PROTECTIONISM AND SOVEREIGN INVESTMENT POST GLOBAL RECESSION

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Session 2.1.: Foreign investment and national security: Future challenges to a balanced approach

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Background

International investment, one of the most important economic drivers, has been one of the victims of the global economic crisis. Foreign direct investment (FDI) flows declined by more than 20% in 2008. FDI helps to increase productivity, foster employment in the host country, facilitate trade between nations, and strengthen international economic and security integration. Thus, any impact on international investment flows makes the prospects of a quick recovery slimmer. The credit crunch, the shortage of liquidity, the lack of trust in many foreign markets, and government protectionism are among the leading factors behind this phenomenon. Yet, addressing this issue promptly and seriously can improve the global response to the FDI decline and international investment can become again an important driver of global economic growth. This paper will focus on protectionism in the context of sovereign cross-border investment and its impact on the crisis and prospective recovery.

As a result of the crisis, governments had to adopt quick and aggressive measures to respond to an unprecedented crisis. Thus, high level of unemployment and the collapse of many local industries forced governments to adopt protectionist regulations that reduce cross-border trade and investment. Our experience has showed that trade and investment protectionism can slow economic activity and have a deeper impact on the prospects of economic growth.

One of the more interesting aspects of the current wave of investment protectionism is governments’ response to sovereign investments. The number and size of worldwide Sovereign Wealth Funds (“SWFs”) have both seen substantial increase between 1990 and today. Although its definition is unclear, the key elements of any sovereign wealth fund are ownership by the general foreign government, an investment strategy that includes foreign financial assets, and an objective to invest government’s funds to achieve financial goals in the mid-to-long term with liabilities that are broadly defined, such as future pension liabilities. SWFs have benefited from a hike in commodity prices and significant amount of foreign exchange reserves. Following a remarkable growth in government budgetary surplus due to large foreign exchange reserves and a commodities boom, especially in several leading emerging markets, many countries have established their own new SWFs. The latter aim to stabilize the local market, protect the state against extreme volatility in foreign exchange and commodities markets, preserve state’s wealth for the next generation, and provide liquidity for global markets, especially when capital markets face credit constrains. At the same time, existing SWFs grew exponentially and became important players in national, regional, and international markets.

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4 These elements are reflected in the Generally Accepted Principles and Practices (GAPP) adopted by the International Working Group of Sovereign Wealth Funds in October 2008, Appendix I (Defining Sovereign Wealth Funds), p. 27. See http://www.iwg-swf.org/pubs/eng/santiagooprinicples.pdf

5 Among the new SWFs we can mention the Heritage and Stabilization Fund (Trinidad and Tobago) and the Future Fund (Australia), both launched in 2006.
Several reasons have led developed economies to adopt protectionist measures against SWFs. First, SWFs’ investments in strategic industries, such as financial institutions and technology, have been perceived as attempts by the SWFs’ governments to increase their political influence on the developed world through strategic investments, which will be influenced by political or military motives. Board representation and membership in executive decisions are potentially among the available tools for SWFs’ management to control their investments and have a strategic advantage over the host states that receive the capital. Several proposed investments by SWFs and other state-owned entities have also highlighted national security concerns due to the nature of these investments. Additionally, lack of proper transparency in these funds makes it difficult to evaluate their investment strategies and motives. Lack of clear governance rules, responsibility and accountability increases the role of a government in its SWF, which makes the case for a politically-motivated function. For all these reasons, many SWFs have responded voluntarily to the global concerns about their actions and publicly shared their size, source of funding, investment allocation, and investment strategy. Similarly, they have adopted more concrete rules of governance and increased the level of accountability of their money managers. The sporadic and inconsistent natures of these practices have led to the creation of a SWFs club, the International Working Group, which will be discussed later in this paper.

