret and apply EU law outside the control of the ECJ itself.[184]

The Court also notes that the Montego Bay Convention itself is not completely incompatible with this principle, since it contains a provision which would have allowed Ireland to submit its dispute with the UK and concerning the Mox plant to the

[179] On this point see also: C. P. R. ROMANO; cit.; p.171-178; P. J. CARDWELL; D. FRENCH; *Who decides? The ECJ's judgment on jurisdiction in the MOX Plant dispute*; in *Journal of Environmental Law*; 2007; p. 123-124.

[180] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 93. The approach of the Court is in fact that the ECJ has an exclusive competence in case of disputes between member States concerning EU law and the notion of EU law must be construed in a way to include also mixed agreements to which the EU is a contracting party. On this point see: C. P. R. ROMANO; cit.; p.176; N. SCHRIJVER; cit.; p. 869-870 and 874-878.

[181] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 123-124

[182] C. P. R. ROMANO; cit.; p.173-174.

[183] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 132

[184] N. LAVRANOS; *The Epilogue in the MOX plant dispute: an end without findings*; cit.; p. 181.

ECJ instead of to an *ad hoc* arbitral tribunal.[185] In fact, art. 282 of the Montego Bay Convention provides that "[i]f the States Parties which are parties to a dispute concerning the interpretation or application of this Convention have agreed, through a general, regional or bilateral agreement or otherwise, that such dispute shall, at the request of any party to the dispute, be submitted to a procedure that entails a binding decision, that procedure shall apply in lieu of the procedures provided for in this Part, unless the parties to the dispute otherwise agree." The procedure referred to in such article can be, of course, the procedure contemplated in art. 259 TFEU, which implies the exclusive competence of the ECJ in case of disputes between EU member States.

In the course of the proceedings before the ECJ, Ireland argues that recourse to *ad hoc* arbitration would have presented more advantages than the procedure laid down in the TEC (today TFEU). The Court, without considering it necessary to assess whether such advantages are real and relevant, simply decides to reject this argument, on the basis that "such advantages could not in any event justify a Member State in avoiding its Treaty obligations with regard to judicial proceedings intended to rectify an alleged breach of Community law by another Member State".[186] Finally, the Court stresses that, by instituting arbitral proceedings which in turn have prevented recourse to the ECJ for a matter falling within the scope of EU (at that time EC) law, and by failing to inform the Commission about this, Ireland not only has failed to fulfil its obligations under art. 292 TEC but also under art. 10 TEC.[187] Such article, which after the entry into force of the Lisbon treaty has become, with some changes, art. 4,3 TEU, provides for a duty of loyal cooperation to enhance the achievement of the objectives of the European Community (at the time of the Mox

[185] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 125. N. SCHRIJVER; cit.; p. 868.
[186] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 136-137.
[187] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 182.

case) and of the EU (today).[188] Such duty has several dimensions, but, in the case at issue, what is relevant is that it requires member States to undertake all the necessary measures to cooperate with EU authorities so that to ensure the respect and the enhancement of EU law.

After having outlined the main findings of the Court in the Mox case it is possible to discuss whether they could help to shed more light on the issue of inter-State arbitration in the EU and, as a result, on the issue of arbitration between a foreign SWF and an EU host State.

First of all, it must be underlined that the Mox case concerns an inter-State dispute and its findings can hardly apply to investor-State disputes. This has been confirmed, *inter alia*, by the Tribunal in the Eureko case, which explicitly discussed whether the Mox jurisprudence should have been applicable also in cases different from those concerning inter-State dispute. The Tribunal found that the Mox judgement could eventually have a relevance in relation to disputes between the two States which had concluded the BIT (and which were governed by art. 10 of the BIT between the Netherlands and the Czech Republic), but it denied that it might have been "applicable to disputes under Article 8, which are not disputes between Contracting Parties but investor-State disputes." The tribunal then added that "[t]here is no suggestion here that every dispute that arises between a Member State and an individual must be put before the ECJ; nor would the ECJ have the jurisdiction (let alone the capacity) to decide all such cases". [189]

If a dispute between two EU members and which arises out of a foreign investment concerns the interpretation and application of provisions of the TEU and the TFEU (for instance of art. 63 to 66 TFEU and art. 207 TFEU), then only the ECJ shall be

[188] Art.. 4,3 TEU reads as follows: "[p]ursuant to the principle of sincere cooperation, the Union and the Member States shall, in full mutual respect, assist each other in carrying out tasks which flow from the Treaties. The Member States shall take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union. The Member States shall facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardise the attainment of the Union's objectives." For a comment of the different steps in which the reasoning of the ECJ is articulated see: F. MARIATTE; cit.; N. SCHRIJVER; cit.; p. 865- 878; P. J. CARDWELL; D. FRENCH; p. 124-125.

[189] *Eureko B. V. v. the Slovak Republic*; cit.; par. 276.

competent to settle it, thus excluding the jurisdiction of any other forum, like *ad hoc* arbitral tribunals whose institution is contemplated in the inter-State arbitration clause provided for in BITs.[190] In other words, it could be argued that if disputes between an EU member and a SWF which is owned by another EU country are referred to an arbitral tribunal and not to the ECJ, this shall constitute a breach of EU law, and, in detail, of art. 344 TFEU. In fact such disputes must be settled according to the procedure which is laid down in art. 259 TFEU. Under such provision, a Member State which considers that another Member State has failed to fulfil an obligation under the EU law shall bring the matter before the Commission. The latter shall deliver a reasoned opinion after each of the States concerned has been given the opportunity to submit its own case and its observations on the other party's case both orally and in writing. In this case the procedure becomes very similar to the one which is provided for in art. 258 TFEU, according to which if the State concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the Court of Justice of the European Union. Art. 259 also envisages the possibility that the Commission has not delivered an opinion within three months of the date on which the matter was brought before it. In this case the absence of such opinion shall not prevent the matter from being brought before the Court by the member State which claims that another EU member has breached EU law.

Another aspect of the Mox case which deserves attention is that in the case at issue the Montego Bay Convention, at art. 282, explicitly allows recourse to mechanisms for the settlement of disputes other than those it provides for in its art. 287. Such mechanisms can therefore include the application to the ECJ. A similar provision is absent in BITs. However, it must be remarked that, in case of inter-State disputes, the broad formulation they adopt may allow to conclude that recourse to procedures other than arbitration should not be *a priori* excluded. In fact, if reference is made to

[190] For further discussion on the issue as to whether the MOX jurisprudence should be interpreted and applied when studying the relation between EU law and international investment law see: F. S. BENYON; cit.; p.108-109; T. EILMANSBERGER; cit.; p. 403-404; M. BURGSTALLER; cit.; p.189.

the articles of BITs providing for inter-State arbitration clauses which have been analysed in previous chapters,[191] it is required that States settle their disputes concerning the interpretation and the application of the BITs by recourse to discussions, diplomatic means and other peaceful means. The latter ones should be construed as including request to refer the dispute to international adjudications like also recourse to the ECJ.

In any case, at least if the issue is discussed from the point of view of EU law, this has little relevance. In fact, as the ECJ repeatedly stressed in the Mox case, an international agreement cannot in no way prevent the application of current art. 344 TFEU.[192] Therefore, even if it is deemed that an applicable BIT provides for an exclusive competence of an arbitral tribunal in case of a dispute between an EU member and the SWF owned by another EU member, an EU member which refers to such tribunal instead of to the ECJ breaches art. 344 TFEU and art. 4,3 TEU.[193]

However, it must be remarked that the Mox case concerns a dispute between two EU States and not between an EU member State and a third country. Therefore, the Mox jurisprudence can be applied *mutatis mutandis* to the issue of the settlement of disputes between SWFs owned by an EU member State and another EU member State. As it has been specified above, cases of intra-EU investments by SWFs are currently irrelevant, while the most important issue is represented by the investments of third country SWFs in EU countries. In this case it does not seem that the Mox jurisprudence may apply. Likewise, the same art. 344 is not so clear, because it only specifies that disputes which shall be settled exclusively by the ECJ shall be those disputes involving EU members and concerning the interpretation and the application of EU law, but it does not explain whether all the parties to the dispute must be EU member States. If art. 344 TFEU means, as it seems much more convincing, that both States to the dispute must be members of the EU, then the Mox jurisprudence shall apply exclusively to disputes between an EU SWF and an EU host State, while

[191] See *supra*, chapter 4 par. 2

[192] Judgment of the Court (Grand Chamber) of 30 May 2006; *Commission of the European Communities v Ireland*; cit.; par. 123 and 132.

[193] P. J. CARDWELL; D. FRENCH; cit.; p. 126-127.

it shall not be relevant in case of disputes (which are more likely to occur) between a third country SWF and an EU host State. It would result that the Mox jurisprudence ultimately does not reduce the possibility to submit to international investment arbitration disputes which arise out of an investment undertaken by a third country SWF into the territory of an EU member State.

However, if it is deemed that SWFs are not to be regarded exclusively as States but also as investors, or as entities which are separate, although only partially, from the States which own them, then investor-State arbitration should be regarded as a more viable option to settle disputes they may enter into with the host State. In this case many of the findings of the Mox case should not apply.

In fact, in the Mox case recourse to inter-State arbitration was barred because it was inconsistent with current art. 344 TFEU (former art. 292 TEC). However, such article merely lays down an obligation upon EU member States in relation to their duty to submit to the ECJ all those disputes which arise between them. It cannot be interpreted as imposing a similar duties to subjects other than States. If it is deemed that SWFs are not (or at least not only) States, but also investors which for certain respects are distinguished from the States which own them, then there would not exist an obligation upon SWFs owned by EU countries to refer exclusively to the ECJ the disputes they may enter into with the host State. In the Mox case, since an inter-State dispute was at issue, there was a conflict of jurisdiction between the ECJ and the arbitral tribunal organised according to the wording of the Convention of the law of the sea. On the contrary, in case of investor-State disputes a similar conflict does not exist.[194] In fact, while current art. 259 TFEU allows States to address the ECJ (although not directly but with the assistance of the Commission), on the contrary no provision of EU law obliges or empowers individuals to address the ECJ in case of disputes with an EU State.

In case of disputes, concerning issues of EU law, which rise between the host State and the foreign investors, the remedies which are available are essentially the same

[194] C. SODERLUND; cit.; p. 459-460.

which exist in case of any dispute between an individual and an EU member State concerning the interpretation and the application of EU law.

In fact, when individuals (in the specific case at issue: foreign investors) believe that their rights have been jeopardised by the conduct of an EU State (which in the case at issue is the host State of the investment), when such conduct is also inconsistent with EU law they will be entitled to start proceedings before the Court of that State and not before the ECJ. The municipal Court which is seized is in principle required to ensure the respect of EU law. When non compliance with EU law is the consequence of certain acts adopted by the host State, then, the domestic Court shall have the duty to disapply the domestic acts which are inconsistent with EU law, according to the well-established principle of the supremacy of the EU legal order. Only when it is unclear whether the State acts at issue are incompatible with EU law, then the municipal Court is allowed (or it is obliged when it is a jurisdiction of last instance) to refer the issue to the ECJ for a preliminary ruling according to the procedures laid down in art. 267 TFEU. However, it must be stressed that in this framework the ECJ shall not issue a decision on the merits, but it shall only provide explanation to municipal courts as to the way EU law must be interpreted and applied. The domestic Court, through the preliminary ruling, may aim at obtaining an explanation as to whether an EU provision must be interpreted in a way so that the State measures at issue may be regarded as compatible with EU law or not. In other words, the ruling of the ECJ would enable the municipal Court to conclude whether EU law must be interpreted in a way that the measures of a member State which make the object of the preliminary ruling are incompatible with EU law and therefore need to be disapplied.

It follows that the preliminary ruling, as it is regulated in art. 267 TFEU, cannot be regarded as providing for a right or a duty upon investors which carry out their operations in the EU to refer disputes they may enter into with the host EU State to the ECJ.

In fact, differently from art. 344 TFEU as it is read in conjunction with art. 259, art. 267 does not provide for an obligation to refer a dispute between a foreign investor and an EU member State to the ECJ. It leaves the parties free to agree other jurisdictions to settle their dispute. Such jurisdictions may include municipal Courts (without prejudice to the possibility or the duty to apply for a preliminary ruling under art. 267 TFEU) as well as arbitration.

In chapter 4 it has already been explained the reason why ICSID arbitration, in the light of the interpretation that tribunals have consistently given to art. 25 of the Washington Convention, is unavailable to settle disputes between a foreign SWF and the host State. Therefore, the issue of the relation between EU law and ICSID arbitration and in particular the issue as to whether EU law can affect ICSID arbitration in the case a SWF is party to the dispute, does not deserve further discussion.

Nevertheless, it must be recalled that, once it is deemed that SWFs should be regarded also as foreign investors and not exclusively as States and therefore that investor- State arbitration should be in principle admissible, then it should be studied which kind of arbitration may constitute the most suitable mean for the settlement of disputes. As ICSID arbitration is unavailable for the reasons stated above, recourse to what has been defined above as non-ICSID investment arbitration should be in principle possible.

It consists in an arbitral proceeding between a foreign investor and the host State and which aims at settling an investment-related dispute (thus similar from this standpoint to ICSID arbitration) but which takes place before an *ad hoc* tribunal or a tribunal administered by an arbitration centre, like the Paris International Court of Arbitration or the Arbitration Institute of the Stockholm Chamber of Commerce and which applies the same rules of procedures which usually apply to disputes between companies and/or individuals. From this last point of view such arbitration would be similar to the so called international commercial arbitration.

Therefore, the study of the impact of EU law on non ICSID arbitration between a SWF and a host State which is also member of the EU, must be articulated in two steps.

First of all, it must be briefly studied the impact on EU law on non-ICSID investor-State arbitration. Since the procedural rules of such kind of arbitration are the same which govern international commercial arbitration, it is necessary to study the relation between EU law and the law of international commercial arbitration[195] and then to assess whether the results of this research may be applied in full or only partially to the study of the relation between EU law and non-ICSID international investment arbitration.

As a second step, it will be studied whether the findings which emerge from such a discussion may apply in case of disputes between a foreign SWF and an EU host State which is submitted to non ICSID arbitration.

First of all, it should be argued that there is nothing which prevents arbitral tribunals from applying EU law in disputes to which they are parties. On this point also the Eureko tribunal stated that: "There is, however, no rule of EU law that prohibits investor-State arbitration. Far from it: transnational arbitration is a commonplace throughout the EU, including arbitrations between legal persons and States; and the European Court of Justice has given several indications of how questions of EU law should be handled in the course of arbitrations, including important questions of public policy." The Tribunal then concluded that: "it cannot be asserted that all arbitrations that involve any question of EU law are conducted in violation of EU law."[196]

So far, there is quite a widespread practise according to which EU law is applied by arbitral tribunals which are required to rule upon disputes on commercial matters and opposing two or more companies or physical persons. It seems therefore that arbitral tribunals should not be prevented from applying EU law in arbitrations in which the rules of procedure are the same of those of the cases envisaged above, and when the only differences reside in the subject matter of the dispute (an investment) and in the nature of the parties (a foreign investor and the host State).

[195] For an in depth analysis of the relation between EU law and international commercial arbitration see: M. BARBIERI; *L'arbitrato internazionale e il diritto comunitario*, Tesi di Laurea Magistrale; Università degli Studi di Milano; 2007.

[196] *Eureko B. V. v. the Slovak Republic*; cit.; par. 274.

The only argument which can be put forward against the arbitrability of State-investor disputes in which EU law must be applied is that of the risk of fragmentation of EU law and of incoherent or even wrong interpretation of EU law by arbitral tribunals and outside the reach of the ECJ.[197] Such arguments are supported by the fact that the tasks of arbitral tribunals consist in settling State investor disputes and in applying first of all the provisions of BITs. Therefore, the application and the respect of EU law and the attainment of the objectives of the Union, included the achievement of the Common Market are not the primary objectives of arbitral tribunals. For this reason they could be much less concerned and less equipped to ensure a proper interpretation and application of EU law. Moreover arbitral tribunals do not have the duty to seek advice on the interpretation of EU law from the ECJ, since the duty of loyal cooperation has laid down in art. 4,3 TFEU and, previously in art. 10 TEC applies only upon the organs and the institutions of the EU and of its member States, and arbitral tribunals clearly cannot fall within the scope of this notion.

It could be argued that, although they are not obliged to do so, Tribunals may nonetheless decide to seek advice from EU institutions as to the proper interpretation of EU law, when they are required to rule in cases in which the application of BITs also affects the interpretation and the application of issues of EU law. For instance, it could be argued that arbitral tribunals may freely and autonomously decide to ask for a preliminary ruling to the ECJ. However, this option does not seem to be available. In fact, a quite consistent case law of the ECJ provides that arbitral tribunals shall not be entitled to refer to the ECJ under art. 267 TFEU.[198] Although ECJ case law on this

[197] T. EILMANSBERGER; cit.; p. 405-406.

[198] Judgment of the Court of 23 March 1982; *Nordsee Deutsche Hochseefischerei GmbH v Reederei Mond Hochseefischerei Nordstern AG & Co. KG and Reederei Friedrich Busse Hochseefischerei Nordstern AG & Co. KG*.; Case 102/81; European Court reports 1982 Page 01095; par. 8-16; Judgment of the Court (Fourth Chamber) of 27 January 2005; *Guy Denuit and Betty Cordenier v Transorient - Mosaïque Voyages and Culture SA*; Case C-125/04; European Court reports 2005; Page I-00923; par. 11-17.

For comments in doctrine on the impossibility for arbitral tribunals to refer to the ECJ for a preliminary ruling see: A. DIMOPOULOS; *The validity and applicability of international investment agreements between EU member States under EU and international law*; cit.; p. 87-89; M. FRIGO; *L'arbitrato e il diritto comunitario*; in M. RUBINO-SAMMARTANO; ed.; *Arbitrato, ADR, conciliazione*; Bologna; Zanichelli; 2009; p. 497-501; F. DUMON; *Questions prejudicielles et arbitrage,* in *Cahiers de Droit Européen*, 1983;

issue has developed in the field of international commercial arbitration, there is nothing suggesting us that it shall not apply in case of non ICSID investor-State arbitration.

However, such a problem should not be excessively dramatised. In international commercial arbitration arbitral tribunals have often given proof of a great respect of EU law. Moreover, it must be recalled that in case of non-ICSID arbitration, the award can be subjected to annulment procedure in the State of the seat of arbitration. The circumstances for the annulment of the award are laid down in most cases in domestic legislation, but in most countries they include the case in which the award is contrary to public policy. If arbitrators don't want the awards they issue to be successfully challenged and set aside, they should adopt awards which are not in breach of EU law, or, at least, of those EU provisions which pertain to the sphere of public policy.[199] Cases in which the ECJ have dealt with the possibility of Courts to annul arbitral awards inconsistent with EU rules of public policy include issues concerning competition law[200] and protection of the consumers.[201]

p. 230; L. FUMAGALLI; *Conferme giurisprudenziali in tema di procedura pregiudiziale*, in *diritto comunitario e degli scambi internazionali*, 1994, p. 713; E. F. RICCI; *Arbitrato volontario e pregiudiziale comunitaria*; in *Rivista di diritto processuale*; 2006; p.710-714; G. CHABOT; *Un tribunal arbitral conventionnel ne constitue pas une juridiction au sens de l'article 234 CE*; in *La Semaine juridique - édition générale*; 2005 II 10079; E. CHITI; *Collegi arbitrali e rinvio pregiudiziale*; in *Giornale di diritto amministrativo*; 2005; p.828-831; A. DE LUCA; *Potenziali conflitti tra giurisdizione comunitaria e istanze arbitrali istituite sulla base di accordi di promozione e protezione degli investimenti; quali possibili soluzioni*?; cit.; p. 123-128.

[199] L. G. RADICATI DI BROZOLO; *Arbitrato, diritto della concorrenza, diritto comunitario e regole di procedura nazionali;* in *Rivista dell'Arbitrato*; 1999; p. 669; T. DIEDERIK DE GROOT; *The impact of the Benetton Decision on international Commercial Arbitration*; in *Journal of International Arbitration,* 2003; p. 367; P. LANDOLT; *Limits on Court Review of International Arbitration Awards Assessed in light of States' Interests and in particular in light of EU Law Requirements;* in *Arbitration International*; 2007; p. 63-92.

[200] On the impact on arbitration in the EU of the public policy character of EU competition law see: Judgment of the Court of 1 June 1999; *Eco Swiss China Time Ltd v Benetton International NV*.; European Court reports 1999 Page I-03055; par. 41. The Court declared that: "a national court to which application is made for annulment of an arbitration award must grant that application if it considers that the award in question is in fact contrary to Article 85 of the Treaty, [today art. 101 TFEU] where its domestic rules of procedure require it to grant an application for annulment founded on failure to observe national rules of public policy.". In that case, the Court assessed first whether current art. 101 TFEU was a rule of public policy and, after having concluded in the affirmative, it argued that, since incompatibility with rules of public policy of a State was sufficient to annul an award, then incompatibility with current art. 101 TFEU, i. e. with an EU rule of public policy, would have

A similar reasoning applies in relation to the recognition and the enforcement of non-ICSID award. It must be remarked that this issue is governed by the New York Convention of 1958, which has been ratified by a large majority of States, including all EU members and the majority of the recipients of the investments of SWFs.[202] Art. V,2 b) of the new York Convention provides that: "recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that: [...] the recognition and enforcement of the award would be contrary to the public policy of that country".

Once again, arbitrators shall interpret and apply EU law, and especially the rules of EU public policy, in the correct way: otherwise, the awards they issue risk to be deprived of any effect, since they would be denied recognition and enforcement.[203]

brought to an obligation upon municipal Courts of the host State to set aside the award at issue. (ibid. par. 30-40).

For a more in depth analysis on the public policy character of EU competition law see: L. BIAMONTI; *Commercial arbitration and the Italian and EC antitrust legislation with an emphasis on intellectual property rights*; in *Diritto del Commercio Internazionale*; 2011; p. 457-480; L. LAUDISA, *Gli arbitri e il diritto comunitario della concorrenza*; in *Rivista dell'Arbitrato*; 2000; p. 596-602; A. GIARDINA; *Rispetto del diritto comunitario della concorrenza e regole nazionali concernenti il principio dispositivo e l'effetto di cosa giudicata dei lodi parziali non impugnati*; in *Rivista dell'Arbitrato*; 1999; p. 307; L. G. RADICATI DI BROZOLO; cit., p. 694; A. GIARDINA; *Nota alla sentenza della Corte d'Appello dell'Aja, sentenza del 28 marzo 1996 Eco Swiss ChinaTime (Honk Kong) c. Benetton International BV. (Olanda)*; in *Rivista dell'arbitrato*; p. 308; M. FRIGO; *L'arbitrato e il diritto comunitario*; cit., 501-504; Y. BRULARD, Y. QUINTIN; *European Community Law and Arbitration. National Versus Community Public Policy*, in *Journal of international arbitration*; 2001; p. 535; H. VAN HOUTTE; *Arbitration and Arts. 81 and 82 EC Treaty? A State of Affairs*; in *ASA Bullettin*; 2005; p. 441; G. BLANKE; *The Role of EC Competition Law in International Arbitration: A Plaidoyer*; in *European Business Law Review;* 2005; p. 169-181; G. BLANKE; *Defining the Limits of Scrutiny of Awards Based on Alleged Violations of European Competition Law*; in *Journal of International Arbitration* 2006; p. 249-258. An important discussion on these topics has been carried out also in: Opinion of Mr Advocate General Saggio delivered on 25 February 1999; *Eco Swiss China Time Ltd v Benetton International NV*; Case C-126/97; European Court reports 1999 Page I-03055; par. 21 seq..

[201] On the impact on arbitration in the EU of the public policy character of EU law on the protection of consumers see: Judgment of the Court (First Chamber) of 26 October 2006; *Elisa María Mostaza Claro v Centro Móvil Milenium SL.*; Case C-168/05; European Court reports 2006 Page I-10421; For a comment on this judgement see: B.U. GRAF, A. E. APPLETON; *Elisa María Mostaza Claro v Centro Móvil Milenium: EU Consumer Law as a Defence against Arbitral Awards, ECJ Case C-168/05;* in *ASA Bulletin*; 2007; p. 48-64.

[202] For more information on the signatories of the New York Convention see: the website of UNCITRAL: at the page: http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html last visited on 23/09/2011

[203] L. G. RADICATI DI BROZOLO; cit. p.669; M. FRIGO; cit.; *L'arbitrato e il diritto comunitario*, cit. p 501-504; T. DIEDERIK DE GROOT; cit.; p. 367.

It must be underlined, also in order to assuage excessive worries on the risk of erroneous interpretation of EU law by arbitral tribunals in investor-State disputes, that the occasions in which EU law shall be applied in the course of arbitral proceedings are expected to be much less frequent in case of investment arbitration than they may be in international commercial arbitration. In fact, also given the direct effect of EU law, several provisions of EU law, for instance those concerning competition, movement of goods, services, capitals and workers, can directly govern business relations between companies or physical persons and therefore they can be often applied by tribunals in international commercial arbitration. On the contrary, in case of investment disputes, the tribunal is mainly required to interpret and apply the BITs, while issues of EU law could be relevant only incidentally and in the relatively limited case in which there may be substantial overlaps and inconsistencies between EU law and the provisions of BITs.

Once it is excluded the possibility that arbitral tribunals may refer to the ECJ, it should be investigated whether they may apply, maybe in a less formal way and outside what is expressly provided for in the TEU and in the TFEU to other EU institutions. From this point of view, an interesting development is represented by the recent practise of the Commission to participate in arbitral proceedings as *amicus curiae*. This has occurred in the above mentioned Eureko and Eastern Sugar cases and it has also occurred in a few ICSID cases.[204] The Commission is able to provide an interpretation of EU provisions and, although its observations shall not be binding upon the arbitral tribunal, nevertheless it could be argued that arbitrators may be interested in taking the advice of the Commission in the utmost consideration, also

[204] The ICSID cases at issue, which are currently pending before ICSID tribunals are: *Ioan Micula, Viorel Micula and others v. Romania* (ICSID Case No. ARB/05/20); *Electrabel S.A. v. Republic of Hungary* (ICSID Case No. ARB/07/19) and *AES Summit Generation Limited and AES-Tisza Erömü Kft. v. Republic of Hungary* (ICSID Case No. ARB/07/22). For a comment see: S. MENÉTREY; *La participation « amicale » de la Commission européenne dans les arbitrages liés aux investissements intracommunautaires*; in *Journal du droit international (Clunet);* p.1127-1157; A. DE LUCA; *Potenziali conflitti tra giurisdizione comunitaria e istanze arbitrali istituite sulla base di accordi di promozione e protezione degli investimenti; quali possibili soluzioni*?; cit.; p. 128-135. For a more general discussion on the issue of the particupation of *amici curiae* in international investment arbitration see: I. MAXWELL; *Transparency in investment arbitration: are amici curiae the solution?*; in *Asian international arbitration Journal*; 2007; p. 176-186.

because of the risks of annulment or refusal of recognition and enforcement that awards issues in breach of EU law may face. Likewise, also the Commission may be interested in providing advice, because this could reduce the risks of fragmentation of EU law which has been mentioned above. Finally, it must be observed that in this way the Commission is expected to increase its experience and skills in participating in investor-state disputes. This should prove particular useful when, in the future, the EU institutions shall be competent to conclude BITs and to stand as respondents in investment disputes opposing them to foreign investors before arbitral tribunals.

In case of disputes before an arbitral tribunal between a SWF and an EU member, if the Commission participates in the proceedings as *amicus curiae,* the observations it can present should be consistent with the principles it laid down in its communication titled "A common European approach to Sovereign Wealth Funds". Therefore, one more function that such Communication may have can be to ensure a certain degree of consistency to the participation of the Commission in investor-State arbitrations concerning the investments of SWFs. Moreover, in this way the Commission should help to promote the respect of the principles contained in such Communication and finally to ensure a higher level of consistency of its policy towards SWFs. However, this should have limited effects from the practical point of view, given the wording of the Communication and the fact that, far from providing for new, although non-binding principles and rules governing SWFs, it actually remarks the need to continue to apply to SWFs the rules already in force to deal with foreign investments in general.

7. The role played by the EU in developing an international legal framework applicable to SWFs

In the present chapter it has been investigated the ongoing attempt of the EU to address the issue of investments undertaken in the territory of EU members by investors from third countries. This is consistent with the belief of EU institutions in the need for a common approach to challenges and opportunities represented by foreign investments in EU. This need appears to be even more acute when such investments are undertaken by third country SWFs, given the particular concerns which are traditionally related to this class of investors.

The EU believes that the issue of the regulation of the operations of SWFs cannot always be addressed in an adequate way at the level of the member States acting individually. Therefore it supports the view that a coordinated response to SWFs (which does not mean an unique or uniform response) should be developed at the EU level. The Communication of 2008 titled "A common European approach to Sovereign Wealth Funds", aims at achieving this objective. Likewise, also the recent amendment of art. 133 TEC, now art. 207 TFEU, as well as the Communication of the Commission and the Proposal of regulation which have been adopted on July the 7th 2010, since they aim at governing certain aspects of foreign investments in the EU, are expected to affect, in the way which has been investigated in the previous paragraphs of the present chapter, the investments of SWFs from third countries into the territories of EU members.

However, the EU institutions also believe that the investments of SWFs do not constitute a phenomenon having a regional relevance only. On the contrary, SWFs are a global issue and the concerns, challenges and opportunities their operations can imply in the EU are the same when SWFs invest in other countries, in particular in other industrialised countries like the US, which in fact are, together with the EU, among the main recipients of the investments of SWFs. This reasoning explains the need for the EU to address the issue of the investments of SWFs also at multilateral level, i. e. by establishing a dialogue and by attempting to agree shared principles and rules with other international organisations and relevant States, included both the other main recipients of the investments of SWFs and the main owners of such particular category of investors.[205]

[205] M. BARBIERI*; A new challenge for the European Union*; cit.; p. 280-281; M. BARBIERI; *The International Regulation of Sovereign Wealth Funds. Which Role for the European Union?*; cit.; A. WONG; cit.; p. 1098-1101.

Such an approach would be consistent with the traditional emphasis the EU has put on multilateralism, which implies, inter alia, the participation in the activities of international organizations in finding mutually agreed solutions. [206] In spite of this pledging, the EU is a member only of the WTO, the European Bank for Reconstruction and Development (EBRD) and the Food and Agriculture Organization (FAO). It is important to stress that even in these cases, it is a mixed membership, which means that the EU is a member of the organization together with its members States. In fact the EU has not all the powers which might enable it to fulfil the obligations deriving from the membership of such organizations and, as a result, it needs to act jointly with its member States.[207] Moreover, it has been argued that direct membership of the EU in an international organization might raise problems. In particular, many international organizations provide membership for States only and admitting the EU makes amending their institutive treaties needed. Further difficulty might emerge when it is necessary to precisely apportion the powers to be exercised by the EU institutions and by its member States within the international organization and when it must be decided the redistribution of voting rights.[208] For these reasons, it has often been preferred to avoid direct membership of the EU in international organizations in favour of an external cooperation or the grant of the status of observer, which ensure more flexibility.

In this paragraph it will be analysed firstly the legal framework governing the relation between the EU, on one side, and, on the other side, the international organizations like the IMF and the OECD, which has been the most involved in the attempt to

[206] For a more general introduction to the involvement of the EU in international relations see, for instance: K. E. JORGENSEN; *Intersecting multilateralism: the European Union and multilateral institutions*; in K. V. LAATIKAINEN, K. E. SMITH; ed.; *The European Union at the United Nations: intersecting multilateralisms*; Basingstoke; Palgrave Macmillan, 2006; p. 195-211; S. KEUKELEIRE, J. MACNAUGHTAN; *The foreign policy of the European Union*; Basingstoke; Palgrave Macmillan, 2008; p. 298; M. CICCONI; *Aspetti istituzionali delle relazioni tra Unione europea e nazioni unite*; in P. MARIANI; *Le relazioni internazionali dell'Unione europea: aspetti giuridici della politica estera, di sicurezza e difesa comune*; Milano; Giuffrè; 2005; p. 135-141.

[207] For more information on the issue of mixed agreements of the EU see, *supra*, par. 3 of the present chapter

[208] P. EECKHOUT; *External relations of the European Union - legal and constitutional foundations*; Oxford; Oxford University Press; 2004; p. 199.

develop an international regulation of SWFs. Then, it will try to explain the role played by the EU in the activity of these organizations concerning the regulation of SWFs. On the contrary, the outcome of such activity, and in particular the content of the documents which have been adopted by international organisations or other international fora concerning the regulation of SWFs will make the object of the analysis which will be undertaken in the next chapter.

Another caveat must be preliminarily made. Since most of the documents at issue have been adopted before the entry into force of the Lisbon Treaty, then the EU law provisions which empowered the EU (or , rectius, at that time the EC) to cooperate with other relevant international organisation in this field, were those contained in the TEU as it was before the entry into force of the Lisbon treaty, and in the TEC. For this reason, in the remainder of the paragraph, reference shall be made both to such provisions and to the corresponding provisions of the TEU as modified by the Lisbon treaty and of the TFEU.

Art. 302 TEC provided that "It shall be for the Commission to ensure the maintenance of all appropriate relations with the organs of the United Nations and of its specialised agencies." Moreover "The Commission shall also maintain such relations as are appropriate with all international organisations." The IMF is a specialized agency of the United Nations and as a result the Commission is entitled to maintain relations with it. The relations between the IMF and the EU have become more important with the establishment of the European Central Bank (ECB) and the introduction of the single currency in the EU. The monetary policy is no more implemented by European States acting separately, but it is enacted by the ECB consistently with art. 105 seq. EC Treaty. This is consistent with art. 4,1 EC Treaty, according to which one of the conferred powers of the Community shall be the "irrevocable fixing of exchange rates leading to the introduction of a single currency, […] and the definition and conduct of a single monetary policy and exchange-rate policy". It is clear that the IMF, when it exercises its "firm surveillance over the exchange rate policies of members" according to art. IV section 3 of its articles of agreement needs to cooperate not only with single EU member States, but also with the EU and in particular with the ECB.

Consistently with these developments, the ECB has been granted the status of observer in the IMF board since 1998. For this reason, although the EC Treaty initially provided that the organ in charge of maintaining the relations with the IMF would have been the Commission , today the ECB too has come to play a very important role in the EU-IMF cooperation.[209]

After having reviewed the relations between the EU and the IMF, it is necessary to study those between the EU and the OECD. Art 304 of the TEC provides that “the Community shall establish close cooperation with the Organisation for Economic Cooperation and Development, the details of which shall be determined by common accord.” The OECD was founded by States and normally only States can become members. Nevertheless, the Convention of 1960 establishing the OECD provides at article 12(b) the possibility to establish and maintain relations with other international organizations, and Article 12(c) even enables the OECD to invite them to participate in its activities. In addition, the case of the European Communities is explicitly envisaged by Article 13 of the OECD Convention and, more particularly, by its Supplementary Protocol No. 1. It is important to underline that such provisions have not been updated to the recent developments of the EU, nevertheless they are quite flexible and can adapt to the current framework of the EU as well. They clearly envisage that the EU institution entitled to represent the EC shall be the Commission but they also provide that “representation in the Organization for Economic Cooperation and Development of the European Communities established by the Treaties of Paris and Rome of 18th April, 1951, and 25th March, 1957, shall be determined in accordance with the institutional provisions of those Treaties.” As a result, if there are relevant changes in the institutional provisions of the EC Treaty, new subjects, for instance the ECB, can be entitled to represent the EC and the EU in the OECD.[210]

[209] D. HORNG; *The European Central Bank’s External Relations with Third Countries and the IMF*; in *European Foreign Affairs Review*; 2004; p. 330; C. ZILIOLI, M. SELMAYR; *The External relations of the euro area: legal aspects*; in *Common Market Law Review* 1999; p. 273-349; S. KEUKELEIRE, J. MACNAUGHTAN;; cit.; p. 307.

[210] D. HORNG; cit.; p. 331; C. ZILIOLI, M. SELMAYR; cit.; p. 340 .

Art. 302 and 304 of the TEC have been replaced by art. 220 TFEU which provides that "[t]he Union shall establish all appropriate forms of cooperation with the organs of the United Nations and its specialised agencies, the Council of Europe, the Organisation for Security and Cooperation in Europe and the Organisation for Economic Cooperation and Development. The Union shall also maintain such relations as are appropriate with other international organisations." Therefore, under art. 220 TFEU, cooperation with the IMF and with the OECD, which so far have been the international organisations which have been mostly involved in the elaboration of documents dealing with the investments of SWFs, is explicitly envisaged.

Par. 2 of art 220 also specifies that "[t]he High Representative of the Union for Foreign Affairs and Security Policy and the Commission shall be instructed to implement" the first part of the article. In spite of the attribution of a competence also to the High Representative, it seems that the Commission should remain the institution which is more suitable to carry out its cooperation with the IMF and the OECD to address the issue of the transnational operations of SWFs.

After having reviewed which are, in general, the relations between the EU on one side and the OECD and the IMF on the other side, it is finally possible to focus on the contribution the EU has given to such international organizations in their work on SWFs.

The EU, through the communication of the Commission which was analysed in paragraph 2 has declared its commitment to support the activities of the IMF and the OECD about SWFs. The actual participation of the EU has been rather informal and it seems it has consisted in taking part in discussions and providing information and advice.

With respect to the cooperation with the IMF, it must be noted that the most important document explicitly governing SWFs, the so called Santiago Principles, has been drafted by the international Working Group of SWFs (IWG) which is composed by States owners of SWFs. The EU could have not been a member of the IWG, because it is not a State and because it has not its own SWF. Nevertheless, the World Bank and the OECD have participated in the activities of the IWG as permanent observers. The EU could have had the same status, as the regulation and the monitoring of SWFs is an issue which can fall within its powers. Moreover, as it was explained above, the EU has established closed institutional links with the IMF and, given the relations between the IMF and the IWG (the IMF promoted the establishment of the IWG and provides for its secretariat), a participation of the European Commission or of the ECB in the IWG as an observer would have been reasonable. This has not occurred and actually the precise role the EU has had in drafting the acts finally adopted by the IWG, and in particular of the Santiago Principles is difficult to assess. In the introduction of the Santiago principles it is only stated that the IWG "has benefited from input from a number of recipient countries […] as well as from the European Commission. […]" Moreover, it specifies that the Commission has acted "on behalf of the European Union, as agreed by the European Council on March 14, 2008". It is important to remark that the cooperation of the EU with the IWG has not excluded that of its member States. In fact among the recipient countries which have cooperated to the drafting of the Santiago principles (without being members of the IWG) there are also France, Germany, Italy, Spain and the United Kingdom[211]. This is consistent with the practice of the EU and the EC external relations which has come to be denoted as mixity: it means that relations with third countries or international organizations are dealt with by the EU institutions and its member States acting jointly.[212]

France, Germany, Italy, Spain and the United Kingdom have the duty to keep the EU institutions and the other EU States informed about their discussions with the IWG. A similar obligation of information and coordination lies upon Ireland too as it is the only EU member State owning a SWF (the National Pensions Reserve Fund[213]) and therefore it is entitled to be a member of the IWG. It is important to identify the provisions of the TEU or of the TFEU which may provide for such an obligation. If the

[211] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 2 and p. 30.

[212] P. EECKHOUT; cit.; p. 190 .

[213] However, also as a result of the severe economic crisis which is currently affecting Ireland and of the need to use the Irish SWF to recapitalise domestic bank and to support the State budget, the external reach of the Irish SWF has been seriously impaired.

EU regarded SWFs as an issue of foreign policy and security, then reference to art. 34 TEU (art. 19 before the entry into force of the Lisbon Treaty) should be made. This article provides that “Member States shall coordinate their action in international organisations and at international Conferences” and that they “shall uphold the Union's positions in such forums”. It specifies that “in international organisations and at international conferences where not all the Member States participate, those which do take part shall uphold the Union's positions” and they shall keep the others “informed of any matter of common interest.” However, since the EU has so far regarded the investments of SWFs as an economic matter, then the applicability of the above mentioned art. 34 seems to be inappropriate.

However, the existence of a duty, upon States which participate in discussions concerning SWFs, to seek coordination when issues of EU law are at stake and to inform of any relevant development the other EU members and in particular the EU institutions, may derive from the more general duty of loyal cooperation enshrined in art. 4.3 TEU (which substantially aims at achieving the same objectives of former art. 10 TEC) according to which "[p]ursuant to the principle of sincere cooperation, the Union and the Member States shall, in full mutual respect, assist each other in carrying out tasks which flow from the Treaties."[214] EU member States should have a general obligation, when they participate in international meeting or in international organizations dealing with SWFs, to coordinate their actions and to behave taking into account the overall interests of the EU. It could also be suggested that their action should be inspired, *inter alia*, by the principles set in the Communication of the Commission titled "A common European approach to Sovereign Wealth Funds". This communication, in fact, can also be construed as laying down the basic guidelines which should govern the actions of the EU and of its members when they participate

[214] Art. 10 was even more detailed, when it provided that: “Member States shall take all appropriate measures, whether general or particular, to ensure fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community”. In addition, member States are required to “facilitate the achievement of the Community's tasks” and to “abstain from any measure which could jeopardise the attainment of the objectives” of the EC Treaty. For a discussion of the application of art. 10 TCE see: P. EECKHOUT; cit.; p. 210; C. W. A. TIMMERMANS; cit.;p. 147-157.

in any international summit or to the activities of any international organisation which deal with the issue of SWFs.

With respect to the cooperation between the EU and the OECD on SWFs, the European Commission has worked together with other OECD and non-OECD governments and representatives of business at the drafting of the report on SWFs and Recipient Country Policies issued in April 2008 which, as mentioned above, has served as the base for the adoption of the “declaration on SWFs and Recipient Country Policies”. Moreover the Commission, acting on behalf of the EU, remains involved in the Freedom of Investment (FOI) process, launched at the OECD in 2006, whose aim is to help governments to reconcile economic openness to foreign investment with the need to safeguard their essential security interests. The FOI process involves, together with the European Commission, the OECD members, non OECD countries adhering to the OECD Declaration on International Investment and Multinational Enterprises and other major country partners, including China, India, Russia and South Africa. The OECD has invited States owning SWFs and which are not members of the FOI yet, to participate in such a process. In this way the cooperation between the European Commission and the OECD with respect to the SWFs will remain constant. The Commission will participate in FOI roundtables where governments compare and analyse policies and domestic rules adopted in relations to investments of SWFs [215]

[215] OECD; *Sovereign Wealth Funds and recipient countries- Working together to maintain and expand freedom of investment*; OECD; 2008; p. 2; J. ALMUNIA; *The EU response to the rise of Sovereign Wealth Funds*; Crans Montana Forum; Brussels; 2008; P. MANDELSON; Putting sovereign wealth in perspective - Speech by Peter Mandelson at the OECD Conference - Paris, 28 March 2008.

CHAPTER 8

THE INSTRUMENTS OF SOFT LAW ADOPTED TO GOVERN THE INVESTMENTS OF SWFS AND THE POLICIES OF RECIPIENT COUNTRIES

Introduction

In the previous chapters the focus has been on the existing legally binding instruments of international economic law. Since none of them explicitly and exclusively aim at regulating SWFs, an effort has been made to investigate whether their provisions could nonetheless be applied, *mutatis mutandis*, to the issues of the creation and of the foreign investments of SWFs.

On the contrary, in the present chapter the focus will be on the few instruments, which have been adopted in recent years, which explicitly deal with SWFs. They are regarded as instruments of soft law, since they are not legally binding and they provide for principles and standards which are drafted in broad terms. However, they represent the first effort of the international community towards the elaboration of a set of commonly agreed principles and practises concerning SWFs. So far only one of such instruments has been studied. It was the Communication of the Commission. “A common European approach to Sovereign Wealth Funds" which has been discussed in chapter 6 paragraph 2. In the present chapter the other instruments of soft law dealing with SWFs will be studied.

The present chapter will organised as follows.

In the first two paragraphs an analysis will be undertaken of a document titled "General Accepted Principles and Practices" (GAPP), also known as Santiago Principles, which has been adopted in 2008 by a forum of SWFs called International Working Group of Sovereign Wealth Funds (IWG). As it will be explained, the GAPP describes the best principles and practises that SWFs have already implemented or desire to implement on a voluntary base. More in detail, paragraph 1 will explain the developments which have led to the adoption of the GAPP and the nature of this instrument, as well as its legal political and economic effects and implications. Paragraph 2 will focus on the content of the GAPP and it will review and comment each principle it lays down.

Paragraph 3 will explore the more recent developments concerning the implementation of the GAPP. It will discuss the issue of the replacement of IWG with the International Forum on Sovereign Wealth Funds (IFSWF) and the efforts the latter has undertaken to review the implementation of the GAPP. To this purpose, an in depth analysis will be made of a document adopted on July 7th 2011: it is the Report, "prepared by IFSWF Sub-Committee 1 and the Secretariat in collaboration with the Members of the IFSWF", titled "IFSWF Members' Experiences in the Application of the Santiago Principles".