It is important to note that SWFs have been criticized by their own home states as well for being over-diversified and investing extensively in the West, especially in Western financial institutions. Most of these financial investments have generated significant losses during the 2008 financial crisis to many SWFs and, indirectly, to the governments of their home countries. Many of these investments are perceived as outside of the core investment strategy of most SWFs and many local conservative voices have called for investing conservatively and mainly in the geographical region of the respective fund. Although this sort of criticism does not lead to protectionism in the classical sense described below, it has an impact on the ability of sovereign funds to execute cross border investment strategy in an open market environment.

Investment Protectionism

As mentioned earlier, the growing criticism against SWFs in Western economies has brought several leading developed countries to introduce or improve existing legal instruments that enhance the ability of host countries to control better proposed investments by SWFs. While many of these instruments are designed to improve the transparency and efficiency of the investment screening process in order to deal with actual national security concerns more effectively, frequently they serve as pretext for investment protectionism. Some scholars have proposed a minimalist approach that targets only governance concerns, and thus the discriminatory effect of investment protectionism has not been addressed yet.

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

7 The Government of Singapore Investment Corporation (or GIC), for example, recently published a Report on the Management of the Government’s Portfolio for the Year 2007/08, which includes detailed information on asset mix, geographical distribution, source and purpose of funds, and governance structure, among other aspects of its operations.

This new wave of protectionism has many forms. Governments can adopt national regulation that blocks foreign investment by certain entities based on their identity as government-owned entities or based on the type of industry of the invested company. They can also implement a screening mechanism of a proposed acquisition or investment that gives the executive branch the ability to evaluate a specific investment and decide upon its commerciality and associated risks.

I would like to give some recent examples. The French government announced last year its controversial proposal to establish a governmental fund that will serve as a white knight when a foreign government-owned entity is bidding for a local champion. This practically means a de-facto attempt to block hostile acquisitions by government-owned entities. It is yet to be seen whether this is a new trend that other European governments will follow. Second, several countries have excluded certain industries from being available for acquisition by foreign entities. Russia, for example, has recently adopted a legislation that limits foreign investment in the gas and oil industries. These excluded industries appear as exceptions in various schedules to international investment agreements or as specific national laws that prevent foreign investors from investing in certain industries.

Also, various governments have improved their investment screening mechanisms. The United States revised its CFIUS review process to include Congress’ participation and to expand the coverage of this mechanism. Similar mechanisms has been adopted or proposed recently in France, Germany, and China. This mechanism can be used to screen investments that are proposed by commercial corporations and SWFs alike. While CFIUS and CFIUS-like models have been in existence for a long time, many of them have been adjusted as a result of the current wave of global SWFs’ investments. According to the revised regulation in the United States, for example, an investment by a foreign government-controlled entity (such as SWF) will have to be investigated by CFIUS for national security purposes, while in the past this review was discretionary. The new law responds to public’s concerns that the previous mechanism could not provide an adequate review of hostile takeovers of American companies by foreign SWFs, a fact that gives the new law a flavor of investment protectionism in addition to legislative effectiveness.

Host governments are well aware of the economic benefits of SWFs’ investments to their economies. Yet, an internal political pressure for a quick and radical response to a potential threat to national interests forces these governments to adopt protectionist measures, which will reduce the ability of SWFs to invest in foreign jurisdictions. Moreover, in rough economic times takeovers by sovereign entities are perceived as a source of weakness and not a source of strength in spite of the immediate need for liquidity. Thus, policy makers cannot completely trust national legislators’ response to the new SWFs’

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10 CFIUS is the American governmental committee that is used to screen proposed investments in sensitive industries. The recent revision was made by the Foreign Investment and National Security Act of 2007 (FINSA).
12 Germans Agree Sovereign Funds Law, Financial Times, 10 April 2008. The new German law allows the government to block SWFs’ acquisition of large stakes in German companies that could threat Germany’s interests. The new law supplements Section 7 of the German Foreign Trade and Payments Act that restricts certain investments to protect essential security and external interests.
14 See Mark Plotkin, Foreign Direct Investment by Sovereign wealth funds: Using the Market and the Committee on Foreign Investment in the United States Together to Make the United States More Secure, 118 Yale Law Journal Pocket Part 88 (discussing the application of CFIUS to cross-border investments by SWFs).
investments. Indeed, the protectionist national legislation has encouraged inter-governmental organizations to explore ways to offer additional and more cohesive rules which will balance this wave of protectionism in national legislation. Since keeping open market policies and defeating protectionism is a multilateral challenge, it requires a multilateral response.