In paragraph 4 the focus will be on the instruments of soft law which have been adopted within the framework of the Organization for Economic Cooperation and Development (OECD). It will be provided an analysis of the OECD “declaration on SWFs and Recipient Country Policies”, adopted during the Ministerial Council Meeting on 4-5 June 2008 in Paris, whose aim is to develop the principles and the best practises concerning the policies that host States may follow in order to govern the investments of SWFs in their territories. Then, it will be studied the applicability to SWFs of other important OECD instruments which have been quoted in the above mentioned declaration: the Code of Liberalisation of Capital Movements adopted in 1961, (which is formally binding and which can hardly be regarded as soft law) and the Declaration on International Investment and Multinational Enterprises of 1976.

Since it has been stressed that, except the OECD Code of Liberalisation of Capital Movements, the other instruments discussed in the present chapter are soft law instruments, in paragraph 5 it will be developed an analysis of the notion of soft law. An attempt will be made to define soft law, to understand the subjects which can adopt it, its addresses, its legal effects, its relations with "hard law", i. e. with international and domestic legally binding provisions. It will be discussed whether the instruments of soft law on SWFs which have been analysed in the present chapter may interact with provisions of hard law discussed in the previous chapters and the effect this may have on the international regulation of SWFs.

1. The creation of the IWG and the adoption of the Santiago Principles

An increased attention on behalf of the international community to the operations of SWFs was first urged on the occasion of the G7 of October 2007, when finance ministers of participating countries mandated the IMF and the OECD to examine policy options regarding SWFs. The IMF, and in its International Monetary and Financial Committee which met a few days later, decided that they would have not attempted to draft a legally binding code applicable to the operations of SWFs. On the contrary, they decided that their task would have been limited to pointing out the main critical issues related to SWFs investments that needed to be discussed. The elaboration of principles or guidelines applicable to such issues would have been left to the same States which own SWFs.

To this extent, the IMF limited itself to the adoption of a work agenda, which was published on February 29th, 2008[1]. Then, the IMF promoted a meeting of countries with SWFs, which took place in Washington D. C. on April 30–May 1, 2008, and which resulted in the creation of the International Working Group of Sovereign Wealth Funds (IWG).

The IWG is neither an organ of the IMF nor it can be regarded as an international organization; it is rather a summit of 23 IMF member countries with SWFs [2] which try to identify the best investment practices SWFs can voluntarily promise to follow when they undertake investments overseas. The OECD and the World Bank too participated in the negotiations with the status of observers, together with Saudi

[1] IMF; *Sovereign Wealth Funds—A Work Agenda*; IMF; 2008; M. AUDIT; cit.; S. KERN; *SWF's and foreign investment policies - an update*; cit.; p 17; A. GUTLIN; cit., pp. 761-763.

[2] These countries 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, the United States.

Arabia, Oman and Vietnam. The IWG has met on three occasions—in Washington, D.C., Singapore, and Santiago (Chile) and during the last meeting it was able to identify and draft, on October 2008, a set of general accepted principles and practices (GAPP) which have become known as Santiago Principles.[3]

The GAPP is[4] so far the most relevant instrument which has been adopted at the international level and whose explicit and exclusive purpose is to regulate the investments of SWFs. The GAPP is included in a broader report, which contains an introductory part, a list of practises and principles, detailed commentaries and annexes which contain further information on SWFs.

As the IWG points out, the GAPP is a voluntary code of conduct "that the members of the IWG 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." It clearly does not provide binding rules and it remains "subject to provisions of intergovernmental agreements, and legal and regulatory requirements" as well as to domestic legislation of the host States or of the State of origin of SWFs.[5] The GAPP, therefore, can fall within the category of international instruments which is generally referred to as "soft law".

It must be stressed that the GAPP is not the outcome of the negotiations of a bulk of recipient countries wishing to attain a certain level of coordination in their efforts to regulate the investments of SWFs in their territory. On the contrary, the primary responsibility for the content of the GAPP is of the same States which own SWFs. By working together, within the framework of the IWG, with recipient countries and other States and international organisations which provided further inputs, they made

[3] For an overview of the GAPP see: A. GUTLIN; cit.; pp. 745-780; J. COOKE; cit.; p. 766-770; A. WONG; cit.; p. 1103-1109. For a more in-depth discussion of the events which brought to the adoption of the GAPP se: J. J. NORTON; *The Santiago Principles' for Sovereign Wealth Funds: a case study on international financial standard-setting processes*; in *Journal of International Economic Law*; 2010; p. 645-662.

[4] In the document of the Working Group the term GAPP is referred to with the singular and not with the plural. In the present chapter it will be used the approach of the working group.

[5] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 4-5.

efforts to find out which are the best practices and conducts they already put in place or they can reasonably put in place.

Once these practices are identified, the same States owners of SWFs are encouraged to ensure that their SWFs may act in a manner consistent with them. For this reason, the GAPP could be regarded as a form of self-regulation, since the principles to be respected are elaborated by the same subjects which are required to respect them. This approach has allowed to reach consensus only after a few months of negotiations on a few basic principles and the reason for its relative success can be explained as follows.

If recipient States had unilaterally adopted a code of conduct, although non-binding, applicable to the investments undertaken by SWFs in their territory, SWFs would have hardly accepted it. It can be rightly observed that, within the limits posed by international law which have been explained in the previous chapters, States remain free to govern foreign investments undertaken in their territory. Nevertheless, especially under such circumstances, such unilateralism would have entailed undesirable consequences. First of all, since the GAPP is not an instrument of soft law, recipient States do not have an obligation to ensure compliance with it within their territories and, likewise, home States are not mandated to ensure that their SWFs respect it.

It could occur that one or more recipient States which have agreed the GAPP decide to enact domestic legally binding legislation substantially reproducing the content of the GAPP.[6] In this case the SWFs investing in those States would have been required to abide by domestic legislation and indirectly, to the GAPP. Nevertheless this would have provoked a reaction of States owners of SWFs. Given the political implications investments of SWFs necessarily have because of the macroeconomic functions they are mandated to pursue, any attempt by the host States, in the exercise of their sovereign powers, to unilaterally regulate foreign SWFs, would have

[6] The practice of adopting legally binding instruments in the domestic legal order which reproduce the content of soft law instruments adopted at the international level is quite widespread and it constitutes an aspect of the broader phenomenon of the "hardening of soft law". For a more in depth analysis of this issue see *infra*, paragraph 5 of the present chapter.

impacted on the same capacity of the owners of SWFs to use their SWFs to achieve their domestic macroeconomic objectives. This would have ultimately restricted the same sovereignty of such States. The political dimension of the investments of SWFs would have then provoked not only economic but also political tensions between the States which own SWFs and those which receive their investments.

On the contrary, the fact that States owners of SWFs have played a key role in the elaboration of the GAPP proves that they deem that they are able and willing to abide by the same principles they contribute to develop, or that they are already abiding by them. In this way it can be expected that SWFs will voluntarily comply with the GAPP, since they are convinced of the necessity, the desirability and the feasibility of such compliance. This should minimise, although not completely eliminate, the need for the establishment of legal mechanisms which ensure the respect of the GAPP.

After having clarified that the GAPP constitutes an example of soft law and, in part, of self-regulation[7], it is possible to study more in detail the content of the GAPP, or *rectius*, of the entire report in which it is provided for.

The report starts with a definition of SWFs [8] and then it immediately stresses that the notion of SWFs encompasses a large array of State-owned vehicles with "diverse legal, institutional, and governance structures." SWFs in fact, are defined as "a heterogeneous group, comprising fiscal stabilization funds, savings funds, reserve investment corporations, development funds, and pension reserve funds without explicit pension liabilities." The common denominator of these entities resides in that they all shares the following features: they are owned and managed by a State, they

[7] In doctrine there may be some perplexities on the soft-law character of the GAPP. In particular, it has been pointed out that "it is premature to denote the Santiago Principles as 'soft law' or 'soft administrative regulation'" although the principles may be meant as laying down the foundations for the adoption of more effective rules. From this point of view, it would have been more correct to regard the GAPP as part of a "soft regulatory process" which takes place, at least in part, within the IWG. On this point see: J. J. NORTON; *The Santiago Principles' for Sovereign Wealth Funds;* cit.; p. 657. Nevertheless, once soft law in meant in a broad sense, as it is done in the present context (see, *infra* paragraph 5 of the present chapter), then there is no reason for excluding that SWFs may be regarded as soft law.

[8] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 3. The definition has been quoted and analyzed *supra* in chapter 1 paragraph 1 of the present research.

are created to meet certain macroeconomic goals and they invest a part of the assets under their management abroad.

The report shares the view that SWFs play a beneficial function both in recipient countries and in the States which own them. The reasoning developed is similar to the one which has been made in previous chapters, although in the report the analysis undertaken is much more concise and more focused on the positive effects of the investments of SWFs; therefore it will not be repeated in the present paragraph.

The report underlines that the establishment of a mutually agreed framework for the operations of SWFs, as well as an improved knowledge of these entities and of the financial and economic objectives they pursue, may enhance their investments and the beneficial economic effects they. In particular, it is necessary to address some critical issues related to SWFs in order to "continue to demonstrate—to home and recipient countries, and the international financial markets—that the SWF arrangements are properly set up and investments are made on an economic and financial basis." One of the aims of the GAPP is assuaging some critical issues and ensure that SWFs and the host States may act in a way to promote the investments of SWFs in a way they prove beneficial to owners and host states both.[9]

It must be finally observed that the GAPP in many respects use a language which is neither mandatory (consistently with the fact that they are not a legally binding instrument) nor hortatory, differently from many documents of soft law. The language is often descriptive: the aim of the GAPP, in fact, is mainly to offer a review of the state of the art of the organisation and management of SWFs, a plurality of models to which State owners may draw inspiration when they organise or re-organise their SWFs.[10] The GAPP, in many case does not provide neither what SWFs and their

[9] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 3-4

[10] It must be reminded that also before the declaration of the GAPP some SWFs, because of their management techniques, strategies, organisation, etc. were regarded as models to which other SWFs may draw inspiration. For instance, when China created one of its SWF, the China Investment Corporation, it took as a model one SWF from Singapore, the Temasek Holdings. Likewise, the Norwegian SWF has constituted a model for several SWFs created as a pool of asset deprived of independent legal personality. R. J. GILSON, C. J. MILHAUPT; cit.; p.1359.

owners *shall* nor what they *should* do. It simply provide some inputs as the way some SWFs *are* and *can be*.

The report recognises that SWFs are a dynamic phenomenon. This is first of all related to "the evolving nature of international capital flows". This impacts both the investment decisions of SWFs and the same funding of SWFs. In fact, as it has been explained in particular in chapter 1 and 3 of the present research, forex SWFs have been created with the purposes of managing rapidly increasing reserves of foreign currency. In case of reduction of such reserves, which can depend, for instance, on a diminished competitiveness of exported goods, which in turn trims the surplus of the trade balance, then a lower amount of foreign currency is expected to be transferred to the SWFs, thus affecting their size and their ability to carry out its operations.

More generally speaking, "as the macroeconomic and financial stability implications of SWF investments change and SWF practices develop, some aspects of the GAPP may need re-examination".

Another argument must be taken into consideration. In the last years an increasing number of States have set up their own SWF, or they have expanded its existing SWFs or they have introduced changes in their management and strategies. Moreover, it is possible that SWFs which present different features than those analysed so far may emerge, thus making the overall picture even more complicated than it is today.

Moreover, given the existing differences among SWFs and among the States owning them, it is envisaged the possibility that not all SWFs may be immediately able to implement the principles laid down in the GAPP. Therefore, the need for a transitional period is envisaged, which can last, and which can be framed in a different way for each State. Likewise, for States which already follow well established practises, "the GAPP may be considered as setting a minimum standard".

All the elements considered above stress the need for a flexible and dynamic interpretation and implementation of the SWFs as well as for continuing coordination and consultation at the international level to update and further develop the practises that SWFs should follow.

To facilitate this, the IWG has explored the opportunity to create a standing group of SWFs. Far from being an international organisation, it would consist in a sort of institutionalised meeting, whose task would consist in facilitating the dissemination, proper understanding, and implementation of the GAPP. "The standing group should also provide SWFs with a continuing forum for exchanging ideas and views among themselves and with recipient countries. The group could examine ways through which aggregated information on SWF operations could be periodically collected, made available, and explained."[11] In a first stage, the IWG itself has played the role of this standing group.

2. The content of the Santiago Principles

According to the report, the principles laid down in the GAPP concern three main areas, which include: " (i) legal framework, objectives, and coordination with macroeconomic policies; (ii) institutional framework and governance structure; and (iii) investment and risk management framework"

Principle 1 stresses the importance of the clarity, soundness and stability of the legal framework governing the establishment and the operations of the SWFs. The beneficial consequences compliance with principle 1 may entail are detailed out in the commentaries. In particular, it is stressed that this "underpins a robust institutional and governance structure of the SWF and a clear delineation of responsibilities between the SWF and other Governmental entities." This should in turn facilitate SWFs in their task of clearly delineating their macroeconomic objectives and of effectively implementing them.

The commentaries further clarify the content and the implications of the principle of soundness and effectiveness of the legal framework. In particular, "the establishment

[11] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - “Santiago Principles*”; cit.; p. 6.

of the SWF should be clearly authorized under domestic law" ,"the legal structure should include a clear mandate for the manager to invest the SWF's assets and conduct all related transactions", " the beneficial and legal owners of the SWF's assets should be legally clear." It is stressed that this improves the accountability of the SWF and in particular of its management in the home country.[12]

This argument is important especially in the light of the discussion which has been undertaken in particular in the first three chapters of the present research. On that occasion, it has been explained which are the important macroeconomic functions performed by SWFs in the States which create them. However, it has also been pointed out that the risk exists that SWFs may be used by unaccountable and eventually undemocratic elites to pursue objectives inconsistent with the official macroeconomic purposes of the SWFs and, ultimately, inconsistently with the general interests of the People. Moreover, it is possible that the persons in charge of the operations of the SWF may be corrupt or incompetent, or both. This would lead to misappropriations or to poor investment strategies whose outcome would be a reduction of the wealth under the management of the SWF and ultimately, a reduction of State-wealth and of the ability of SWFs to effectively pursue their economic goals. If, by establishing a clear and sound legal framework governing the SWFs, accountability is increased, this should improve the ability of the SWF to deliver its goals and to effectively pursue the public interests of the States which have created them. Under this point of view, it could be added to the commentaries that a proper legal framework should include legal remedies under the domestic legislation of the state which owns the SWF, providing effective procedure to detect and redress cases of corruption, misappropriation and mismanagement concerning SWFs, based on the accountability of the SWF itself and of its management.

Principle 1 also implies that all the relevant features concerning the legal framework governing the SWF must be publicly disclosed, in order to ensure also a satisfactory level of transparency. The issue of transparency of SWFs underpins all the GAPP

[12] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 10-11.

and emphasis on the need for transparency and disclosure is found in many other principles of the GAPP. It is therefore appropriate to undertake within the analysis of principle 1 a general discussion of the issue of transparency applied to SWFs. The reasoning developed in this context shall apply to other principles of the GAPP which refer to transparency in relation to other aspects of the operations of SWFs.

Transparency and disclosure of SWFs first of all is important in order to avoid protectionist reactions of recipient States. If host States have access to information on SWFs they will be in the position to properly evaluate whether SWFs' investments could actually threaten their national security. On the contrary, if host States are not provided with decently broad and reliable information on the SWFs which are investing in their territory, then they may be justified if they adopt precautionary measures whose outcome is a restriction or even a prohibition of such investments. Recipient States in fact, could decide not to risk to admit foreign investments which do not provide them with any guarantee as to the fact that they will not threaten domestic national security. In other words, a protectionist reaction in the recipient country which is due to lack of transparency and disclosure on behalf of SWFs could be fully motivated.

Nevertheless, the emphasis put on transparency in the GAPP should not be regarded as a concession grant by States owners of SWFs to recipient States in order to milden their attitude *vis-à-vis* the investments of SWFs. In fact, the owners of SWFs themselves may significantly benefit from enhanced transparency. First of all, by minimising the risk of protectionist backlash in recipient States, they have more possibility to invest abroad and to pursue their investments strategies with less restrictions. It must be remarked that a certain investment of a SWF may actually entail some risks for the host State. However, it could be suggested that, if the host State is provided with all the relevant information on the SWF concerned and on the kind of investment it means to undertake, then this could serve as a basis for proper discussion whose outcome could be that the SWF agree with the competent host State authorities to undertake further commitment or to disclose more relevant information in order to eliminate potential risks to the essential interest of the host

State. In previous chapters it has been studied the screening procedure adopted in the US and the role of mitigation agreements. It could be argued that, in case of investments in the US the disclosure of relevant information concerning the SWF to the CFIUS may help the investment to avoid being forbidden and may serve as a basis for possible negotiation for the conclusion of a mitigation agreement.

There is a another reason why States which own SWFs are expected to benefit from increased transparency. While the arguments discussed so far focused on the relation between the host State and the home State of the investment of the SWF, the present one mainly concerns the relation between SWF, the State owning it and the people of such State. Opacity is often related to mismanagement, misappropriation, lack of accountability. In fact, if a SWF is badly managed, if some of its managers are incapable or corrupt, lack of transparency prevents such problems from being adequately and promptly detected and addressed. Therefore, transparency may ensure that the assets under the management of SWFs are used in order to effectively pursue the macroeconomic purposes of the SWFs themselves and of the States which have created them.[13]

Finally, coming back more in detail on the content of the commentaries to principle 1, it must be reminded that the GAPP recognises that in the practise SWFs have been organised according to three legal models. SWFs may be established as independent legal entities under public law, as independent legal entities under corporate law, as pools of assets without independent legal personality. The details of these legal frameworks have been discussed in chapter 1 of the present research and therefore they shall not be repeated. However, what deserves to be stressed is that according to the GAPP all three models can in principle provide for a sound and

[13] For a discussion of the GAPP which emphasis the importance of the issue of transparency see, for instance: S. KERN; *SWF's and foreign investment policies - an update*; cit.; p. 18; M. AUDIT; cit.; A. WONG; cit.; p. 1098; Z. FENG; cit.; p. 489-490; R. J. GILSON, C. J. MILHAUPT; cit.; p.1360-1365; T. A. HEMPHILL; cit.; p. 551-556. For a comment in particular on the fact that transparency of SWFs may allow the SWF to best serve the interests of the peoples of the State owner see: P. J. KEENAN; *Sovereign Wealth Funds and Social Arrears*; cit.; p. 432-472; S. MOVSUMOV; *Establishing professionalism and transparency; the case of Azerbaijan*; in M. RIETVELD; ed.; *New perspectives in sovereign asset management*; Central Banking Publication; 2008; p. 83-90; M. BARBIERI; *Developing Countries and their Natural Resources*; cit.; p. 26-31.

effective legal framework and therefore States may chose the one they deem more consistent with their objectives and preferences.[14]

Principle 2 GAPP stresses that "[t]he policy purpose of the SWF should be clearly defined and publicly disclosed." As the commentary point out, the main purposes of SWFs consist in serving as stabilization funds, as saving funds, as instruments for the management of foreign exchange reserves. Such purposes are not mutually exclusive, since it is possible that a SWF may at the same time pursue two of them or more. In any case, the main purposes of the SWFs should be clearly stated, also because this has an impact on the investment strategies pursued. The commentaries provide for some convincing examples of this concept. "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."

Principle 2 is closely connected with principle 1, since the existence of a sound and clear legal framework should also include a clear statement of the macroeconomic purposes of the SWF and of effective tools to prevent the management of the SWF from pursuing other goals as well as to prevent Governmental authorities from using the SWF to pursue undue objectives. The Commentaries are clear on this point, where they remark that "[t]he pursuit of any other types of objectives should be narrowly defined and mandated explicitly. 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 obligation to fulfill, directly or indirectly, any geopolitical agenda of the Government." This last expression shows that the drafters of the GAPP are aware of the fact that many recipient countries may fear that SWFs may be used as tools in the hand of hostile countries to pursue geostrategic advantages at the expenses of the States in which

[14] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit. p. 11-12.

they invest, possibly threatening their national security. If a country which owns a SWF is able to clearly state in domestic law which are the purposes of its SWFs and if it undertakes the measures necessary to ensure that its SWF shall pursue these purposes and not other functions, than the political dimension of the operations of SWFs shall not be abolished, but it would acquire a nature so as not to pose a threat to the countries where investments are undertaken. In fact, as it has been explained in chapter 1, the fact that SWFs are created to pursue certain domestic macroeconomic goals undeniably confer them a political dimension. However, if the SWF is provided with certain arrangements, included a proper legal and institutional framework governing its operations, then the pursuit of these goals shall not entail, but on the contrary shall exclude, the attempts to pursue other objectives like those mentioned in chapter 1 paragraph 4 which would put in danger the national security of the host State.[15]

In principle 3 it is stressed the need for the SWFs to maintain a close cooperation with the Government and the Central Bank, especially in relation to those operations of SWFs which may have a significant impact on the fiscal and monetary policy of the State which own them. As it has been underlined in chapter 1 and 2 of the present research, commodity SWFs are tools for the management of the revenues obtained from the exploitation of natural resources and, in particular in countries where such revenues constitute an important item of the State budget, the proper management of such SWFs is fundamental for the conduct of budgetary and fiscal policies. Likewise, as it has been explained in chapter 1 and 3 of the present thesis, forex SWFs are tools for the proper management of foreign exchange reserves. Therefore, in order to ensure consistency of the fiscal or of the monetary policies of a State, cooperation between SWFs, Governments and Central Banks is necessary.[16] When a SWF is established as a pool of assets with no legal personality and which is owned and managed by a department of the Government or of the Central Bank, consistency of

[15] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 12-13.

[16] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit. p. 13.

the policies at issue can be assumed. Some problems of lack of coordination may rise when the SWF is separate from the Government or from the Central Bank. In this case it is necessary to establish clear and sound links between the SWF, the Government and the Central Bank, as well as predictable and workable procedures which may ensure smooth communication between these entities. The Chinese SWF guarantee this coordination also through the pervasive role played by the Communist Party. The fact that the leaders of the Government, the Central Bank and the SWF must all be high officer of the Communist Party, informally entrusts the latter with important task to coordinate.[17]

Principle 4 stresses the importance of "clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations on behalf of the Government." The commentaries specify that such policies should be clearly stated in the domestic law, or in other relevant normative acts, of the State which owns the SWF,[18] also consistently with principle 1. This should help to improve the management of SWFs, ensuring that withdrawal of resources from the fund may occur only consistently with previously established principles, priorities and rules, and not according to extemporaneous needs, which would otherwise result into waste of State resources. Moreover, setting the rules concerning the way resources can be given to or withdrawn from an SWF is strictly related to the investment strategies that the fund may pursue. In fact, if the domestic legal framework entitles Governmental authorities of a State to tap into the resources under the management of the SWFs of that State, in this case the investment strategy pursued should attempt to maximise liquidity. In fact, if a SWF undertakes long-term, risky investments, and if competent authorities are entitled to withdraw wealth from the SWF also when the market price of the assets under the management of the SWF is lower than the price at which the same assets have been purchased, the operations of the SWF would result into

[17] L. C. BACKER; *The Chinese Communist Party and the Governance Structures of SWFs and SOE*; cit.; L. C. BACKER; *Sovereign Investing in Times of Crisis*; cit.; p. 5 -136.
[18] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 13-14.

severe financial losses. Therefore, if the investment strategy of an SWF envisages long-term and potentially high risk and high yield investments, then it is recommendable to provide for mechanisms which allow Governmental authorities to tap into SWF's resources only in certain, well determined circumstances and only in certain periods. As to the issue of the importance of disclosure and transparency, the reasoning developed above when discussing them in relation to principle 1 applies. The importance of disclosure and transparency emerges also in principle 5, concerning statistic compilation and recording; moreover, since this allow the elaboration of reliable data, this should also serve to enhance the proper management of the SWFs.[19]

The importance given by the GAPP to the establishment and disclosure of clear rules, and especially of legal rules, governing the organisation and the operations of SWFs can be better understood by taking into consideration the efforts which are often made to create a divide between on one hand the SWF acting as a sovereign and as a State organ performing governmental functions, and, on the other hand, the SWF acting as a market participant.[20] In fact, the possibility of confusions and overlapping in the performance of these two functions may cause on one side the impossibility of SWFs to manage its resources in order to maximise financial returns and, on the other side, may rise fears in the host States, thus prompting them to a protectionist backlash. Fears in the host States may be particularly acute when they perceive that governmental functions of SWFs are not only performed within the jurisdiction of the owner State, as it is normal for an SWF, but also within the jurisdiction of the host State, where it is on the contrary expected that SWFs may invest in a way similar to other non-State-owned foreign investors. The establishment of a sound legal framework aims at reducing the above mentioned risks.

Principle 6 focuses on the governance framework for the SWF. It remarks that it should "be sound and establish a clear and effective division of roles and

[19] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - “Santiago Principles*”; cit. p. 14-15.
[20] L. C. BACKER; *Sovereign Wealth Funds as regulatory chameleons*; cit.; p. 432-433.

responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives". It must be remarked that, according to the commentaries, it is irrelevant which "specific governance framework" is adopted in practise. [21] This implicitly means that the GAPP does not promote the adoption of one specific model of corporate governance. This would have been unacceptable, especially because of the great differences existing between SWFs of different countries and also between the same States owners of SWFs. It would have been hardly conceivable to prompt for the adoption of the same governance model for the SWFs of Norway and of those of Kuwait or China. This does not necessarily mean that certain countries, like for instance, some African or Middle East countries simply are too much corrupt or that they lack the knowhow and the skills to adopt a model of corporate governance similar to one adopted by the Australian or Norwegian SWF. On the contrary, this is also related to the fact that SWFs are too much related with the economy but also the politics and the policies of the State which own them to benefit from a simple adoption of models of corporate governance which are inconsistent with its domestic political economic and business culture.

Principle 7 and 8 offer further insight into the basic requirements that the corporate governance of a SWF should meet. They provide that the procedures through which the objectives of the SWF are decided and its management and staff are appointed by the State owner, should be clearly stated. They also argue that the governing bodies of the SWF should have a clear mandate and adequate authority and competency to carry out their functions and that they should be put in condition to act in the best interests of the SWF. Principle 9 stresses the need that the governance model adopted by the SWF ensure that the implementation of the investment strategies of the SWF may be carried out by the management in an independent way and according to clearly defined responsibilities. The commentaries are even more precise when they refer to the "day-to-day" operations of the SWF which should be carried out by the management of the SWF without undue interferences of political

[21] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - “Santiago Principles*”; cit. p. 15.

authorities, which would end up to hinder the effectiveness of the investments of the SWF and its ability to pursue the macroeconomic goals it is expected to achieve. Such independence is therefore instrumental to the goal of maximizing the ability of the SWF to pursue its objectives and not as allowing a certain irresponsibility of the management. In fact, principle 10 provides that the governance of the SWF should ensure adequate accountability of the management and of the owner of the SWF (which can be the Government or the Central Bank). The GAPP does not specify which specific arrangements ensuring accountability should be adopted, but it requires that they be clearly defined, also in appropriate legal instruments.[22]

Principle 11 and 12 provide that SWFs should release an annual report and accompanying financial statements on their operations and performances. Such documents should be prepared in accordance with recognized international or national accounting standards and in particular the financial statements should be audited annually in accordance with recognized international or national auditing standards. The rationale underlying these principles is clear: they aim at improving at establishing a proper and possibly neutral mechanism which allows to effectively check the performance and the activities of SWFs, in order to assess whether SWFs are properly pursuing the objectives they have been mandated and to ensure that they are managed in a proper way, also minimising risks of mismanagement, misappropriation and waste of resources. Moreover, this is expected to improve the transparency of the SWF.

Principle 15 provides that "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." This statement may appear redundant, since it is clear that foreign investors are always required to respect any applicable rule in the host State. Non binding principles like the GAPP cannot derogate legally binding provisions, be they contained in domestic or in international law. It could be

[22] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - “Santiago Principles*”; cit.; p. 16-17.

concluded that such principle is rather a rhetorical formula aimed at assuaging the worries of recipient States about the risks that SWFs may entail to national security.

Nevertheless, if attention is paid to the commentaries, it is possible to better understand the importance of principle 15 and the interactions it can have with international hard law and domestic legislation. In detail, the commentaries underline that SWFs should disclose any information they may be requested, in compliance with applicable laws and regulations, to the competent regulators of the country where they invest. The commentaries explicitly mention the importance to comply with national securities laws, antitrust law and tax law. It must be stressed that failure to comply with the applicable legislation of the host country should allow the latter to impose sanctions upon the foreign SWF as well as to restrict its investments. In this case it seems that the treatment to be afforded to the foreign SWF should not be different from the one which it is expected to be afforded to any other investor. Likewise, SWFs should have the obligation to disclose any relevant information that competent regulators of the host State require acting consistently with the law. This means that SWFs are expected to provide information as far as the competent authorities are legally allowed to demand them. This implies that principle 15 should be deemed to be respected if a SWF refuses to provide information competent regulatory authorities of the host State would have not been entitled to collect under the law of the host State. This may have important implications for the applicability of BITs. In fact, if a SWF does not comply with disclosure requirements, then the host State may adopt sanctions, may withdraw the authorization to invest or may adopt other restrictive measures. All these measures will not amount to a breach of BITs provisions, and in particular of those affording fair and equitable treatment to the foreign investor, since they would be the predictable and lawful consequence of an unlawful or unconscious conduct of the foreign investor, in this case the foreign SWF. Only disclosure requirements which are inconsistent with the domestic legislation of the host state and which therefore seem to be arbitrary and even discriminatory, since they may aim at harassing the foreign SWF, could be regarded as inconsistent with BITs. Likewise, refusal of the foreign SWF to such disclosure requirements, since it cannot amount to a breach of the domestic provisions of the host State, cannot justify the adoption of restrictive measures of the host State which would end up to be inconsistent with the applicable BIT too.

Principle 15 GAPP focuses on the law and regulations which are applicable in general to foreign investors and it does not deal with those measures host States may adopt which explicitly apply to SWFs. While in principle compliance with these additional rules must be ensured, since the GAPP cannot provide SWFs with the possibility to derogate either international or domestic legally binding provisions, nevertheless the commentaries add that "[t]he SWF expects that host countries would not subject the SWF to any requirement, obligation, restriction, or regulatory action exceeding that to which other investors in similar circumstances may be subject."

Principles 16 and 17, which conclude the part of the GAPP on the governance of SWFs, provide for further disclosure duties upon SWFs.

Principle 18 introduces the third part of the GAPP which deals with the issue of the investment strategy SWFs pursue. First of all, it stresses that a SWF, or its owner, should elaborate an investment strategy clear and consistent with the objectives, risk tolerance and general strategy of the SWF itself. As the commentaries correctly point out, "by defining the investment policy, the SWF commits to a disciplined investment plan." Therefore, the SWF will carry out only the operations consistent with the investment strategy mentioned above. The GAPP does not provide for detailed guidelines on the content the investment strategy of SWFs must have. In fact, as the commentaries note, "there is no set formula [providing the best investment strategy] that suits all situations". If attention is paid to the great differences which exist between SWFs, in particular as to their macroeconomic goals, source of financing and legal and governance framework, this observation proves particularly appropriate. Nevertheless, the same commentaries specify that "investment policy, including the strategic asset allocation, should draw upon appropriate portfolio management principles." Then, the commentaries attempt to outline some basic elements of such portfolio management principles. They specify that usually the strategic asset allocation is embodied in a benchmark portfolio which is determined taking into account the SWF's policy purpose, its liability profile, the horizon over which expected returns and risk are defined, and characteristics of different asset classes.[23]

In case, for instance, of a SWF which invests with a long term horizon and with a high risk tolerance it can be expected that the benchmark may be composed of assets which are expected to provide high returns although with possible paper losses in the short term. The commentaries to principle 18 also deals with the possibility that SWFs may use derivatives and financial leverage. In principle, the GAPP is not against the use of these investment strategies. Nevertheless it is recommends that "the use of derivatives, and leverage [be] commensurate with the SWF's investment horizon and risk bearing capacity" of SWFs. Otherwise, there is the risk that the "ability [of the SWF] to meet its investment objectives and [to] contribute to financial market stability" may be seriously hindered. Moreover it is recognised that SWFs often are not leveraged: this is consistent with the fact that SWFs manage wealth owned by States to make profits in a manner consistent with the macroeconomic purpose of the SWFs themselves, and not to make profits by borrowing money States do not have.[24]

In any case, the commentaries to principle 18 stress that the investment strategy adopted, included the eligible asset classes, the possibility of the SWF to invest in derivatives, to use the financial leverage, etc. should always be disclosed.[25]

Principle 19 provides that "the SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and

[23] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit. p. 20-21. For an introduction on the role of the benchmark in asset management see: I. BASILE; *Il benchmarking nell'attività di asset management*; in E. M. CARLUGGIO, ed.; *Strategie, benchmarking e performance nell'asset management*; Bancaria Editrice; 1999; p. 39-103. For an application of the notion of benchmarking in SWFs See: F. WEINBERGER, B. GOLUB; cit.; p. 71-116 and in particular, p. 73-74

[24] However, some cases in which SWFs issue bonds or even sell their own shares in order to raise money on the market and to increase the size of the assets under their management have been recently reported. V. BARBARY, B. BORTOLOTTI, V. FOTAK, W. MIRACKY; *Sovereign Wealth Fund Investment Behavior;* cit.*;* p. 20-25

[25] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 20-21.

based on economic and financial grounds." This implies, first of all, that investments undertaken by SWFs should be commercially driven. In this way, an attempt is made to assuage the fears that SWFs operations may be politically motivated. Actually, as it has been explained in previous chapters, the fact that SWFs are created, owned and managed by States, as well as the fact that they are expected to pursue macroeconomic goals, inevitably make them politically driven for certain aspects. Nevertheless it must be underlined that, if the only public purpose they pursue is the enhancement of monetary and fiscal policies of the home State, as well as the improvement of the management of the wealth obtained from the exploitation of their natural resources, then such objectives may be consistent with the objective of maximising the returns of the investments undertaken overseas, in accordance with the risk tolerance and the investment horizon of the SWFs. An example may illustrate the above mentioned concept. If a commodity SWF undertakes investments which do not aim at maximising financial returns and which therefore significantly reduce the value of the assets under its management, this will have a negative impact on the ability of the owner State to use the resources of the SWF at issue to pursue revenue stabilization and inter-generational saving tasks. Therefore, the pursuit of the political objectives related to monetary and fiscal policies in principle does not prevent the SWFs from being commercially driven in their investment decisions when they carry out operations overseas *and vice versa*.[26]

The commentaries to principle 19 also stress that if SWFs' 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".[27] In the light of the reasoning developed above, the "term economic and financial considerations" must be meant broadly, in the sense that the financial and economic considerations SWFs take into account are not limited to the maximisation of profits but they also include the pursuit of domestic monetary and fiscal policies and the proper management of

[26] Z. FENG; cit.; p. 483-511

[27] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - “Santiago Principles*”; cit.; p. 22.

the revenues obtained from the exploitation of natural resources. Such decisions, although economic in character, also have a political dimension to the extent they inevitably impact on the governmental activities of the State. Therefore, the considerations which under the GAPP are not "economic and financial" include all those politically-driven considerations which bring the SWF to act in a manner which may threaten the national security of the host State, or cause losses for the SWF itself, or severe destabilisation of financial markets. It appears that in these cases not only the recipient State, but also the State owner of the SWF would be adversely affected. In particular, the owner would bear the negative consequences, in terms of a reduction of State wealth, of investment strategies which do not pay enough attention to the maximisation of financial returns. Moreover, its ability to make investments overseas through its SWF would be hindered by the protectionist reactions that non-commercially driven investments may provoke in the recipient countries.

The commentaries to the GAPP, when they refer to the fact that SWFs may base their investment decisions on non economic and financial considerations do not explicitly deal with the risk that a State may use the investments of its SWFs to directly and intentionally endanger the national security of the host State, in one of the ways which have been explained in chapter 1 paragraph 4 of the present research. They only argue that "some SWFs may exclude certain investments for various reasons, including legally binding international sanctions and social, ethical, or religious reasons" or because of their commitment to address in their investment policy social and environmental factors. Once a SWF uses its investments to promote, acting outside its jurisdiction, certain non-commercial objectives and values, irrespective of how worthy and commendable they may be, it does not act as a commercially driven, but as a politically motivated entity.[28] It must be dismissed the argument that SWFs owned by developing countries and countries with economy in transition are the most likely to be non exclusively economically and financially driven

[28] L. C. BACKER; *Remark: The Norwegian Sovereign Wealth Fund: between private and public*; in *Georgetown Journal of International Law*; 2009; p 1272.

in their investment activities.[29] In fact, there are outstanding examples of SWFs owned by western countries which exclude certain assets from their investments because of ethical, social environmental concerns and which, by doing so, pursue political objectives, even, when necessary, at the expenses of the financial aim of profit maximization. For instance, the investments the Norwegian SWF[30] may undertake have to be in line with ethical guidelines which are based on sector and on company behaviour.[31] A Council of Ethics is established, whose members are appointed by the minister of finance. The Council of Ethics monitors the companies in which the SWF invests or mean to invest and if it finds that they do not operate in a manner consistent with the ethical guidelines it may provide advice to the minister of finance to reconsider investments or planned investments in such companies.[32]

[29] Such a statement would rather witness a widespread prejudice in western economies vis-à-vis inbound investments of SWFs owned by emerging economies.

[30] For an overview of the Norwegian SWF see, for instance: K. N. KJAER; cit.; p. 189-202; L. C. BACKER; *Sovereign Wealth Funds as regulatory chameleons*; cit.; p. 450-459. For a more in depth analysis of the role of ethical (i. e. non commercial) principles in its investment strategies see: G. CLARK, A. MONK; *The Norwegian Government Pension Fund: Ethics Over Efficiency*; in *Rotman International Journal of Pension Management*; 2010; p. 14-19; G. CLARK, A. MONK; *The legitimacy and governance of Norway's sovereign wealth fund: the ethics of global investment; Oxford Project on SWFs*, working paper; 2010; L. C. BACKER; *Remark: The Norwegian Sovereign Wealth Fund: between private and public*; cit.; p. 1270-1280.

[31] Guidelines for the observation and exclusion of companies from the Government Pension Fund Global's investment universe. Adopted by the Ministry of Finance on 1 March 2010 pursuant to Act no. 123 of 21 December 2005 relating to the Government Pension Fund, section 7. Available online at http://www.regjeringen.no/en/sub/styrer-rad-utvalg/ethics_council/ethical-guidelines.html?id=425277 page visited on 29/7/2011 . For a brief comment see: L. C. BACKER; *Remark: The Norwegian Sovereign Wealth Fund: between private and public*; cit.; p 1277.

[32] The Advisory Council of Ethics was established in autumn 2004, when the Ministry of Finance issued ethical guidelines for the Government Petroleum Fund. It replaced the Advisory Commission on International Law, which in turn had been appointed by the Ministry of Finance in 2001 and whose task was to provide an evaluation of whether specific investments were in conflict with Norway's commitments under international law. More information on this issue may be found on the website of the Norwegian ministry of finance at the page: http://www.regjeringen.no/en/dep/fin/Selected-topics/the-Government-pension-fund/responsible-investments/History.html?id=434896 visited on 29/7/2011 and at the page: http://www.regjeringen.no/en/dep/fin/Selected-topics/the-Government-pension-fund/responsible-investments/the-council-on-ethics-for-the-Government.html?id=447010 visited on 29/7/2011. On these issues see also: G. CLARK, A. MONK; *The Norwegian Government Pension Fund: Ethics Over Efficiency*; cit.; p. 16; L. C. BACKER; *Sovereign Wealth Funds as regulatory chameleons*; cit.; p. 460-464.

Section 2 of the Ethical Guidelines specifies which companies shall be excluded "from the Fund's investment universe". They are those which, directly or through entities they control:

"a) produce weapons that violate fundamental humanitarian principles through their normal use;

b) produce tobacco;

c) sell weapons or military material to states mentioned in section 3.2 of the guidelines for the management of the Fund."

Moreover, section 3 specifies that the Ministry of Finance, on the advice of the Council of Ethics, may exclude investments in other companies when "there is an unacceptable risk that" such companies contribute or are responsible for:

"a) serious or systematic human rights violations, such as murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other child exploitation;

b) serious violations of the rights of individuals in situations of war or conflict;

c) severe environmental damage;

d) gross corruption;

e) other particularly serious violations of fundamental ethical norms."

In compliance with the Ethic guidelines, investments have been excluded in a large number of companies.[33]

In an attempt to reconcile the somehow conflicting objectives of promotion of ethical values and of maximisation of shareholder value, it could be suggested that shareholder value should not be construed in a narrow sense, so as to include

[33] A non exhaustive list of companies (which is provided for in: the Norges Bank Investment Management. Annual Report 2006) in which the Norwegian SWF has decided not to invest include: Singapore Technologies (Singapore) BAE Systems (UK), EADS Airbus (Netherlands), Finmeccanica (Italy), Alliant Techsystems, (US) General Dynamics, (US) L-3 Communications, (US) Lockheed, (US) Raytheon, (US) GenCorp Inc, (US) Boeing, (US) Honeywell, (US) Northrop Grumman, (US) Textron, (US) United Technologies, (US) Safran, (France) Thales, (France) Wal-Mart Stores Inc, (US) Wal-Mart de Mexico (S.A) Freeport McMoran, (US) Poongsan Corporation, (South Korea) Hanwha Corporation, (South Korea) Barrick Gold, (Canada) Rio Tinto plc, (UK) Rio Tinto Ltd, (Australia) Sterlite Industries Ltd, (India) DRDGOLD Ltd, (South Africa). (Source: Norges Bank Investment Management. Annual Report 2006).

financial returns only, but also as encompassing the advantages of the projection of Norway's values in the word. In this case, investments which may provide less financial returns but more political and ethical advantages may increase shareholder value. This occurs because, in case of SWFs, the shareholder, being a State, may consider as shareholder value also political and non only financial returns. Nevertheless these considerations bring back to the problem that SWFs are politically motivated for the same reason that their owners, the States, have different objectives than non-sovereign investors.[34]

The GAPP seems to be aware of these complexities when it decides not to aim at dissuading SWFs from taking into consideration non-economic and non-financial factors in their investment decisions. It only requires that, when SWFs do so, "these reasons and factors should be publicly disclosed."[35]

Finally, it must be stressed that these concerns can be assuaged if it is thought that there are also privately-owned, socially responsible funds which in their investment decisions take into account social, environmental, ethical principles and therefore which try to promote them in the countries where they invest, for instance by means of excluding certain companies or States from their investment decisions. Pursuant to this reasoning, SWFs which also pursue political goals would not be regarded as acting very differently from such socially responsible funds.[36] Nevertheless, this argument pays insufficient attention to the fact that, since SWFs are owned by States, their attempts to pursue political goals in the jurisdiction of other States rise more concerns than similar attempts which are carried out by privately owned funds.[37] In can be concluded that, although SWFs are not the only investors which can pursue

[34] L. C. BACKER; *Remark: The Norwegian Sovereign Wealth Fund: between private and public*; cit.; p. 1277-1278.

[35] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 22.

[36] On the difficulty to draw a clear divide between SWFs which can be politically motivated and privately-owned funds which are exclusively financially driven (and which do not rise political issues in the State which own them) see also: L. C. BACKER; *Sovereign Wealth Funds as regulatory chameleons*; cit.; p. 432-433.

[37] L. C. BACKER; *Remark: The Norwegian Sovereign Wealth Fund: between private and public*; cit.; p. 1279-1280.

other than strictly financial objectives, their sovereign nature make them different from other entities like, for instance, socially responsible funds. This argument could be validly used to dismiss an interpretation of principle 19 according to which the conduct and the financial strategies of privately owned SWFs should be used as a benchmark for SWFs so as to distinguish between benign SWFs, which behave as privately owned funds, and dangerous SWFs which act differently.[38]

Principle 20 too seems to address further concerns on the public nature of SWFs. In fact, while SWFs operate in the market, i. e. in the same context in which non-State actors operate, the fact that they also are Governmental entities *inter alia* entrusted with the task of performing Governmental functions, may bring to the situation in which SWFs do not compete at arm's length with private sector companies. In detail, the special connection SWFs have with Governmental authorities of the owner State may give them access to "privileged information or inappropriate influence by the broader Government in competing with private entities." The GAPP underlines that SWFs should not make use of their particular position to gain undue advantages at the expenses of other market participants.

Principle 21 deals with the issue of the exercise of shareholder ownership rights of SWFs in invested companies. This has very important implications. In fact, since SWFs are usually regarded as (and since they often claim to be) long-term investors, which are interested in establishing long lasting relations instead of profiting from speculative operations, then they would be expected to exercise such rights. On the other side, one of the main concerns related to SWFs is that they may seize control of strategic companies of the countries where they invest. This may provoke fears in the recipient countries and ultimately a protectionist backlash against SWFs. In fact, as it was argued in chapter 1, one of the reasons why SWFs investments were welcomed is related to the fact that, while providing a relevant contribution of capitals, they have often shown scarce interest in making use of their shareholdings to exert influence over the strategic choices of the invested companies. The GAPP is not

[38] L. C. BACKER; *Sovereign Wealth Funds as regulatory chameleons*; cit.; p. 430-433 and p. 482- 499.

against the exercise of shareholder ownership rights of SWFs; on the contrary, it remarks that it considers it as "a fundamental element of the equity investments' value" of SWFs. What is important is that when a 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" and, in any case, it should disclose "its general approach to voting securities of listed entities".[39]

Principle 22 and 23 contain further suggestions on Risk management and performance measurement.