The OECD, representing a club of leading developed economies that focus on the host states themselves, has called for adoption of voluntary rules for its members that prevent adoption of any protectionist measures and secure open market policies. These rules were scheduled to be released this year following endorsement by the G-7 Group. And, indeed, the OECD group adopted the OECD Guidance on Sovereign Wealth Funds (OECD Guidance) in October 2008. This guidance, which presents investment policies relating to national security for the first time at the OECD, will be followed by a “peer review” mechanism of investment policies that will also involve non-OECD member states from capital-exporting economies. Clearly, the sovereign wealth funds and host states communities should and do consult with each other, but since they share different interests it is not surprising that they have created different appropriate forums. Clearly, it remains to be seen how OECD member states will implement these new rules on SWFs in light of the existing national legislation above-mentioned, whether by revising this existing legislation or by changing the policy towards future rules that limit market access of SWFs.

SWFs will find themselves facing protective measures that are driven either by genuine national security interests or by classical protectionism. Effective national laws that ensure transparency and commercial motivation during an investment screening process, which covers SWFs and non-sovereign investors alike, can provide the appropriate response to most fundamental and immediate concerns about SWFs’ activities. Yet, legislative and executive measures can sometime be driven by classical protectionism and discrimination, and SWFs can find themselves lacking the appropriate remedies. The need to address this protectionism is extremely timely as global protectionism in trade and investment is increasing in times of economic recession and any reaction to SWFs’ investments can be part of it. The G-20 official commitment to open investment environment and the OECD Guidance on Sovereign Wealth Funds above-mentioned can create the necessary framework for maintaining a pro-investment atmosphere as a tool for economic recovery. However, I argue that this framework is not sufficient to keep a sustainable positive approach towards foreign investment by SWFs. The two missing elements that I would like to focus on here are the ‘hard law’ instruments available to foreign investors, and the funds and governments’ need to create a positive public opinion that supports international investment by SWFs.

Protectionism and Trade and Investment Law

As mentioned earlier, the dominant approach so far has been the adoption of ‘soft law’ type instruments such as group declarations and OECD self-regulated practices. These practices will be adopted by the members of the OECD and hopefully will be reviewed by their peers. Since predictability is an important factor for foreign investors, the remaining question is whether there are any binding rules in the existing legal framework that keep host governments accountable and provide investors with any remedies for unjustified protectionist measures. In a separate article that will be published later this year

15 For the statement of the G-7 Group see Department of Treasury, Statement of G-7 Finance Ministers and Central Banks Governors (October 19, 2007).
16 See http://www.oecd.org/document/19/0,3343,en_2649_34887_41807059_1_1_1_1,00.html ((last visited August 6, 2009).
“Rethinking Global Investment Regulation in the SWFs Era” I make the case for using the existing trade and investment instruments to address these concerns as described briefly below.

The General Agreement on Trade in Services (GATS) is one of the WTO trade agreements designed to provide free trade platform for trade in services and prevent discriminatory measures against foreign investment in services as the role of services in the global economy is growing dramatically, including through SWFs’ investments19. Although the GATS covers only trade in services, it covers investment in services indirectly as one of the ways to build a ‘commercial presence’ in the recipient country is by acquiring a local supplier. By applying the anti-discriminatory standards to acquisition of local distribution company in the services sector, the GATS serves an important role in facilitating the freedom of capital inflows in the services sector. Thus, when a SWF of one WTO member is investing in a services company of another WTO member, any attempt to block such investment by using protective measures can involve WTO procedures based on WTO members’ obligations in the GATS. These obligations can be based on the Most-Favored-Nation (“MFN”) and National Treatment principles, where a member state is committed not to discriminate between a local company and a foreign company or between companies from different countries, or based on specific commitments in the schedules to the GATS as part of the market access principle. United States, for example, made specific commitments with respect to its financial services sector, which allows SWFs to invest in many of its financial institutions.