Principle 24 provides that SWFs will meet on a regular basis to review the implementation of the GAPP. This is consistent with the dynamic and evolving character of SWFs as well of the economic framework in which they are established and subjected to changes.

3. The establishment of the International Forum on Sovereign Wealth Funds and the implementation of the Santiago Principles

Consistently with principle 24, SWFs decided to meet in other occasions. In particular, on April 6, 2009 in Kuwait City the SWFs meeting within the framework of the IWG reached a consensus to establish the International Forum of Sovereign Wealth Funds IFSWF). The Kuwait Declaration[40] provides that the Forum "will be a voluntary group of SWFs" whose "purpose will be to meet, exchange views on issues of common interest, and facilitate an understanding of the Santiago Principles and SWF

[39] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - "Santiago Principles*"; cit.; p. 22-23. It can be argued that one of the possible solutions to the threat that non-transparent SWFs may pose when exercising their shareholding rights can consist in a voluntary commitment of SWFs not to exercise such rights. See: R. J. GILSON, C. J. MILHAUPT; cit.; p.1363-1369.

[40] INTERNATIONAL WORKING GROUP OF SOVEREIGN WEALTH FUNDS; "*Kuwait Declaration": Establishment of the International Forum of Sovereign Wealth Funds*; April 6, 2009 available online at: http://www.iwg-swf.org/mis/kuwaitdec.htm page visited on 20/08/2011.

activities". It underlines that "the Forum shall not be a formal supranational authority and its work shall not carry any legal force".[41]

The members of the Forum shall be the SWFs of the States which participated in the IWG and endorsed the Santiago Principles. In any case they stress that "membership will be open to other Funds" provided they "meet the Santiago Principles definition of a SWF and endorse the Santiago Principles".[42] Members shall meet at least once a year[43], in order to discuss and compare their investments practices and strategies.

The efforts of the in monitoring the implementation of the GAPP within the framework of the IFSWF brought to the publication, on July 7th 2011, of the Report, "prepared by IFSWF Sub-Committee 1 and the Secretariat in collaboration with the Members of the IFSWF", titled "IFSWF Members' Experiences in the Application of the Santiago Principles"

This document was originally meant as an internal exercise. It would have promoted comparison and dissemination of information on the best practises SWFs may follow and it would have helped Members of the IFSWF to learn from each other. However, during the Beijing meeting of the IFSWF it was decided that this report should have been published, because it would have improved knowledge of SWFs worldwide and in particular in recipient States. Moreover, the publication of the report would have helped to make it clearer that SWFs do not constitute a homogeneous category and therefore that they could not implement the GAPP in the same way. On the contrary, implementation of the GAPP need to be undertaken considering the peculiarities of SWFs and of the States which own them.[44] This indirectly seem to explain *ex post* why the GAPP contains very general and broad principles. Had the principles been

[41] INTERNATIONAL WORKING GROUP OF SOVEREIGN WEALTH FUNDS; "*Kuwait Declaration": Establishment of the International Forum of Sovereign Wealth Funds*; cit.; par A. See also: J. J. NORTON; *The Santiago Principles' for Sovereign Wealth Funds;* cit.; p. 657.

[42] INTERNATIONAL WORKING GROUP OF SOVEREIGN WEALTH FUNDS; "*Kuwait Declaration": Establishment of the International Forum of Sovereign Wealth Funds*; cit.; par. C.

[43] INTERNATIONAL WORKING GROUP OF SOVEREIGN WEALTH FUNDS; "*Kuwait Declaration": Establishment of the International Forum of Sovereign Wealth Funds*; cit.; par. E.

[44] INTERNATIONAL FORUM ON SOVEREIGN WEALTH FUNDS; *IFSWF Members' Experiences in the Application of the Santiago Principles*; available online at: http://www.ifswf.org/pst/stp070711.pdf p. 4 and p. 9.

more detailed, their applicability would have been desirable and feasible only for certain SWFs.

The report is based on the answers which have been provided by every member of the IFSWF on the way they have implemented or they are implementing the GAPP. More in detail, for each principle of the GAPP the members of the IFSWF had to specify in a questionnaire they were previously submitted whether: they had already implemented it before the inception of the GAPP, or they have partially implemented it since the inception of the GAPP, or they have fully implemented it since the inception of the GAPP or they have not implemented it.

It emerges that an overwhelming majority of IFSWF members currently implement the GAPP and that in most case they already implemented it also before that the principles such document contains were formally stated in October 2008 during the Santiago meeting of the IWG[45]. This further proves what had been argued in paragraph 1 of this chapter when it was emphasised the descriptive rather than hortatory character of the GAPP. This document, rather than urging SWFs to respect certain principles, more often merely describes which are the best practises SWFs may implement and, in most cases, have already implemented.

The report devotes some pages to the issue of transparency, which is defined as "the extent to which the underlying purpose, structure, conduct and outcomes of a Member‘s investment and operational practices can be easily accessed and understood". [46]

The report stresses that the level of transparency of each member of the IFSWF is a combination of compliance and judgement, the former indicating the respect of

[45] For the purposes of the present research it is not necessary to investigate the degree of compliance of IFSWF members with each principle stated in the GAPP. (for more details on this issue see: INTERNATIONAL FORUM ON SOVEREIGN WEALTH FUNDS; *IFSWF Members' Experiences in the Application of the Santiago Principles*; cit.; p. 13-37) Therefore, it is sufficient to quote the general results which are provided for in the executive summary of the report (p. 6). It stresses that in the 80% of the answers, the practices of members of the IFSWF were consistent with the principles laid down in the GAPP before the formal adoption of the GAPP itself. Only in 15% of cases implementation of these principles has occurred after the adoption of the GAPP, while the 4% of answers relate to some principles of the GAPP which have not been implemented yet.

[46] INTERNATIONAL FORUM ON SOVEREIGN WEALTH FUNDS; *IFSWF Members' Experiences in the Application of the Santiago Principles*; cit.; p. 38, note 6.

domestic provisions imposing transparency and the latter pertaining to a certain degree of discretion of the relevant authorities. There is a widespread consensus among members that the suitable degree of transparency for members "is first a function of their domestic legal requirements". This is consistent with the idea that, given the protean nature of SWFs, a one-size-fits-all standard of transparency should be hardly feasible or desirable. Nevertheless there is also a shared opinion that in principle a high level of transparency is desirable. In fact, "no Members perceive transparency as value-destroying and the overwhelming majority agreed that there is value in transparency and the SP".[47]

The value of transparency essentially has four dimensions. First of all, transparency increases the legitimacy of the SWF in the same State which owns it. In fact, it enables the Government and the parliament (according to the applicable domestic legal framework) and, ultimately, the citizens, to understand how state wealth is managed and to assess whether it is managed in a proper way. Moreover, it must be remarked that there may be political resistances against the use of part of the resources under the management of the SWF to carry out investments overseas.[48] Lack of transparency of SWFs may strengthen those who ask that Government use resources in excess to undertake domestic investments or to lower taxes or to increase public spending, instead of financing foreign firms and foreign States. On the contrary, if policymakers and the public are well informed about the purposes of the SWF and of its performance, then they will be more likely to accept the activity of the SWFs. To use the words of the report: "[a]chieving that critical mass of

[47] International Forum on Sovereign Wealth Funds; *IFSWF Members' Experiences in the Application of the Santiago Principles*; cit.; p. 38.

[48] The reasons why these pressures should be resisted have been explained especially in chapter 1 and 2 of the present research. For some examples of disputes among state organs and decision makers as to the use to be made with resources in excess see also: S. Fortescue;cit.; p. 113-132; L. H. Liew, L. He; cit.; p. 26-46; A. Arduino; cit.; M. Zhang, F. He; *China's Sovereign Wealth Fund:Weakness and Challenges*; in *China &World Economy*; 2009; p. 101-116; For a more general discussion on these topics see: X. Yi-chong; cit.; p. 1-24.

information is seen as assisting in forming trust, credibility, and a 'license' to operate"[49]

Secondly, some IFSWF members argue that transparency provides SWFs with commercial advantages.

In particular if the purpose and investment approach of the SWFs are well and broadly understood by the market and by the recipient countries, the opportunities of SWFs to make investments across the full scope of asset classes, access points and locations would be maximized.[50]

The third dimension of transparency, which however is dealt with quite briefly and unconvincingly in the report, consists in increased reputation. Finally, and this represents the fourth dimension, transparency, as it is developed in the context of the GAPP, assist SWFs in their communication with stakeholders, especially those of the same State which own the SWFs. The report provides some examples of this concept. For instance, it quotes the case of the Oil Revenues Stabilization Fund of Mexico (ORSFM), which said that it used the GAPP as a reference point for its communications, particularly with Congress and broader public stakeholders.[51]

4. The documents adopted by the OECD governing the policies of recipient States

The other international organization required by the G7 of October 2007 to deal with SWFs is the OECD.[52] While the IMF, acting trough the IWG, has focused on the practices of SWFs, the OECD on the contrary has focused on those of recipient

[49] INTERNATIONAL FORUM ON SOVEREIGN WEALTH FUNDS; *IFSWF Members' Experiences in the Application of the Santiago Principles*; cit.; p. 40.

[50] INTERNATIONAL FORUM ON SOVEREIGN WEALTH FUNDS; *IFSWF Members' Experiences in the Application of the Santiago Principles*; cit.; p. 41.

[51] INTERNATIONAL FORUM ON SOVEREIGN WEALTH FUNDS; *IFSWF Members' Experiences in the Application of the Santiago Principles*; cit.; p. 42.

[52] For an overview of the role of the OECD in promoting economic cooperation, also through the adoption of standards, guidelines and other instruments of soft law see: F. VOLPI; *L'organizzazione per la cooperazione e lo sviluppo economico*; in L. S. ROSSI; ed.; *le organizzazioni internazionali come strumento di governo multilaterale*; Milano; Giuffré; 2006; p. 165-189.

States. On April 2008 a Report by the OECD Investment Committee on SWFs and Recipient Country Policies has been adopted. It is the result of discussions among representatives of thirty OECD countries, ten non-OECD countries adhering to the OECD investment instruments, four other Governments participating in the project and the European Commission. On the basis of this report, the OECD adopted, on the occasion of the Ministerial Council Meeting on 4-5 June 2008 in Paris, the “declaration on SWFs and Recipient Country Policies”. The OECD affirms that SWFs bring in general a beneficial contribution to world economy and that they could rise legitimate concerns only when they are not sufficiently transparent, they are not economically motivated and they unduly pursue political objectives. The OECD welcomes the work of the IMF and of the IWG, which are implicitly considered as complementary to those of the OECD itself.

Then, the OECD lists a few general principles recipient States should follow when they take measures affecting the investments of SWFs. Recipient countries should not erect protectionist barriers to foreign investment and should not discriminate among investors in like circumstances. Foreign investments should only be restricted when they raise national security or public policy concerns; in any case measures taken to this purpose should be transparent, predictable and proportional to clearly-identified national security risks. Such principles are similar to those which can be found in other official documents, like the Communication of the Commission of 2008 "a Common European approach to Sovereign Wealth Funds" and which have been discussed in different occasions in the present research. This constitutes a further proof of the existence of a shared attitude towards SWFs, as it has been highlighted above.

Moreover, the OECD recalls that other OECD instruments, although they are not specifically devised for the SWFs, can apply to them in the same way they already apply to any other foreign investor.[53] Such instruments are the OECD Code of

[53] OECD; *Sovereign Wealth Funds and recipient countries- Working together to maintain and expand freedom of investment;* cit. For an introductory comment of this document see: J. COOKE; cit.; p. 771-

Liberalisation of Capital Movements, adopted in 1961,[54] and the OECD Declaration on International Investment and Multinational Enterprises of 1976 as revised in 2000 and in 2011, adopted by forty-one OECD and non-OECD country Governments.

The Code of Liberalisation of Capital Movements has been adopted with a decision of the of the OECD Council. Therefore it cannot be regarded as an international treaty but as an act of an international organisation. It is a legally binding instrument and member States are required to ensure that their law and regulations comply with it.[55] Nevertheless, differently from, for instance, EU law, it does not have direct effect and therefore "individual citizens or enterprises of member countries can not directly invoke rights resulting from the Codes to invest abroad, move funds or provide cross-border services."[56] The code lays down no mechanism for ensuring the enforcement of its provisions. Application of the code is overseen by the OECD investment Committee, where member countries meet to discuss application and implementation of the Code itself.[57] Compliance is therefore expected to be enhanced trough e mechanism of peer review and possible political pressures of OECD members on non abiding States. The code provide for a duty of standstill, i. e. a duty not to introduce new restrictions to capital movements and a duty of rollback which implies that members undertake to gradually eliminate existing restrictions to capital movements. The elimination of restrictions will not occur through bargaining and negotiating mutual concessions, as it occurs, for instance in case of liberalisation of international trade in the WTO. On the contrary, members are required to act in order to autonomously abolish existing restrictions, without expecting any immediate comparable concession from other countries. This is consistent with the underlying philosophy of the Code, according to which, at least on the long term, "liberalisation

775; A. GUTLIN; cit., pp. 763-765; F. BASSAN; *Host States and Sovereign Wealth Funds, between National security and international law*; cit.; p. 175-176.

[54] Full text of the code is available online at http://www.oecd.org/dataoecd/10/62/39664826.pdf page visited on 31/07/2011

[55] On the possibility that the OECD, in limited cases, may adopt legally binding acts see: F. VOLPI; p. 180-181; T. GRUCHALLA-WESIERSKI; *A framework for understanding "soft law*"; in *McGill Law Journal*; 1984 p. 53.

[56] OECD; *OECD codes of liberaliaation - user's guide*; OECD; 2008; p. 14.

[57] OECD; *OECD codes of liberaliaation - user's guide*; cit.; p. 8 and 13.

is as much in a country’s own interest as it is an advantage for its trading partners". Finally, the code underlines that discriminations to capital movements by reason of the nationality of the capitals or of the investors are forbidden.[58]

Capital movements which are covered by the code are listed in detail in annex A and B. A detailed analysis of their content would clearly fall outside the scope of the present research; however, it can be stressed that the list of covered transactions includes all the operations SWFs may undertake, from foreign direct investments to portfolio investments including the purchase of debt and equity instruments as well as investments in investment funds. It must be remarked that the code at art. 3 contains a self-judging public order and security exception. In fact, it provides that none of its provisions shall prohibit "a Member from taking action which it considers necessary for:

i) the maintenance of public order or the protection of public health, morals and safety;

ii) the protection of its essential security interests;

iii) the fulfilment of its obligations relating to international peace and security."

The discussion on the national security clause which has been developed supra in chapter 4 paragraphs 8 to 10 applies to the discussion as to whether SWFs operations may be restricted if they represent a threat to national security of the host State. Nevertheless art. 3 could not be construed as allowing the host State to derogate provisions concerning the admission and the treatment of foreign investments of SWFs which may be contained in other international instruments (at least those having a multilateral character) to which it is party. In fact, art. 4 provides that "[n]othing in this Code shall be regarded as altering the obligations undertaken by a Member as a Signatory of the Articles of Agreement of the International Monetary Fund or other existing multilateral international agreements."

Another OECD instrument whose applicability to SWFs deserves to be investigated is represented by the Guidelines on Multinational Enterprises[59] They are a non

[58] OECD; *OECD codes of liberaliaation - user's guide*; cit. 10-11.

legally binding set of principles and standards for responsible business conduct whose adoption OECD Governments jointly recommend to multinational enterprises, the latter ones remaining free to decide whether or not to comply with them.[60] The guidelines in fact stress that they do not prejudice the relevant provisions of domestic and international law governing the relation between investors and the States in which they carry out their operations.[61]

The first issue to be addressed is whether SWFs could fall within the notion of multinational enterprise under the OECD guidelines. To this extent, it must be remarked that although the OECD text first declares that a "precise definition of multinational enterprises is not required for the purposes of the Guidelines" nevertheless it points out, in descriptive terms, which are the main features that a multinational enterprise must have to be regarded as such. Therefore, multinational enterprises are "companies or other entities established in more than one country and so linked that they may co-ordinate their operations in various ways. While one or more of these entities may be able to exercise a significant influence over the activities of others, their degree of autonomy within the enterprise may vary widely from one multinational enterprise to another." [62] Multinational enterprises are therefore constituted by a network of a parent company and subsidiaries which are

[59] OECD; *OECD guidelines on multinational enterprises*; OECD; 2011. The text of the guidelines, as it has been updated in 2011, is available online on the OECD website at the page: http://www.oecd.org/dataoecd/43/29/48004323.pdf visited on 1/8/2011. For a comment see: P. ACCONCI; *Il nuovo testo delle Guidelines per le imprese multinazionali adottato dagli Stati membri dell'OCSE*; in *Comunicazioni e Studi dell'Istituto di diritto internazionale e straniero dell'Università degli studi di Milano*; 2002, pp. 377-411; P. ACCONCI; *The Promotion of Responsible Business Conduct and the New Text of the OECD Guidelines for Multinational Enterprises*; in *Journal of World Investment*; 2001; p. 123-149; F. BORGIA; *La soft law come strumento di regolamentazione delle attività delle imprese multinazionali*; in *Diritto del commercio internazionale*; 2010 p. 309-333. Some authors underlines that OECD guidelines are consistent with a western approach of corporate governance which can hardly be applicable to SWFs or SOEs of States with different economic and political systems. For instance in China, the Communist party plays a role in ensuring the consistency between the operations of the SWF and the macroeconomic objectives of the State which cannot be compared to any form of corporate governance existing in western countries. For more informations on this issue see: L. C. BACKER; *Sovereign Investing in Times of Crisis;* cit.; p. 5 -136; L. C. BACKER; *The Chinese Communist Party and the Governance Structures of SWFs and SOE*; cit..

[60] OECD; *OECD guidelines on multinational enterprises*; cit.; p. 11.

[61] OECD; *OECD guidelines on multinational enterprises*; cit.; p. 15-16.

[62] OECD; *OECD guidelines on multinational enterprises*; cit.; p. 15.

based in different countries. Such subsidiaries are created or purchased by means of foreign direct investments. Under this point of view, it must be remarked that most SWFs cannot fall within this notion. Firstly, all SWFs which have not an independent legal personality (be it under public law or corporate law) would be excluded from the notion. Moreover, also consistently with the macroeconomic purposes of SWFs, their do not carry out economic activities by establishing subsidiaries in foreign countries, but they mainly undertake portfolio investments. Only a very few SWFs can be regarded also as multinational enterprises: it is the case, for instance, of the Temasek holdings, one of Singapore's SWF, which is established as a company and manages also controlling stakes in domestic and foreign companies, which can be regarded for several aspects as its subsidiaries.[63]

More in general, a SWF can be regarded as a multinational enterprise when it is established as a company and when it acts as a parent company of a set of Sovereign Wealth Enterprises (SWE), provided that the latter ones are based in different States. A SWE is a sovereign investment vehicle that is owned and controlled by a sovereign wealth fund. In other words, a SWF which is a subsidiary of another SWF is a SWE.[64] The ensemble of a SWF and the controlled SWEs can be regarded as a multinational enterprise, when the SWF and SWEs are based in at least two different States.

The fact that SWFs are owned by States is irrelevant for the purposes of the applicability of the OECD guidelines on multinational enterprises, since they argues that "[o]wnership [of multinational enterprises] may be private, State or mixed."

Also considering the limited applicability of the guidelines at issue to SWFs, an in depth review of their content would not be necessary for the purposes of the present research. It is sufficient to remind that they lay down very general principles multinational enterprises should comply with in order to ensure that their activities

[63] For more information on the way Temasek is also a holding whose task is to manage stakes in State invested enterprises, both in Singapore and abroad see: A. GOLDSTEIN; *Temasek: fondo sovrano o una reincarnazione dell'IRI nello stretto di malacca?* in M. LOSSANI, F. BERTONI, S. CHIARLONE, ed; *Fondi sovrani: economie emergenti e squilibri globali*; Milano; Francesco Brioschi Editore; p. 155-172.

[64] The definition of SWE is the one provided for by the SWF Institute on its website at the page: http://www.swfinstitute.org/statistics-research/sovereign-wealth-enterprise-swe/

might not adversely affect the interests of the States where they operate, but, on the contrary, might contribute to achieving sustainable development. The underlying rationale is that the multinational enterprises themselves can benefit from a business approach which, takes into account the promotion of the development and the wellbeing of the States and of the populations affected by their investments.[65] It must be remarked that some of these principles are the same which are stated in the mission of the above mentioned Temasek holdings. In fact, on the website of this Singaporean SWF the following statements are provided for: "[w]e [the Temasek Holdings] recognise that social, environmental and governance factors can impact the larger community as well as the long term sustainability of companies and businesses. We actualise our commitment as a responsible corporate citizen by supporting efforts that build people and communities through education, healthcare and research; build bridges between peoples through deeper understanding and friendship; build better governance through a culture of integrity and excellence; and rebuild lives and livelihoods devastated by major natural disasters."[66]

A last OECD documents which deserves a quick mention are the OECD Guidelines on Corporate Governance of State-owned Enterprises, which were adopted in 2005[67]. It must be stressed that these guidelines, which are not legally binding, can be implemented also in non-OECD countries[68], which, as it has been described in chapter 1 of the present research, own the majority of SWFs.

[65] The OECD guidelines, in other words, attempt to reconcile the interests of multinational enterprises, on one side, with the interests of the States where they invested, on the other. Their approach is therefore quite different to the one followed within the framework of the UN, where the focus was on subordinating the activity of multinational enterprises to the achievement of the developmental objectives of the host States. On this point see: P. ACCONCI; *Il nuovo testo delle Guidelines per le imprese multinazionali adottato dagli Stati membri dell'OCSE*; cit.; p. 377-411.

[66] The possibility that SWFs through their investments may constitute an important tool for the development of the host State has been explored, *inter alia*, in P. J. KEENAN; *The human rights potential of sovereign wealth funds*; 1151-1180

[67] OECD; *OECD Guidelines on Corporate Governance of State-owned Enterprises*; OECD; 2005.

[68] In fact, as it is written in the foreword of the guidelines (p 3): "the strong support that OECD has enjoyed for this work, and the broad endorsement of the Guidelines themselves" makes it possible to expect that "they will be widely disseminated and actively used in both OECD and non-OECD countries."

The definition of State-owned enterprise is worded in very broad terms, since it "refers to enterprises where the State has significant control, through full, majority, or significant minority ownership." SWFs should fall within such wording, since they are owned and controlled, although in different ways, by States. Moreover, the guidelines seem to further broaden their scope when they underlines that "many of the Guidelines are also useful in cases where the State retains a relatively small stake in a company, but should nevertheless act as a responsible and informed shareholder." In this case, if a company is participated by a State through the SWF of the latter, and if the State or, rectius, its SWF, exercises its shareholding rights, then such company can be regarded as a SOE under the guidelines. It would result that a company like Unicredit, in which Libya, through its SWFs and Central Bank, owns relevant participations [69] and appoints the vice-chairman,[70] could be regarded under the guidelines, as a Libyan SOE (at least until the freezing of Libyan participations pursuant to resolutions 1970 and 1973 UNSC made the situation much more confused).