Similarly, Bilateral Investment Treaties (BITs) can allow foreign investors to sue governments directly for a violation of protection standards provided to them in a bilateral treaty. BITs are bilateral treaties designed to protect open investment environment in both states and provide investors with protection standards, which can be enforced in ad hoc investor-state arbitral tribunals. This unique feature of enforcement of protection standards, such as MFN and National Standard, in arbitral forum has become an important part of the emerging jurisprudence of international investment law20. SWFs can use these investment treaties to enforce the various protection standards being violated by protectionist and discriminatory measures.

Any attempt to integrate SWFs into the existing framework of international economic law and to use trade and investment agreements to address investment protectionism faces several substantive and procedural challenges. I would like to share some of the key challenges. With respect to the GATS rules, they apply only when the foreign entity has control over the acquired company, and so a minority investment by a SWF will not be sufficient21. Second, the GATS includes an exception for services which are provided by a sovereign government. The purpose of this exception is to ensure that the government can provide its services without competing with the private sector. The applicability of this exception will depend, among other factors, on the legal nature of the specific acquiring entity in any proposed investment, and since many SWFs are not incorporated as a separate legal entity the government exception may apply. Finally, the GATS includes general and specific exceptions that can frequently be applied to investments by SWFs. WTO members can list a specific commitment or limitations on this commitment as part of the GATS’ obligations, and each investment by SWF should be analyzed separately.

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19 In fact, when we look at SWFs’ investments, 44% of the transactions so far have been in the services sector. The Monitor Group, Assessing the Risks, The Behaviors of Sovereign wealth funds in the Global Economy (June 2008), pp. 38-42 (tracking SWFs’ investment in services since 1975).


Application of investment treaties to SWFs’ investments raises similar obstacles. First, investment agreements cover investments by a natural person or a legal entity. In other words, BITs do not serve as a platform for international commercial disputes between governments and SWFs as public entities may be qualified as private separate legal entities and thus cannot bring an investment treaty claim. Second, most BITs cover investments in their post-establishment phase. In other words, they do not secure market access pre-establishment, but once an investment has already been made, investment agreements provide investor protection standards. Since most concerns around SWFs’ investments in host states arise when they try to access the host economy, applicability of many BITs to SWFs pre-establishment is questionable. Also, it will be very difficult to show damages if the only protective action made by the respective government is preventing the SWF from entering the host country, unless the SWF as a bidder has already experienced significant expenses to prepare its bid, such as due diligence, financial analysis, or legal costs.

The potential use of binding trade and investment legal instruments to enforce SWFs’ rights raises the question which forum is more appropriate to address SWFs’ concerns and fight investment protectionism. Although this topic calls for a separate discussion, I would like to share briefly some initial thoughts. Several academics and policy makers have suggested that the WTO should deal with any violation of the rules against SWFs due to the trade-distortion effect of SWF activity. They also focus on the need to include private players, such as SWFs, in the WTO forum to increase its credibility and expand its agenda in order to increase the political capital of the member states who want to liberalize capital inflows. However, recent attempts to negotiate investment-related rules in the WTO and to expand its agenda have failed. These attempts are perceived as an obstacle to the conclusion of the current trade negotiations round. Moreover, the WTO has very limited institutional expertise in this field and not all investment rules are trade-related. For the same reason, any inclusion of additional SWFs rules in the WTO or application of existing rules to SWFs will diminish the ability of the organization to conclude additional agreements on its core agenda.