In any case what is more important is that most principles contained in the OECD guidelines may apply to any shareholding of States. Although it seems that the guidelines have been drafted having in mind State participation in its domestic companies, nevertheless there is nothing in the guidelines which allows to exclude from their coverage also investments States undertake overseas, for instance by means of their SWFs. Therefore the guidelines may have some relevance also in governing the portfolio investments of SWFs in foreign companies irrespective of the fact that SWFs are not the same as SOEs, as it was explained in chapter 1

[69] As to July 2011 The Central Bank of Libya owned 4,988% of Unicredit, thus ranking as the third biggest shareholder of Unicredit. Moreover, if we consider also the 2,594% stake of the Libyan investment authority, it can be argued that the combined shareholdings of Libyan state entities in Unicredit reaches 7,582% of the company, much more than the 5,247% owned by Mediobanca, the biggest individual shareholder. It follows that ultimately the main shareholder of Unicredit is Libya. Source of the data: website of Unicredit Group, webpage: http://www.unicreditgroup.eu/it/Governance/Shareholder_structure.htm visited on 12/08/2011

[70] The vice Chairman of Unicredit is Farhat Omar Bengdara, who, at the time of the appointment, was also the governor of the Central Bank of Libya and a member of the Board of Trustees della Libyan Investment Authority. Such information are available on the website of Unicredit at the webpage: http://www.unicreditgroup.eu/it/Governance/Farhat_Omar_Bengdara.htm visited on 12/08/2011

paragraph 1 of the present research. Furthermore, some of the principles of the guidelines are very similar to some of the principles contained in the GAPP.

In the remainder of the present paragraph it will be carried out a very quick comparison of the content of the OECD guidelines on State owned enterprises and of the GAPP. The aim is to point out that there is a widespread consensus, both at the level of the OECD and of the IWG and IFSWF on the existence of some principles of good governance and of best practises concerning State participation in the economy especially when it occurs by means of State shareholding in companies. These principles may be fruitfully applied both in case of investments undertaken by a State in companies based in its jurisdiction and in case of investments undertaken by a SWF in companies based in the jurisdiction of States other than the owner of the SWF at issue.

For instance, guideline 1 A. stresses the need for a separation between the State as a shareowner and as a regulator. This implies first of all that the State-regulator cannot take advantage of its sovereign powers and entitlements to advantage the State-shareholder at the expenses of other market participants. Guideline 1 D. emphasises another aspect concerning the fact that the State, when it is involved in market operations, should do so on an equal footing as other non-State actors. It fact, it provides that "SOEs should face competitive conditions regarding access to finance. Their relations with state-owned banks, state-owned financial institutions and other state-owned companies should be based on purely commercial grounds."[71] It is undeniable that the objective of principle 1 of the guidelines is very similar to that of principle 20 GAPP, which provides that "[t]he SWF should not seek or take advantage of privileged information or inappropriate influence by the broader Government in competing with private entities."

Also guideline 2, which deals with the practises States should follow when exercising their rights as shareholders, contains some basic concepts which can be found in the GAPP too. For instance, guideline 2 A. stresses that "[t]he Government should

[71] OECD; *OECD Guidelines on Corporate Governance of State-owned Enterprises*; cit.; p. 11.

develop and issue an ownership policy that defines the overall objectives of state ownership, the state’s role in the corporate governance of SOEs, and how it will implement its ownership policy". The importance that a State or a State entity, when it acquires stakes in a company, decide the ownership policy it means to adopt and then disclose it, is emphasised also in principle 21 GAPP. Likewise, when guideline 2 B stresses that "[t]he Government should not be involved in the day-to-day management of SOEs and allow them full operational autonomy to achieve their defined objectives" it seems consistent with GAPP 9, which, also according to the commentaries, provides that "the management of the SWF responsible for its day-to-day operations should have the authority to make individual investment decisions, as well as to make operational decisions relating to staffing and financial management"[72]. Guideline 2 F. provides that "[t]he state as an active owner should exercise its ownership rights according to the legal structure of each company" and then it lists some of the primary responsibilities which rest upon the State when it acts as shareholder. From this standpoint the guidelines are quite different from the GAPP: in fact, while the latter, in principle, leaves SWFs free to exercise their ownership rights or not, on the contrary the wording of the guideline suggests a bias in favour of a more active exercise of its shareholder rights on behalf of the State.[73]

Guideline 5 deals with the issue of transparency and disclosure, and explores the circumstances in which they must be regarded as particularly important.[74] They are very similar to the circumstances in which transparency is required to SWFs according to the GAPP. Transparency and disclosure must apply in particular to reporting, (guideline 5 A. and principles 5, 7 and 22 GAPP) audit, (5 B to 5 D of the guidelines; 12 and 22 GAPP) as well as to the information which should be released on the objectives of the SOE or of the SWF (5 E 1 guidelines; 2 - 3 - 7 GAPP) and on the mechanisms for the detection and the management of risks (5 E 3 guidelines; 17 and 22 GAPP).

[72] INTERNATIONAL WORKING GROUP FOR SOVEREIGN WEALTH FUNDS; *Generally accepted principles and practices - “Santiago Principles*”; cit.; p. 17.

[73] OECD; *OECD Guidelines on Corporate Governance of State-owned Enterprises*; cit.; p. 13.

[74] OECD; *OECD Guidelines on Corporate Governance of State-owned Enterprises*; cit.; p. 16.

5.The soft law nature of the instruments specifically addressing SWFs. The concrete impact they may have on the regulation of their operations

All the documents which have been analysed in the present chapter are instruments of soft law. Therefore, in this last paragraph some general considerations on soft law must be carried out, in order to achieve a full understanding of the concrete impact they may have on the regulation of SWFs. It will also be developed a discussion of their possible interactions with the instruments of hard law which have been analysed in chapter 3 to 7 of the present research in order to study whether provisions of soft and hard law, read jointly, may help to properly govern the operations of SWFs and the policies host States may adopt in relation to them.

The notion of international soft law generally refers to those instruments like recommendations, standards, guidelines, declarations, statements, which are not legally binding and therefore it is juxtaposed to international hard law, which includes legally binding instruments like, for instance, international treaties and international custom.[75] It can be argued that a law which is not binding could hardly qualify as law and therefore soft law would rather pertain to the sphere of politics rather than to the

[75] F. DIALTI; *Principali differenze e somiglianze tra standards e norme aventi valore di legge nel settore della regolamentazione finanziaria*; in *Diritto del commercio internazionale*; 2005; p. 535-553; M. GIOVANOLI; *A new architecture for the global financial market: legal aspects of international financial standard setting*; M. GIOVANOLI; ed; *International monetary law: issues for the new millennium*; Oxford; Oxford University Press; 2000; p. 33-44; M. GIOVANOLI; *Reflections on international financial standards as "soft law";* in J. NORTON, M. ANDENAS; ed.; *International monetary and financial law upon entering the new millennium. A tribute to sir Joseph and Ruth Gold*; British institute of international and comparative law; 2002; p. 72-73
Some authors consider soft law in broader terms, so as to include both non-legal and legal rules, provided that the latter ones are vague. On this point see: T. GRUCHALLA-WESIERSKI; cit.; p. 44-48. In particular, the author defines economic soft law as the law which provides "legal and non-legal obligations which create the expectation that they will be used to avoid or resolve disputes".
Other authors suggest that the notion of soft law goes beyond the simple binary binding/non binding divide and that it has three dimensions. They are: the non-legally binding character, the vagueness of the content, the lack of delegation to authorities to monitor its implementation or to interpret and enforce. A legal instrument can therefore pertain to soft law according to only one or two of these dimensions. For a more detailed discussion on this approach see: G. C. SHAFFER, M. A. POLLACK; *Hard law v. soft law: alternatives, complements, and antagonists in international governance*; in *Minnesota Law Review*; 2009-2010; p. 712-717. Although suggestive from a theoretical point of view the above mentioned approaches do not improve a clearer and more workable understanding of soft law. Therefore, for the purposes of the present research, the element which will be considered to define soft law will be its non binding character only.

sphere of law. Nevertheless, what distinguishes soft law is that, in spite of its non-binding nature, it is able to produce legal effects, also as a result of its interaction with hard law, [76] in the way which will be explained in the following pages.

Instruments of international soft law are very heterogeneous because of the existing variety of subjects which may adopt them, of their addresses, of their degree of precision, of their relation with hard law and of the legal or political effects they may have. [77]

As to the subjects which may adopt acts of soft law, it must be remarked that most acts adopted by international organisations, for instance resolutions or recommendations, can be regarded as soft law, except when the contrary is explicitly provided for in the treaty which instituted the organisations at issue. Therefore it is possible that under certain circumstances international organisations may adopt legally binding acts: the resolutions of the UN Security Council, or the regulations, directives, decisions adopted by the EU institutions represent the main examples. Nevertheless the large majority of acts adopted by organs of international organisations are not binding and therefore they pertain to the sphere of soft law. It is the case, for instance of the resolutions of the UN General Assembly.[78]

Other examples of soft law are the documents issued at the conclusion of international meetings, which may take place under the auspices of an international

[76] On this issue see: A. T. GUZMAN, T. L. MEYER; *International soft law*; in *Journal of legal analysis*; 2010; p. 172- 174; I. DUPLESSIS; *Le vertige et la soft law: Réactions doctrinales en droit international*; in *Revue québécoise de droit international*; 2007; p. 249; J. KLABBERS; *The redundancy of soft law*; in *Nordic Journal of International law*; 1996; p. 168.

[77] M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 130-132; I. DUPLESSIS; p. 249.

[78] For an overview of the non-binding character of acts adopted by international organizations see, for instance: C. F. AMERASINGHE; *Principles of the institutional law of international organisations*; 2nd edition; Cambridge; Cambridge University Press; 2007; p. 160-192; C. ZANGHÌ; *Diritto delle organizzazioni internazionali*; Torino; Giappichelli; 2001; p. 227-243. For a discussion on the non-legally binding nature of UNGA resolutions see, *supra* chapter 2 paragraph 2 of the present research. It must be added that, while UNGA resolutions are not legally binding upon UN member States, they should nonetheless bind the organ which have adopted them. On this point see: T. GRUCHALLA-WESIERSKI; cit.; p. 52-53.

organisation or independently from it.[79] These documents can be named in different ways: for instance as conclusions, declarations, etc... In the field of the protection of the environment, the Stockholm Declaration, the Rio Declaration and the Johannesburg Declaration[80] are examples of soft law instruments adopted by States as a result of conferences convened and organised by the UN . Other examples are provided for by the practise of the EU and its members to lay down the principles and the general framework governing their relations with their Mediterranean and eastern neighbours in documents called "declarations" issued at the end of summits in which EU institutions and member States take part together with concerned third countries. Although such documents mainly have a political dimension and clearly are not legally binding, they nonetheless have legal effects in the sense that they establish a framework in which cooperation between concerned parties will be mainly governed in hard law instruments which in turn will be concluded or interpreted in accordance to the principles laid down in the above mentioned declarations.[81]

In recent decades some of the meetings which usually bring to the adoption of instruments of soft law have been progressively institutionalised. This implies that

[79] On the important development according to which instruments of international soft law are no more adopted by international organizations only, but they are increasingly adopted by a plurality of actors see: I. DUPLESSIS; cit.; p. 247.

[80] For more information on these declarations see, *supra*, chapter 2 paragraph 4.

[81] The general framework governing the relations between the EU and its neighbors of eastern Europe is laid down in a joint declaration of heads of States and Governments at the Prague Eastern Partnership Summit hold on 7 May 2009. (the text of the document is available online at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/er/107589.pdf page visited on 05/08/2011). The general framework governing the relations between the EU and its neighbours of the Mediterranean region is governed by the joint declaration issued in Barcelona as the outcome of the Euro-Mediterranean Conference which took place in 27-28/11/1995 and in which EU intuitions, EU member States, and non-EU Mediterranean countries participated. (The text of the document is available online at http://eeas.europa.eu/euromed/docs/bd_en.pdf page visited on 05/08/2011). The Mediterranean partnership has been recently "re-launched" by joint Declaration of the Paris Summit for the Mediterranean, issued in Paris on 13/7/2008 (available online at: http://www.ue2008.fr/webdav/site/PFUE/shared/import/07/0713_declaration_de_paris/Joint_declaration_of_the_Paris_summit_for_the_Mediterranean-EN.pdf). More nformation on the interaction between soft law and hard law in the foreign relations of the EU can be found for instance in: P. EECKHOUT; cit.; M. CREMONA; *The European Neighbourhood Policy: Legal and Institutional Issues*; CDDRL WORKING PAPERS No. 25; 2004; C. HILLON; *Institutional aspects of the partnership between the European Union and the Newly independent states of the former Soviet Union: case studies of Russia and Ukraine*; in *Common market Law Review*; 2000; p. 1211-1235; M. E. SMITH, M. WEBBER; *Political dialogue and security in the European neighbourhood: the virtues and limits of "New Partnership perspective*"; in *European Foreign Affairs Review*; 2008; p. 73-95.

they are convened on more regular basis and their agenda and composition are increasingly structured. The main examples of these institutionalised meetings, especially if the focus is on international economic, monetary and financial cooperation, is represented by the G7, G8, G10 and, more recently, the G20.[82]

Finally, and this represents a relatively recent trend, soft law instruments may even be adopted by subjects other than States or international organisations. For instance, they may be adopted by independent authorities of States or other bodies of the State which are to a certain extent separate from the Government (which is traditionally regarded as the State organ entrusted with the task of conducting the international relations of the State at issue). Several instruments of soft law may be regarded as pertaining to this category. For instance, the Basel Principles have been drafted by financial regulators rather than by the Governments.[83]

[82] For a general discussion on the role of institutionalised meetings in adopting soft law instruments see: M. Panebianco; *Il G 8 nel nuovo ordinamento di organizzazione internazionale contemporanea. l'euro G 8*; in M. Panebianco, A. Di Stasi; *L'Euro- G 8. La nuova Unione Europea nel gruppo degli otto*; Torino; Giappichelli; 2001; p. 65-75; A. Di Stasi; *Il G 8 tra autonomia collettiva e governance "istituzionale*" in M. Panebianco, A. Di Stasi; *L'Euro- G 8. La nuova Unione Europea nel gruppo degli otto*; Giappichelli; Torino; 2001; p. 79-102; M. C. Malaguti; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 121-130; C. Brummer; *Why Soft Law Dominates International Finance - and not Trade*; in *Journal of International Economic Law*; 2010; p. 627-628.

On the peculiarity of the documents of soft law adopted by the G 7 see: M. Panebianco; *Il G 7 ed il soft law istituzionale*; in VV AA; *Divenire sociale e adeguamento del diritto. Studi in onore di Francesco Capotorti*; Giuffrè; 1999; p. 345-356. On the role of the G 7 in the promotion of efforts for a regulation of SWFs see, *supra*, paragraph 1 of the present chapter. On the evolution from the G7 to the G8 and then to the G20 ad their role in the international economic governance see: M. Frigessi di Rattalma; cit.; p. 211- 214; M. Giovanoli; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 17-20.

[83] On the role of financial regulators and of other independent authorities in developing soft law applicable to finncial issues see: F. Dialti; cit.; p. 536-537; M. C. Malaguti; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 68-70; J. J. Norton; *Pondering the parameters of the "new international financial architecture": a legal perspective*; in R. M. Lastra; *The reform of the international financial architecture*; London; The Hague; Boston; Kluwer Law International, 2001; p. 16-20. For an overview of the Basel standards and the role and the nature of the Basel Committee see, again, M. C. Malaguti; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 171-172; M. Giovanoli; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 21-25.

The existence of different networks of regulators may rise problems of consistency among the standards they develop and the mechanisms to enhance their implementations. The creation of the Financial Stability Forum (FSF), later replaced by the Financial Stability Board (FSB), constitutes an attempt to ensure a higher degree of consistency and coordination to the international efforts of regulators. On this aspect of the activity of the FSF and FSB see: M. Frigessi di Rattalma; cit.; p. 216-218; G. Walker; *A new international architecture and the Financial Stability Forum*; in R. M. Lastra; *The reform of the international financial architecture*; London; The Hague; Boston; Kluwer

The GAPP may fall within this last category of soft law. In fact, it has been drafted by SWFs which may be regarded as State organs, but which at the same time can be regarded as distinct from, although connected to, the Government of the State which own them.

One of the reasons why Governments may delegate other State organs in drafting soft law instruments is that such State organs may have greater expertise than other ministries to deal with highly technical issues. In the case of the GAPP it has been estimated that the State bodied which were better placed to find out which are the best practises that SWFs may follow were the SWFs itself. Nevertheless, in the case of SWFs delegation from the Government is more formal than substantial, given the close links between SWFs, on one side, and the Government or the Central Bank of the owner State, on the other side[84]

Finally, it must be stressed that involvement of subjects like market participants or their associations may occur. This helps to improve the dialogue and the circulation of information between all the concerned parties and it may increase the possibility of compliance of the soft law, when the principles and standards it develops address these non-State actors. In fact, if an instrument of soft law is drafted taking into consideration the observations of relevant market participants, the latter ones will be incentivised to voluntarily comply with its principles.[85] This reasoning may apply to SWFs as well, if it is deemed that they not only are State organs but also market participants. The fact that SWFs have played a key role in the elaboration of the GAPP, should make it expect that they will be ready and willing to comply with them.

Law International, 2001; p. 119-153; M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 71 and p. 93 and p. 198-204; R. BISMUTH; *Le système international de prévention des crises financières. Réflexions autour de la structure en réseau du Forum de stabilité financière*; in *Journal du droit international (Clunet)*: 2007; p. 57-84; M. GIOVANOLI; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 25-27.

[84] The details of this relation can vary depending on the domestic legal framework governing the SWF in the owner State. Nevertheless, also taking into consideration the need for accountability of the SWF such relation needs to be quite close.

[85] I. DUPLESSIS; cit.; p. 251; F. DIALTI; cit.; p. 536-537. In some cases involvement of entities other than Governments international organisations or public regulators and supervisors may give rise to mixed committee or mixed groups. The CPSS IOSCO represent some examples of this trends. M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 71 and p. 93 and p. 174-180.

These considerations allow to introduce the discussion of the potential addressees of soft law.

First of all, soft law instruments may address the same subjects which have contributed to their drafting. As it was argued above, this is the case of the GAPP, in which the same SWFs provides a list of principles they could and should implement. This is also the case of the OECD declaration on SWFs and Recipient Country Policies, where OECD members discussed the principles that should inspire the policies they may adopt in relation to the investments undertaken by SWFs in their territory. Alternatively, soft law instruments may be adopted by States and apply to other actors, like, for instance, multinational enterprises, as it occurs in the OECD Guidelines on Multinational Enterprises.

If the focus is put on the degree of precision and on the relation with hard law instruments, very relevant differences emerge among soft law instruments.[86]

Sometimes soft law instruments can be worded in very broad and general terms. In this case they may witness the existence of a general desire of the States which have adopted them that an issue might be dealt with in accordance with the principles or approaches expressed in the soft law instruments adopted. Under such circumstances soft law could promote the establishment of a political framework which may be conductive to the conclusion of legally binding instruments. The declarations concerning the relations of the EU with its eastern and Mediterranean neighbours which have been analysed before, fall in this category, because they constitute the framework for the establishment of legal relations, for instance trough the adoption of association agreements between the EU and its members on one side and, on the other side, each EU neighbour.

The GAPP, or the other soft law instruments applicable to SWFs which have been discussed in the present chapter, may have a similar function, if they are meant so as to serve as a basis for further negotiations which may in turn lead to the conclusion of international treaties concerning SWFs, or to the renegotiation of existing hard law

[86] For an introduction on these aspects see: T. GRUCHALLA-WESIERSKI; cit.; p. 70- 79.

instruments with a view to including in their texts clauses explicitly dealing with SWFs.[87]

In other cases the content of soft law instruments may be more detailed than the one of hard law and may contribute to interpret existing provisions of hard law.[88] This occurs particularly frequently in the regulation of international financial and banking issues. It cannot be said that the GAPP or the OECD declaration on SWFs and Recipient Country Policies are detailed and precise. Nevertheless, they can have an interpretative function of hard law. In fact, since existing hard law provisions do not explicitly mention SWFs, the way they could be applied to SWFs may be clarified by the soft law instruments of SWFs.

The issue of the degree of precision of soft law and hard law is closely related to the more general issue of the relation between these two kinds of laws and to the discussion of which of them may best suit the interests of States and of other relevant actors[89].

One of the reasons for the adoption of instruments of soft law instead of hard law is related to the fact that States may be wary of concluding binding instruments in certain sensitive fields. For instance, they may be afraid of being unable to always comply with them.[90] Moreover, they may not feel ready to relinquish their sovereignty in certain issues. The adoption of instruments of soft law would therefore represent the most viable compromise between, on one side, the desire to engage with other international actors in a cooperation aiming at governing important global issues, and, on the other side, the desire not to undertake legally binding commitments in certain

[87] For a more in-depth discussion of the role the GAPP may have as a preliminary step in adopting legally binding and/or more detailed rules on SWFs see: J. J. NORTON; *The Santiago Principles' for Sovereign Wealth Funds*; cit.; p. 645-662.

[88] T. GRUCHALLA-WESIERSKI; cit.; p. 65; J. KLABBERS; cit.; p. 177-179.

[89] The term "actors", although it may sound inadequate in legal language, is preferred to the term "member of international community", because it better defines the broad ensemble of entities which can be involved in drafting soft law and in implementing it. In fact, such actors may be more than the traditional members of the international community.

[90] Soft law would not give rise to these problems: in fact, as soft law does not imply an obligation, at least not in the terms of hard law, it does not entail international wrongdoings and possible responsibility for such breach. See. C. CRAWFORD LICHENSTEIN; *Hard law v. soft law: unnecessary dichotomy?;* in *the international lawyer*; 2001; p. 1433

areas. From this point of view international soft law is an important tool to enhance cooperation among the actors of the international community. In certain cases, soft law could prove the only form of international cooperation possible, given the unavailability of hard law instruments.[91] Moreover, it is possible that soft law may prove to be a precursor of hard law: States initially agree on a set of non binding principles and, in a second moment, they decide to make such principles legally binding. This proves once again that soft law and hard law, far from being to mutually excluding alternatives, are rather complementary and they often are part of the same law making process.[92]

A last aspect which deserves to be considered is that the higher degree of flexibility of soft law presents undeniable advantages especially when it attempts to govern certain financial and economic issues. The negotiation (or renegotiation) and subsequent ratification of international treaties may require a long period of time. Customary international law normally requires an even longer period to develop. If the object of the regulation is a fast evolving and changing issue, as it often occurs in international financial and economic matters, then there is the risk that, once the treaty has finally entered into force, the developments occurred in the meanwhile have made it outdated and useless. Soft law instruments allow to overcome these problems, enhancing flexibility and allowing cooperation between member States without excessive delays.[93] Moreover, also because of the fast evolving character of several economic and financial issues, it is possible that rules, principles and standards adopted as a result of international cooperation may lose their utility and attractiveness very quickly. Were they provided for in a legally binding instruments,

[91] I. DUPLESSIS; cit.; p. 250; A. T. GUZMAN, T. L. MEYER; cit.; p. 180 and p. 188-190; T. MEYER; *Soft law as delegation*; in *Fordham international law journal*; 2008-2009; p. 892.

[92] M. GIOVANOLI; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 52; M. GIOVANOLI; *Reflections on international financial standards as "soft law*; in J. NORTON, M. ANDENAS; ed.; *International monetary and financial law upon entering the new millennium. A tribute to sir Joseph and Ruth Gold*; British institute of international and comparative law; 2002; p. 90-92.

[93] I. DUPLESSIS; cit.; p. 250-251; T. GRUCHALLA-WESIERSKI; cit.; p. 41-43; F. DIALTI; cit.; p. 547-548; M. GIOVANOLI; *Reflections on international financial standards as "soft law*; cit.; p. 79-80; C. BRUMMER; cit.; p. 631-632.

then their modification would be a long and burdensome process, not free from possible frictions between concerned parties. Soft law allows States, when they deem that certain standards are no longer valid, to disapply them, thus encouraging the international community to re-start efforts to reach a new consensus on new, more effective principles and standards.[94] On the other side, the commitments States undertake when they adopt an instrument of soft law and not of hard law present a much lower level of stability and credibility.[95] In other words the risk of non compliance increases, in spite of the fact, or for certain aspects, because of the fact, that no responsibility upon the non complying party may arise.[96]

This reasoning may apply in part to the GAPP and to the other instruments analysed in the present chapter and governing the investments of SWFs. In particular, it is true that the choice to adopt a soft law instrument has allowed to reach a consensus on the GAPP in a period of time of less than six months since the establishment of the IWG. It would have been clearly impossible to negotiate, conclude and ratify a multilateral agreement, especially on such a controversial issue, in the same period of time. Moreover, it is likely that States owners of SWFs would have not accepted to undertake binding commitments on the issues which are addressed in the GAPP.[97]

In the beginning of the present paragraph it has been stressed that soft law instruments, although they are not legally binding, are nonetheless characterised by the fact that they produce certain legal consequences. In the following pages, these effects will be studied.

Since soft law instruments are not legally binding, their effectiveness depends on whether their addresses decide to voluntary comply with them. If the addressees are States, the effectiveness of soft law instruments may also depend on the decisions of

[94] T. GRUCHALLA-WESIERSKI; cit.; 1984; p. 43; T. MEYER; cit.; p. 894.

[95] G. C. SHAFFER, M. A. POLLACK; cit.; p. 717-727; I. DUPLESSIS; cit.; p. 253.

[96] A. T. GUZMAN, T. L. MEYER; cit.; p. 183-184. Moreover, when the "updating" of soft law occurs on the initiative of certain States, then some authors have remarked that this entail a sort of delegation of powers in drafting soft law in favor of these States. For more in depth discussion on this last issue see and on the tension between the need for stability of legal commitments and the need for sufficient flexibility which may allow adjustments needed to maintain the regime in force see: T. MEYER; cit.; p. 892-894 and 898-916.

[97] L. HSU; cit.; p. 454.

these same States to voluntary adopt domestic measures which make such instruments of soft law mandatory in their jurisdictions.[98]

The decision to comply with them, or to impose compliance with them, depends in turn on whether addresses are persuaded of the effectiveness, validity and utility of the principles and provisions soft law instruments lay down. This is influenced, *inter alia*, by the recognised degree of expertise of the drafters of the standards at issue and by the way the rationale underlying the adoption of the principles at issue is motivated. This explains why, especially in case of soft law instruments which take the form of standards, code of conducts, guidelines or best practises, the principles and recommendations which are laid down are often accompanied by extensive commentaries. Their aim is not only to clarify the content of the principles, but also to specify the reasons why they have been adopted and their implementation should be useful and desirable.[99] In many cases such commentaries are much longer and articulated than the principles they are expected to comment. For instance, in the document of the GAPP, the enunciation of the principles takes just three pages, while the commentaries, (or, *rectius*, the "discussion" of the GAPP) takes 15 pages.

Finally, another way through which compliance with soft law is enhanced is when States, international organisations or other market actors subject their assistance, cooperation or their willingness to enter into business transactions, to the

[98] For an overview of the complex issue of the enforcement of soft law and the sanctions which are possible in this case see: M. GIOVANOLI; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 45- 46; T. GRUCHALLA-WESIERSKI; cit.; 1984 p. 79-86; When such standards are adopted by networks or meetings of regulators and not of Governments, it is possible that their enforcement is delegated by the same regulators. On this aspect see: M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 70. For a more in depth discussion on the implementation of international soft law through the adoption of domestic hard law, especially in the outstanding case of the Basel principles see: D. E. HO; *Compliance and international soft law: why do countries implement the Basle accord?*; in *Journal of international economic law*; 2002; p. 647-688. Finally, it deserves to be quoted the argument according to which international soft law is often more likely to become binding not because it brings to the adoption of international treaties reproducing its content, but because of the adoption of domestic legislation. In other words, international soft law is more likely to become domestic hard law instead of international hard law. On this issue see: F. DIALTI; cit.; p. 542-544.

[99] M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 2003; p. 192-194 and p. 272-275; F. DIALTI; cit.; p. 543-544.

implementation of certain principles of soft law on behalf of their counterparties.[100] For instance, the IMF and the WB have often made their assistance conditional to the adoption of reforms in the banking and financial sectors, when such reforms consisted inter alia in the adoption of the Basel standards and to other instruments of soft law.[101] Moreover, the entity which fails to implement certain financial standards may be perceived by the markets as being riskier: the market sanction may consist for instance in more difficulties in rising capitals needed, in finding business partners, etc..[102]

In the context of the study of the relation between soft law and hard law, it deserves to be mentioned the interaction of instruments of soft law with international custom. In particular, it has been discussed whether the adoption of instruments of soft law may bring to the development of rules of customary international law whose content is similar to the one of the soft law instruments at issue. In this case soft law could be regarded as an element of the *diuturnitas*: in other words, the fact that States adopt certain documents would be constitutive of a practise of States *vis-à-vis* certain issues. Other authors support the view that soft law should be more correctly related to the other element of customary international law, i. e. to the *opinio juris*. In fact, by adopting acts of soft law, States show their convincement that certain issues should be governed according to the principles they declare in the instruments of soft law they adopt. On the other side, it could be argued that the same fact that States have wanted to lay down these principles and standards in non-legally binding instruments, would be an evidence of the lack of the *opinio juris,* i. e. of the lack of the convincement that these standards and principles would be or should be legally

[100] T. GRUCHALLA-WESIERSKI; cit.; 1984 p. 65- 68.

[101] D. SINGH; cit.; p. 1395-1421; R. HOCKETT; cit.; p. 153- 193. M. C. MALAGUTI; *Crisi dei mercati finanziari e diritto internazionale*; cit.; p. 92 and p. 210-213; M. GIOVANOLI; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 46-48; M. GIOVANOLI; *Reflections on international financial standards as "soft law*; cit.; p. 84-86; G. ADINOLFI; *Le recenti evoluzioni in seno al FMI*; cit.; p. 283.

[102] F. DIALTI; cit.; p. 544-546; M. GIOVANOLI; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 48; M. GIOVANOLI; *A new architecture for the global financial market: legal aspects of international financial standard setting*; cit.; p. 86-87; C. BRUMMER; cit.; p. 638-641.

binding.[103] From this quick discussion of the relation between soft law and customary law, it is difficult to conclude whether the former may be regarded as a precursor of the latter. Therefore it is probably too early to argue that principles of the GAPP (or at least some of them) on the way SWFs should act, are currently contributing to the rise of an international customary law of SWFs. The same reasoning should also apply to those principles contained in soft law instruments adopted by the EU or the OECD governing the policies of their members related to SWFs.

Another effect that soft law may have can be defined as "internationalisation of a subject matter". This implies that, once a State has contributed to the adoption, at the international level, of an instrument of soft law, then it can no longer claim that the subject matter of this instrument pertains to its exclusive domain. This implies that a State may no longer complain that an unlawful intervention in its domestic affairs has occurred when another State accuses it of non-compliance with a soft law instrument the former state has contributed to adopt.[104] The consequences this may entail for the instruments of soft law governing the operations of SWFs are relevant. For instance, if an OECD member adopts measures governing the investments of SWFs which, although not amounting to a breach of hard law provisions, are nevertheless inconsistent with the principles laid down in the "declaration on SWFs and Recipient Country Policies", then it will not be entitled to claim the existence of an unlawful interference in its domestic affairs when a State owner of an SWF criticizes the measures at issue as incompatible with the OECD declaration. Likewise, a State which owns a SWF and which has contributed to the adoption of the GAPP could not complain that interference in its domestic domain has occurred if another State criticises its failure to abide by the principles laid down in the GAPP[105].

A further effect of soft law, which has been discussed above in chapter 4 paragraph 6 and in chapter 6 paragraph 1, is related to the issue of good faith and of legitimate

[103] J. KLABBERS; cit.; p. 173-174; T. GRUCHALLA-WESIERSKI; cit.; p. 54-55 and 60-62; F. DIALTI; cit.; p. 540.

[104] T. GRUCHALLA-WESIERSKI; cit.; p. 58-60.

[105] However, this is mitigated by the fact that the GAPP clearly points out that the principles it contain are related to practices SWFs either already implement or aspire to implement and not undertake to implement.

expectations.[106] Actually, soft law can be regarded as law not because of its legally binding character but because the rules it provides shape expectations as to what constitutes compliant behaviour. From this point of view they may have legal consequences.[107] In the case of the regulation of SWFs, if OECD countries and the EU adopt soft law instruments in which they pledge for the maintenance of an open environment to the investments of SWFs and to apply to them the same rules currently in force and applicable to any other investor, then SWFs investing in OECD and EU countries respectively, would legitimately expect that their investments will be treated in the same way as those undertaken by other investors. Failure to do so on behalf of OECD or EU countries may entail frustration of legitimate expectations of the SWFs, with the consequences this may entail under existing rules of international investment law which have been analysed above in chapter 4. It must be stressed that the degree of legitimacy of expectations is also related to the precision and clarity of the soft law instruments. Representations and expectations of foreign SWFs which rely on vague and unclear documents should be regarded as hardly legitimate. Under this point of view it must be stressed that in particular the OECD declaration has a particularly vague and generic wording and therefore it is difficult to understand which can be the legitimate expectations to which it can give rise.

[106] T. GRUCHALLA-WESIERSKI; cit.; 1984 p. 62-63; G. ADINOLFI; *Le recenti evoluzioni in seno al FMI*; cit.; p. 280-281.

[107] A. T. GUZMAN, T. L. MEYER; cit.; p. 174-175.

CONCLUSIONS

The present research has tried to assess whether and how provisions of international economic law and European Union law may properly govern the following issues: the creation of SWFs, their investments and, in case of transnational investments, the policies host States may adopt to regulate them.

The analysis developed in the present work has been carried out taking into consideration the interactions between, on one side, the rise and the operations of SWFs and, on the other side, the main developments of international economic relations which occurred in the last decades. In particular, it has been emphasized the complex relationship the creation and the foreign investments of SWFs have with the existing international monetary and trade imbalances, the fluctuations of the world prices of commodities, the evolving forms of the involvement of States in the economy, the liberalization of transnational investments, the change in the world patterns of capital flows, the partial transfer of economic and political power from western capitalist democracies to emerging countries of regions, like Asia and Latin America, which until recently had played a relatively marginal and passive role in international economics and politics. It has also been explained the extent to which such economic developments have been favoured by the evolution of international economic law.

It has emerged that SWFs at the same time represent the consequence and the cause of these historical changes. In fact, the above mentioned economic developments fist of all have in different and sometimes unexpected way enabled and encouraged certain States to create their SWFs. For instance, the need for assuaging the effects on State budget of sharp fluctuations of commodity prices is one of the reasons for the creation of commodity SWFs, while the world monetary turbulences and the perceived inadequateness of the international monetary institutions entrusted with the task of coping with them is one of the causes of the accumulation of large reserves of foreign currency which later made it possible the establishment of forex SWFs.

Likewise, some of the above mentioned developments have contributed to the establishment of an international economic and legal framework which can contribute to make the investments SWFs can now undertake overseas smoother. For instance, the enhanced protection of foreign investments under IIAs, the ICSID Convention and, in limited case, WTO law, has undoubtedly convinced an increasing number of States of the feasibility and opportunity to use a part of their wealth to carry out transnational investments through their SWFs.

On the other hand, SWFs have contributed to further enhance such macroeconomic changes, especially since they have constituted an instrument used by certain emerging economies for a better management of monetary and fiscal and policies, which in turn helped them to better preserve and use their reserves of foreign currency as well as to increase and stabilise the revenues obtained from the exploitation of their natural resources. This in turn has allowed such States to foster their economic growth which ultimately favoured that transfer of economic and, inevitably, political power, which was mentioned above, from western countries to them.[108]

In the foregoing of these conclusions, an attempt is made to highlight the main findings of each chapter. The present research has provided in chapter 1 a brief overview of SWFs, especially from an economic point of view. In this occasion, it has been pointed out that the notion of SWFs encompasses a large array of State-owned investment vehicles or arrangements, which may differ as to their organisation, their legal and governance framework, their investment and management techniques, but which are always characterised by the facts that they manage State-owned wealth, they pursue macroeconomic purposes and they invest a quota of their resources overseas.

[108] On this issue see also: A. ELSON; *Sovereign Wealth Funds and the International Monetary System*; in *The Whitehead Journal of Diplomacy and International Relations*; 2008; p. 71-82.

In chapter 1 it has also been explained that SWFs, according to their source of financing, may be divided into different categories: the most important ones are commodity funds, which are financed by the proceeds from the exploitation and the sale of domestic natural resources, and forex funds which are financed by transfers of foreign currency reserves the owner State holds in excess. It has been pointed out that the majority of SWFs, and the largest ones, are commodity SWFs and that they are mainly owned by the States of the Gulf region, although important commodity, and in particular oil funds, are owned also by European countries like Russia and Norway. On the contrary, the main forex funds are those owned by Eastern Asian countries which in the last decades have run persistent surpluses of the trade balance and which in this way have been able to hoard the foreign exchange reserves which have in turn made it possible and recommendable to create SWFs.

As to the investment strategies pursued by SWFs, it has been pointed out that in the majority of cases SWFs so far have been long term, passive and countercyclical investors, more interested in undertaking portfolio investments than in seizing control of foreign firms. Especially since 2003- 2005, they have massively invested the assets under their management abroad and in particular in western economies, privileging the banking and the financial sector.

Finally, chapter 1 has addressed the issue as to whether SWFs are only commercially driven or if they also pursue political goals and whether, for this reason, they may threaten the national security of the host State through their investments abroad. It has been remarked that the political dimension of SWFs mainly resides in that they are required to perform *macroeconomic* functions, which actually means *public policy* or *political* functions in the States which own them. Therefore, the political dimension of the activity of SWFs should rather pertain to the function they play in the State which own them, rather than in the host State of their investments, where SWFs are supposed to act mainly as commercially driven investors. This has allowed to dismiss, at least in part, many of the anguishes which are popularly associated with SWFs. Finally, chapter 1 has discussed which are the possible approaches for the regulation of SWFs. In particular, States may chose to regulate the investments of SWFs unilaterally or to undertake efforts to develop internationally agreed rules. Likewise States, or the international community if a multilateral approach is deemed to be preferable, could adopt ad hoc rules, which would be devised exclusively for SWFs and which would explicitly apply to them only, or general rules, which are applicable to all foreign investors. Finally, it has been remarked that the issue of SWFs may be addressed by means of legally binding or non-binding rules.

The explanation of the basic features of SWFs and of their investments has allowed to develop in the following chapters a more in-depth analysis of how selected branches of international economic law and of European union law may apply to the issue of the creation and of the operations of SWFs.

Chapter 2 has explained the relation between the creation of commodity SWFs and the principle of the permanent sovereignty over natural resources. It has stressed that the content of such principle, as well as its legal and political effects, are far from being clear, also because the principle of permanent sovereignty over natural resources has been worded in different ways in several international instruments and, especially in its most radical formulation, it has not evolved into a rule of customary international law. Nevertheless it has been argued that such principle has been used in the past to justify the efforts of developing countries to increase their control over their domestic natural resources and to increase their ability to retain a larger quota of the proceeds from the exploitation of such resources. It has been explained that when such States succeeded in these efforts and when they got able to obtain larger revenues from the exploitation of their natural resources, they could, provided other conditions were fulfilled, hoard large wealth, which later made it possible and useful to establish commodity SWFs. In this way, it has been demonstrated that the application of the principle of permanent sovereignty over natural resources has been an indirect cause of the establishment of SWFs. However, not only SWFs can be regarded as the consequence of an increased wealth obtained thanks to the international sale of commodities by developing States but, at the same time, they also contribute to preserve and to increase such wealth, as well as to improve the control of the States at issue over the exploitation of their natural resources. For this reasons, SWFs can be also considered as a tool for the enhancement of the principle of permanent sovereignty over natural resources.

Another issue which has been discussed in chapter 2 was whether the beneficiaries of the principle of permanent sovereignty over natural resources should be also the Peoples and not only the States. This entails important practical effects: in fact, once it is assessed that Peoples are the beneficiaries of this principle, then the States of such Peoples shall have an obligation under international law to manage and to use the natural resources at issue for the wellbeing of their Peoples. Since SWFs are tools for the management of such resources, then it would follow that States owning a commodity SWFs should have an obligation to manage them in a way to benefit their peoples, which should be the ultimate beneficiaries and owners of SWFs.

Chapter 3 has explored the relation between forex SWFs and international monetary and trade law. It has explained that States find it possible or even necessary to create forex SWFs when their reserves of foreign currency reach and exceed certain levels. It has also discussed that such accumulation can be regarded as a form of self insurance against sudden shortages of foreign currency.

It has been investigated that, with the aim of avoiding such shortages, and the disruptive effects they may entail, the international community has developed certain mechanisms and, in particular, it has entrusted the IMF with the task of providing financial assistance to States which need it, subject to certain conditions. Nevertheless, it has also been argued that the way the IMF fulfilled this task, especially in the 1990s, gave rise to severe criticism in particular in emerging economies. It was also for these reasons that they decided to reduce their reliance on the IMF assistance and to put in place their own mechanisms to prevent future monetary crises. Such mechanisms included the increase of foreign exchange reserves and, also in order to better manage them, the establishment of SWFs, to which a part of such reserves was transferred. In this way, it has been demonstrated that the allegedly unsatisfactory conduct of the IMF, especially in the monetary crisis of the 1990s, indirectly led to the creation of forex SWFs.

In chapter 3 it has also been discussed that today, as a result of the last economic crisis which started in 2007, the IMF has regained its importance and it has played a key role not only in providing temporary liquidity to States experiencing unbalances of their balance of payments, but in actively participating in their bailouts. What needs to be underlined is that now many of the addressees of such assistance are no more those emerging economies which currently own large reserves of foreign currency and important forex SWFs, but other States, including those belonging to the Euro area. Many former addresses of IMF assistance are now able to provide more funding to IMF, and the State bodies in charge of dealing with the IMF for these purposes may include also SWFs.

In addition, in chapter 3 it has been remarked that, especially in the 1990s, the IMF actively promoted a full liberalisation not only of the current account, but also on the capital account. In other words the IMF contributed to the establishment of an international legal framework which was open to international capital flows. At that time this was in the interest of capital exporting countries and sometimes at the expenses of the emerging countries which were the recipient of the investments; however today also SWFs of such emerging countries may greatly benefit from this liberalisation.

Chapter 3 has also discussed that the accumulation of foreign exchange reserves as a result of current account surpluses, when it is protracted for a very long time and when automatic adjustments are prevented from occurring, can be made possible by currency manipulation. In particular it has been discussed that the efforts of China to keep the Yuan artificially low in order to preserve the competitiveness of its exportations could be regarded as a form of currency manipulation. Hence, it has been discussed whether international monetary law may be construed as forbidding such practises. In such a case, when forex SWFs are the consequence of foreign exchange accumulation because of currency manipulation and when they also are tools for the perpetration of such manipulation, then both their creation and their investment activity should be regarded as inconsistent with international law.

The analysis which has been developed has first of all focused on the case of China and it has discussed all the arguments in favour and against the compatibility with the law of the IMF of China's international monetary practises and arrangements. It has been found that some State policies which create the conditions for the establishment of SWFs, i. e. State policies amounting to currency manipulation, can be partially regarded as inconsistent with art. IV of the IMF Articles of Agreements. On the contrary, it is more difficult to conclude that Chinese SWFs are a tool for the perpetration of such currency manipulation and therefore that *per se* they should be regarded as incompatible with IMF law. In any case, it has been observed that the law of the IMF does not provide for adequate means to redress such situation and in particular to oblige States with large reserves of foreign currency to stop the currency manipulations they carry out.

Chapter 3 has then turned to discuss whether the monetary practices and arrangements at issue, included the same creation of SWFs, may be regarded as inconsistent with customary international monetary law. It has been discussed that the creation of SWFs, and also most monetary practices underlying their creation, represent a manifestation of the monetary sovereignty of the States which create SWFs. The monetary sovereignty of a State implies that the measures the latter adopts to govern its money shall not be questioned by other States. Likewise the monetary practices at issue should not be regarded as being liable to hinder the monetary sovereignty of other States (for instance of those against whose currency the currency of the owner of the SWF is pegged) even if certain economic interests of such States may be impaired. It follows that it would be difficult to conclude that customary international law prevents States from creating SWFs and from implementing policies which bring to the accumulation of foreign exchange reserves and to the creation of SWFs, on the ground that among the economic effects of these policies there is also the impairment of some interests of other States. In fact, the principle of monetary sovereignty cannot be construed so as to provide for an obligation upon States to refrain from adopting any measure which can be inconsistent with the interests of the monetary systems of the other States.

After having concluded that neither the law of the IMF nor customary international law may provide for workable means for addressing problems and disputes concerning monetary issues like those related to the accumulation of foreign exchange reserves and the creation of SWFs, an attempt has been made to study whether the same problems and disputes could be addressed within the framework of the WTO. In fact, currency manipulations or any other monetary practice which allows to keep the domestic currency artificially low in order to boost exportations have an impact on international trade, which clearly falls within the domain of the WTO.