The investment treaties regime, on the other hand, may be more appropriate. First, the liberalization of capital is becoming a growing element in BIT’s language and investment arbitrators’ decisions. Applying investment agreements to SWFs will empower the liberalization element of the treaties through protection of market access in an environment where many cross-border investments are made by SWFs. Additionally, the investment arbitration is a unique procedure that brings together a private investor and a public entity. Thus, the hosting forum can discuss a SWF, a private entity with public features, more effectively. Finally, as I argued elsewhere, investment treaties are a unique opportunity to include investors’ obligations in the new global economic order, and provide arbitrators with the ability to enforce human rights standards when applying investor protection standards. It will allow us to use investment agreements to promote the development agenda within the international

22 Some treaties offer a broader coverage. See, e.g., Article 3 of the 2004 U.S. Model BIT applies the National Treatment standard to “the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.”

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


25 Id.

economic law framework and to encourage private commercial entities to play a role in public policy through private-public partnerships in the host states. Since SWFs play an important role in fostering economic development in home and host states, the inclusion of the development agenda in the investment law regime makes the case for the use of BITs as a tool to protect SWFs’ market access.

To sum, SWFs can use existing legal instruments, such as GATS and BITs, to guarantee market access when the host government’s discriminatory action is driven by protectionism. Both legal regimes suffer from procedural and substantive challenges, but the emerging investment law regime seems more suitable for absorbing the regulation of SWFs. The current ‘soft law’ system of OECD Guidance should be supplemented by binding rules that can be available to foreign investors when their protection standards are being violated. This important evolution in international investment law will be very useful to SWFs in the future. The Singaporean SWF has recently contemplated filing a case against the government of Indonesia as a response to protective measures against it in the Telecom industry. Additional cases may follow. One of the reasons for the limited use of investment claims by SWFs can be the need to achieve a preliminary settlement since these funds tend to invest on a repetitive basis and build positive long-term relationships between the fund and its host government. However, a growing trade and investment protectionism, along with a dramatic rise in big developing economies with large SWFs such as China, may change this dynamic.

**Anti-Protectionism Campaign and SWFs**

Binding rules that hold host governments accountable for their market access commitments are only part of the solution. As we learned from the Dubai Port transaction in 2005 in the United States, unjustified negative emotions among the general public, driven by protectionist sentiments and local nationalist voices, can have a significant impact on politicians’ view on specific transactions and their involvement in the bureaucratic approval process of the investment. In this case, the controversy was about the purchase of P&O, a British port operator, by Dubai Port World, a UAE state-owned entity in 2006. The assets included a U.S. port facility. A serious political criticism in the United States has forced DP World to sell the U.S. asset, which eventually was not part of the deal. This transaction has led to the congressional view that the United States cannot screen foreign investment effectively. Consequently, as I mentioned earlier, the United States revised its CFIUS review process to include Congress’ participation and to expand the coverage of this mechanism to include all foreign-controlled transactions.

Although the perception of SWFs’ investment has improved dramatically, SWFs should continue to manage perceptions in the government and with the public in general. Since many of these funds will continue to invest in the same territory in the future, it is important to preserve a positive investment process. This can be achieved by working closely with the capital-importing governments during the screening process, building a mutual trust, and emphasizing the benefits to all parties. The media can play an important role in this process by ‘packaging’ the deal to the public as promoting strategic interests of both sides, improving cross border economic activity, and creating jobs.

Moreover, SWFs as a group can create media channels where they can inform governments and the public about the nature of their investments and their economic benefits. The SWFs community and the IMF, in cooperation with the World Bank, established an International Working Group (IWG) and in November 2008 came up with proposed rules, the Santiago Principles (GAPP), which will be adopted by SWFs

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27 Temasek Holdings, Singapore's state-owned investment company, was required by the Indonesian antitrust authorities to sell its stake in either of the country's two biggest mobile-phone operators within a year. Temasek considered international arbitration procedures after exhausting local procedures in Indonesia.

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

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