WTO law provides for the possibility of States to adopt, under certain conditions, measures which restrict international trade but which are necessary for the safeguard of the balance of payments and therefore which may consist in a response to currency manipulations carried out by other States. Even more important, art. XV,4 of the GATT prevents contracting parties from "by exchange action, frustrat[ing] the intent of the provisions of this Agreement". Moreover, both the IMF Articles of Agreement and the WTO law contain legal provisions which ensure a proper cooperation between these two international organisations and which empower the dispute settlement mechanisms of the WTO to obtain support and advice from the IMF, when the former has to deal with monetary issues affecting international trade.

In summary, the WTO has a competence in monetary issues and its panels and its appellate body are competent to settle disputes concerning monetary issues affecting international trade, including those related to the creation and the operations of SWFs. It has been explained that, since in some cases the WTO panels and Appellate Body are empowered, and in a few cases even mandated, to seek advice from the IMF and to rely on the determinations of the IMF (which in turn must be adopted consistently with the IMF law), in these cases IMF provisions on currency manipulation could be indirectly enforced through the dispute settlement mechanism of the WTO.

Then, in chapter 3 it has been explained why WTO provisions on State subsidies or those on dumping and countervailing measures may not be effectively used to prevent the monetary practises which have been the object of the analysis developed so far.

It has been argued that if a State keeps its currency artificially low, although this can help its domestic exporters, this should not fall within the notion of prohibited subsidy under WTO law. In fact, to be prohibited a subsidy must meet, inter alia, the requirement of specificity, i. e. it must be selectively granted to an enterprise or industry or group of enterprises or industries. A favourable exchange rate supports all the exporters and for this reason it cannot be regarded as being specific under WTO law.

Likewise, it has been concluded that under WTO law the notion of dumping cannot be meant so as to include the monetary dumping, i. e. the maintenance of an exchange rate which allows exporters to sell their goods abroad at lower prices . It follows that WTO law on dumping cannot allow States which deem to be damaged by monetary dumping to adopt countervailing measures against the State which is keeping its currency undervalued. As a result, monetary practises which enable the creation of forex SWFs cannot be regarded as inconsistent with WTO provisions on subsidies and dumping.

The issue of the relation between WTO provisions on subsidies and SWFs has finally been investigated under another point of view. It has been pointed out that SWFs not only invest overseas, but they could also acquire stakes in the companies based in the same States which own them. In this case, SWFs are used as instruments for the conduct of a domestic industrial policy. It has been stressed that when they acquire stakes in companies national of the same States owning them and when they do so at different conditions than other investors (for instance when they pay for such stakes a price which is far higher than the one any other investor would have paid) then they could be regarded as tools trough which States subsidise certain domestic companies. In such cases breaches of WTO provisions concerning State subsidies could occur.

In chapter 4, the focus has been on the investments SWFs undertake abroad and in particular on the applicability of international investment law to this complex issue.

After having reviewed the definition of investor contained in most BITs it has been argued that some BITs explicitly mention State funds or State agencies and instrumentalities or even the State itself as covered investors. In this case it is for sure that SWFs shall fall within the scope *ratione personae* of the BIT. On the contrary, other BITs do not explicitly include SWFs in their definition of investor, nevertheless the broad terms in which such definition is worded allow to include the large majority of existing SWFs.

Then, in chapter 4 it has been explored whether the clauses contained in BITs which provide that investor-State disputes shall be settled by means of arbitration, and in particular of ICSID arbitration, might apply when such investors are SWFs. Since art. 25 of the ICSID Convention provides that ICSID tribunals shall have jurisdiction only in case of disputes between a foreign investor and the host State, it has been necessary to study whether SWFs could be regarded not as States but only as investors according to the ICSID Convention. In fact only in this case ICSID tribunals would have had jurisdiction. A review of awards in which Tribunals were required to decide, inter alia, whether certain parties to the disputes should have been regarded as States or as investors, has been made. The principles developed by arbitral tribunals have also been compared with those provided for in the Draft articles on Responsibility of States for Internationally Wrongful Acts.

It has emerged that, in order to understand whether SWFs should be regarded as States or as investors under international investment law, both a structural and functional test must be applied.

The structural test requires an assessment of the organisation of the SWF and of the legal framework governing its relations with the organs of the State which owns it. In particular, a SWF which is organised as an organ of the State entrusted with the exercise of the executive, legislative or judiciary powers, must be regarded as a State and not as an investor, thus precluding the competence of ICSID tribunals to adjudicate disputes between such SWF and the host country.

The functional test should focus on the issue as to whether SWFs, irrespective of their structure and of the formal elements linking them to the government, are entrusted by the government with the task of performing functions which have a typically governmental nature.

The analysis of the two categories of commodity and forex SWFs has clarified that both of them perform macroeconomic functions which pertain to the sphere of governmental authority. Therefore, the application of the functional test suggests that even those SWFs which are organised as distinct entities from the government should nonetheless be regarded as States for the purposes of art. 25 of the ICSID Convention. This has brought to conclude that disputes between foreign SWFs and the host State could hardly be settled by means of ICSID arbitration.

It has also been argued that, the most appropriate system for the settlement of investor-State disputes is inter-State arbitration. In other words, a dispute between the host State and a foreign SWF should be settled as a dispute between the host State and the State which owns the SWF.

Chapter 4 has also studied whether the investments of SWFs should be regarded as covered investments under the BITs and the ICSID Convention. Since most investments undertaken by SWFs are portfolio investments, the analysis actually consisted in assessing whether BITs and the ICSID Convention covered portfolio investments too. First of all it has been demonstrated that BITs include in the notion of investments also financial securities whose purchase constitutes the most frequent form of investments of SWFs. As to the issue of the ICSID convention, it has been argued that on one side it does not provide for a definition of investment, but on the other side several arbitral tribunal have developed a definition of investment, which must be respected in order to enable the jurisdiction of the ICSID tribunals. The requirement a transnational economic operation must fulfil in order to be regarded as an investment under the ICSID Convention are known as the Salini criteria, since they have been worded for the first time in the Salini v. Morocco case. It has been demonstrated that the investments of SWFs, although they are portfolio investments, should be regarded as satisfying the Salini test and therefore they should be regarded as covered investments also under the ICSID Convention.

Chapter 4 has also studied the applicability of MFN and NT clauses to the investments of SWFs. It has been argued that discrimination occurs, and therefore a breach of such clauses can be complained, when in identical situations different treatments are accorded. Nevertheless, if the peculiar nature of SWFs makes that their investments cannot be regarded, all else being equal, as identical or even comparable to those undertaken by other investors, then the application to SWFs of standards of treatments different from those applied to other investors should not entail any form of discrimination.

The present research has underlined that two approaches can be adopted to address such issue. The first one consists in focusing on the fact that SWFs are owned by States and that they perform important macroeconomic functions in such States. These elements would allow to conclude that SWFs are always and necessarily different from other investors and therefore that host State measures applicable to them and which differ from those applied to other investors cannot be regarded as discriminatory. The second approach, which is the preferable one, stresses the need to focus, on a case by case basis, on the nature of the operations SWFs undertake abroad. In principle such operations should not be regarded as different from those made by other investors. Except when SWFs use their investments to pursue political goals, (which shall be assessed on a case by case basis) if they or their investments are treated in a different and less favourable way than other similar investments undertaken by non-sovereign investors, then violation of the MFN or of the NT clauses are likely to occur.

Chapter 4 has also studied in-depth the application of the FET clause to SWFs. First of all, it has been studied the content and the interpretation made by arbitral tribunals of such clause. It has focused in particular on the cases in which acts adopted by the host State in the exercise of its sovereign power to regulate economic activities undertaken in its jurisdiction must be regarded as inconsistent with the FET clause. It has then discussed the recent trend of arbitral tribunals to consider also the conduct of the foreign investor to assess whether the conduct of the host State could be regarded as non fair and non equitable. It has emerged that if a foreign SWF fails to respect the relevant law or regulation of the host State, or if it fails to disclose relevant information to competent authorities, or if it acts in an unconscionable way, or in general in a way to endanger the national security of the host State, then proportional, transparent, non arbitrary measures adopted by the latter, shall not be regarded as amounting to a violation of the fair and equitable treatment clause even when they adversely affect the operations of the foreign SWFs. The same reasoning should apply also in case of indirect expropriation which often occurs as an outcome of regulatory measures adopted by the host State and which may differ from a violation of the FET clause essentially in that in case of violation of the FET the loss suffered by the foreign SWF is relevant while in case of indirect expropriation such loss is entire and complete. It has been discussed that some soft law instruments concerning SWFs (whose content is discussed in-depth in chapter 8) may provide guidance to States and to arbitral tribunals when they need to assess the conduct of the SWFs for the purposes of the application of the FET.

Finally, chapter 4 has paid great attention to the way international investment law may allow the host State to adopt measures necessary for the protection of its national security. It has investigated the different kinds of national security clauses which can be found in some BITs and whose lawful invocation may allow a State to act in a manner otherwise inconsistent with one or more of the other provisions of a BIT. It has been explained that national security must be meant in a way to include also economic issues, although there is not a satisfactory level of predictability and legal certainty as to the level of severity economic situations may attain in order to be considered as posing threats to national security.

It has been explained that if a State deems that an investment of a SWF threatens its national security, then both BITs and customary international law leave that State free to decide not to admit it. In case of risk posed by the foreign SWF after its admission, if such risk is the consequence of an illegal or an unconscionable conduct of the foreign SWF, then measures adopted by the host State could not be regarded as tantamount to an indirect expropriation or as amounting to a breach of the MFN, NT, FET clauses. In all these cases it should not be necessary to invoke a national security clause, because no breach of a BIT provision would have occurred.

The invocation of the national security clause could occur when a State measure is inconsistent with other provisions of applicable IIAs and when the threat to the national security is not the consequence of an act of the foreign SWFs. In this case it does not seem that SWFs should be treated in a different way than any other foreign investor. Finally, it has been underlined that, even if BITs do not contain a national security clause, a breach of other BIT provisions which is committed by the host State in order to preserve its essential security interests could be justified by the rules of customary international law governing the State of necessity.

Chapter 5 has studied whether SWFs, when they undertake economic operations within the jurisdiction of other States, should enjoy immunity from host State's jurisdiction to adjudicate and to enforce. It has been stressed that, in spite of the difficulties in finding clear and well established rules of international law detailing out when a State or a State organ should enjoy immunity, a trend has developed according to which acta jure imperii, and assets used in relation to these acts, should enjoy State immunity, while acta jure gestionis and State assets used in relation to them, should not.

It has been explained that in the countries which own them SWFs perform acta jure imperii, since the conduct of the monetary policy, the budgetary policy and the management of the revenues obtained from the exploitation of natural resources are activities only States are in principle entitled to perform. On the contrary, if the focus is on the operations SWFs undertake overseas, in this case SWFs in principle act in a way which is similar to other investors and therefore they perform *acta jure gestionis*. It has been explained that, for the purposes of the law of State immunity, it is necessary to focus on the acts SWFs perform as investors in the territory of other States. Therefore, the activities of SWFs and the assets under their management should not be regarded as being entitled to State immunity.

It has also been studied the impact this may have on the enforcement of awards issued as the outcome of investor-State disputes. In fact, the rise of SWFs has been necessarily related to the increase of the assets owned abroad by States which could be the object of measures of enforcement. If assets under the management of SWFs are meant as not used and not intended to be used for acta jure imperii, then they could be seized in order to ensure compliance with awards and other decisions in which the State owner of SWFs is required to pay a compensation and when it refuses to do so.

In the last part of chapter 5 it has been studied that the same principles concerning immunity from adjudication and enforcement should apply to the issue of immunity as well. Therefore, SWFs should not be entitled to immunity from taxation, although it has been explained that many of the main recipients of their investments actually grant SWFs partial or complete immunity from taxation, which, inter alia, implies possible distortion of competition and of the world allocation of capitals. Finally, it has been discussed that, taking into consideration the macroeconomic role played by SWFs and the potential they have to be instrumental to the promotion of sustainable development in the countries which own them, an exemption from taxation could be granted as a form as aid to development, at least in the case of a SWF owned by a developing country investing in a developed country.

Chapter 6 has studied the investments of SWFs in the European Union. It has stressed that one of the reasons why the EU economy is able to attract the investments of SWFs is related to its high degree of competitiveness, but it has also added that the investments of SWFs, when they are accepted and properly regulated, may in turn increase the competitiveness of the EU economy.

Then, after having discussed the content of a Communication adopted by the Commission which explicitly addresses some issues related to the investments of SWFs, chapter 6 has explored which provisions of the TEU and of the TFEU could be used to properly govern the investments of SWFs in the EU. In principle, EU provisions which apply to investments are those concerning freedom of establishment and free movement of capitals. However, since most SWFs investments are portfolio investments, then it appears that the most suitable provisions are those concerning free movement of capitals only. Moreover, since the majority of SWFs are owned by non-EU countries, provisions on freedom of establishment, which may govern exclusively intra-EU investments, have a limited applicability. For these reasons, in the present research only an in-depth discussion on the applicability of EU provisions on free movement of capitals have been undertaken.

It has been underlined that pursuant to art. 63 TFEU, investments of SWFs in the EU should not be prevented, restricted or hindered. More broadly speaking, it would be inconsistent with EU law any measure whose effect would be to render less attractive the enjoyment of the freedom of movement of capitals to and from the EU. However, it has been remarked that the TFEU envisages some possible derogations to such principle, which nonetheless have been interpreted very narrowly by the ECJ. In particular, it is possible that a State may enact appropriate laws and regulations which aim at protecting its overriding interests but whose effect is also to restrict the investments of SWFs. However, to be lawful under EU law, such measures must state very clearly the circumstances under which an investments of SWFs shall represent a threat to the national security or to the overriding national interests of the host State, as well as the powers that the host States preserve to safeguard such interests. In this way the SWFs should be put in the condition to know in advance with a certain degree of predictability if the investments they mean to undertake in an EU member will be restricted because of the particular features of the investment itself, or because of the particular sector targeted or because a combination of these motivations. Finally, it has been pointed out that the same notion of overriding interests cannot be autonomously determined by the host State, but on the contrary it is subject to a review of the ECJ.

Chapter 6 has also studied the relation between the issue of the golden shares and the investments of SWFs. It has remarked that the ECJ has meaningfully restricted the possibility of EU members to make recourse to golden shares. While the ratio of the ECJ was to prevent States from jeopardising provisions of EU law on freedom of establishment and on free movement of capitals, the outcome has also been a reduction of the ability of EU members to protect certain companies or sectors from certain foreign investors. This may reduce the flexibility and discretion of EU members when they need to act in order to restrict the investments of SWFs which are regarded as threatening their overriding interests.

Chapter 7 has discussed the interaction between EU law and BITs and the impact this may have on the regulation of SWFs which invest in the EU. It has stressed that in principle the content of EU law, as well as its objectives, are different from those of BITs; nevertheless some inconsistencies may arise. Such incompatibilities may be particularly acute in relation to the mechanism of dispute settlement, since EU law does not provide anything equivalent to investor-State arbitration or to inter-State arbitration (which, as explained above, is the more appropriate form of international arbitration governing disputes between a foreign SWF and the host State). In case of intra-EU BITs, any incompatible provision of EU law must immediately prevail by virtue of the principle of primacy of EU law. On the contrary, extra-EU BITs concluded before the entry into force of the EU Treaties according to art. 351 TFEU, are safeguarded. Nevertheless, in this case EU members have an obligation to eliminate the incompatibilities (included those which appear to be potential incompatibilities) between EU law and extra- EU BITs, also by means of renegotiating and even terminating the BITs at issue. It has also been studied that the Lisbon Treaty seems to have increased the competence of the EU in the field of FDIs. Therefore, a greater involvement of EU institutions in the conclusion of BITs and of other IIAs with third countries is to be expected. In principle, a higher degree of consistency should be ensured by the replacement of a number of BITs concluded by each single EU members with third countries by a more limited number of BITs concluded on behalf of the EU. Since the appropriate response to the challenges and opportunities posed by the investments of SWFs should be developed at the EU level and not at the level of each member State acting individually, the adoption of a common investment policy at the EU level which might include the conclusion of EU BITs should be considered favourably.

It has also been investigated whether the EU should develop a screening mechanism, which might enable it to decide more consistently and predictably which are the investments of SWFs which could be admitted and, possibly, under which particular requirements. It has been suggested that such a mechanism, which in principle should apply to all investments and not only to those undertaken by SWFs, should envisage a close cooperation between national authorities and the EU Commission. A workable screening mechanism can be inspired to the one provided for in art. 11 of directives 2009/72 and 2009/73 on common rules for the internal market of electricity and natural gas respectively.

In the last part of chapter 7 it has been stressed that, since SWFs are a global issue, an approach to their regulation at the regional level (i. e. at the level of the EU only) could prove insufficient. On the contrary, it is necessary to achieve a higher degree of coordination at the international level. This explains the involvement of the EU in the activities of the IMF, the OECD, the G8 and the IWG i. e. of the international organisations and of other international meetings, which so far have played the main role in developing mutually agreed standards and principles concerning the regulation of SWFs. It has been explained that the EU, by virtue of the provisions of the TEU and of the TFEU, is empowered to participate in the activities of these international organisations and meetings. It has also been pointed out that this is consistent with the content on the Communication of the Commission providing for a common EU approach to SWFs which has been mentioned above.

After having studied the applicability of existing legally binding instruments of international and European Union law, in the last chapter of the present research the focus has been on the soft law instruments which have been adopted in the last few years and which explicitly address SWFs.

It must be stressed that these instruments, although not legally binding, may nonetheless integrate existing hard law instruments, and provide guidance as to how they should be interpreted when an issue concerning SWFs is at stake.

Chapter 8 first of all focused on the GAPP, also called Santiago principles. This document has been drafted by a group of States which own SWFs (the International Working group on SWFs - IWG) and with the initial support of the IMF. It represents a collection of general principles and best practises that SWFs deem they can and should implement. Therefore, the principles contained in the GAPP are not legally binding: SWFs remain free whether to accept them or not. The GAPP deals with several aspects of SWFs: from the legal framework governing their operations to their governance, management and investments strategies. Nevertheless, also taking into consideration the protean and dynamic nature of SWFs, the GAPP does not specify in detail how these aspects should be regulated, while it only stresses the need to ensure a certain degree of transparency and disclosure in relation to them. For instance, the GAPP does not detail out which are the best investment strategies a SWF should adopt, but it only emphasises that a SWF should disclose which are the investment strategies it means to adopt. It has also been argued that according to the GAPP, SWFs may pursue investment decisions based on other than economic and financial considerations, but in these case "these should be clearly set out in the investment policy and be publicly disclosed". It has been explained that a SWF acts as it was politically driven when it decides not to invest in certain companies because they do not respect certain values it pledges to support. It has been clarified that investments which, in this sense, are politically driven, can be undertaken also (or, maybe, more often) by SWFs owned by western countries, and to support this view the example provided for by the Norwegian SWF has been extensively quoted. Moreover, it has been pointed out that also some privately-owned funds, the so-called socially responsible funds, may act in a similar way when they exclude for ethical or social reasons certain assets from their investment choices. These arguments have therefore mitigated the criticism that SWFs, by attempting to promote abroad certain values through their investment choices, act in a way different from any other non-sovereign investor.

After having discussed the content of the GAPP, in chapter 8 it has been explained that the IWG, which was later replaced by the International Forum on SWFs (IFSWF), promoted a debate among SWFs and the States which own them, on the implementation of the GAPP. The outcome of such debate has been a report published on July 7th 2011. The analysis of such document has pointed out that the principles and best practises laid down in the GAPP have been largely implemented;

however, what is particularly meaningful is that the majority of SWFs declared that implementation took place before the adoption of the GAPP itself. This has been considered as a further proof that the GAPP, rather than providing for recommendations on the way States should deal with their own SWFs, actually describes the best practice the same States has already implemented.

The following part of chapter 8 of this thesis has then turned its attention to an OECD declaration which aims at providing its members with very broad and general guidelines as to the policies they should maintain relative to the investments SWFs undertake in their territory. Such document underlines the need to preserve an open environment to foreign investments and to refrain from undue protectionist reactions, also considering the beneficial effects the investments of SWFs may bring to the recipient economy. Then, the OECD declaration underlines that other instruments it previously adopted and which deal with the issue of investments could apply to the operations of SWFs as well. Chapter 8 has therefore devoted some pages discussing whether and how such instruments may apply in practise to the operations of SWFs. In particular, it has underlined the difficulties in applying to SWFs the content of the OECD Guidelines on Multinational Enterprises, because of the fact that SWFs could be hardly included within the definition of "multinational enterprise". On the contrary, the OECD Guidelines on Corporate Governance of State-owned Enterprises are more likely to apply to SWFs too. In fact, such instrument of soft law is intended to deal with any relevant participation of the State or of State entities in companies: since SWFs are the tools though which States acquire participation in foreign and (in some cases) domestic companies, then companies in which SWFs invest can be regarded as State owned enterprises for the purposes of the OECD guidelines. It has been explained that the basic principles contained in the OECD Guidelines on Corporate Governance of State-owned Enterprises are similar to those provided for in the GAPP.

As a conclusive remark of these conclusions, a last observation needs to be made, which has permeated the entire thesis but which, perhaps, has not been stated in an outright way so far. The developments in international economic law and in EU law which have taken place especially in the second half of the 20th century have greatly contributed to the establishment of a legal framework (or *rectius*, of a plurality of legal frameworks) which encourages transnational investments, supports and protect the foreign investors and reduces the ability of host States to adopt protectionist measures. Such developments have been largely promoted by western capitalist States, both directly and through the international organisations they dominated *de facto*, in the interests of their companies and of their financial and business circles. The interests of the recipient economies, especially when they were developing countries, were not adequately taken into account. Developing countries and socialist States, (later States with economies in transition) after having tried to resist these trends, finally accepted (or were de facto forced to accept) such economic order which was based on the principles of capitalism, often in a way inconsistent with their own needs and interests.

Nevertheless a complex array of international economic, political but also technological and social changes has brought to a situation in which some developing or (former) socialist States which previously were the recipients of foreign investments now have become able to turn into capital exporters. In this way the investors from such economies, included the SWFs, have largely benefited from a legal framework their country not only did not contribute to establish, but for certain respects, tried, although mostly unsuccessfully to resist. At the same time, many western countries unexpectedly turned (also) into recipients of the investments originating from emerging economies. These western countries, which so far were vociferous in criticizing any form of protectionism and any restrictions to transnational investments, now started to pay more attention to the issue of the protection of the interests of the host States when they are deemed to be put in question by the operations of foreign investors, especially when such foreign investors are SWFs. It seems therefore that the ability of western countries to adequately protect their overriding interests may be hindered today by the same legal framework they have largely contributed to shape.

SWFs owned by emerging countries (which represent a relevant part, although not the entirety, of existing SWFs) are the best example of such historical change, which at the same time is the cause and the consequence of their rise.

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